CMA INVESTMENT CONSULTANTS MARKET INVESTIGATION

10 April 2018

Redington response to CMA working paper- asset manager product recommendations

INTRODUCTION

We acknowledge that manager selection is much less impactful to the end outcomes than other key elements such as the agreement of a specific long-term objective, putting in place a clear framework which trustees use to guide decision making, and getting the right policies in place regarding risk management and strategic asset allocation. Nonetheless, we believe that investment consultant advice on manager research can be a key component of value add and risk management for pension schemes across various asset classes and we support more comparable and transparent information on both total fund performance and manager research.

Redington's manager research process was put in place during 2013. We started with a small number of asset classes; broadening out to our full coverage today. Redington's data has been largely excluded from the CMA's analysis, given that the quantitative analysis you have carried out only includes data to 2015. Therefore, we do not consider that the results are representative of the value add we provide through manager research.

eVestment is a very valuable tool for experienced investment professionals, however, we have significant concerns about flaws in the CMA's methodology, largely because of the various challenges of using the eVestment database for a purpose it was not designed for and the way that the data has been filtered. We set out in our response the changes to the CMA's methodology we consider to be essential to improve the reliability of the results, and would also refer the CMA to the planned confidentiality ring submission by our Authorised Advisers Oxera.

We are concerned also that the results of the analysis have been presented in a way that is open to misinterpretation. This risks causing great confusion and concern to pension trustees about the value add from manager research, and could result in trustees making decisions that may be detrimental for member outcomes. Furthermore, the working paper implies that Redington's data is included in the analysis when in fact it has been largely excluded, and we are disappointed this is not made clear by the CMA. We would urge the CMA to be very careful in how it presents its emerging thinking or findings in this area, and the importance of making clear any limitations in its analysis that may affect the reliability of the results.

Should the CMA conclude that an informational remedy is required in order to allow trustees to better assess the value provided by asset manager product recommendations, it would be essential to address the issues we highlight below. Otherwise there is a real risk that any additional information provided to trustees would be misleading rather than helpful.

A common methodology has many merits, but equally a common framework to which a particular consultant's methodology must subscribe could be as advantageous but more flexible. We believe that the real issue is where firms have made false or misleading claims about the impact of their manager research value add. This has been dangerous as it has pointed clients in the wrong direction and risked a lack of focus on clear objectives and strategic asset allocation. We agree that manager selection exists to serve the needs of a client's asset allocation strategy and consider, therefore, that the CMA must not overlook the value of non-performance factors in identifying appropriate managers aimed at meeting the needs of a client's asset allocation strategy.

FLAWS IN THE ANALYSIS

We have highlighted below the key concerns we have as well as input or design changes that could be made to potentially mitigate them.

- We believe that aggregate analysis of all (or a significant number of) market players by its very nature will always show market-like results; potentially 'hiding' valuable insights and resulting in misleading headlines, however, even if aggregate analysis is the only option, the following flaws make the analysis unreliable.
- eVestment, as you have highlighted, does not on its own have enough coverage of the market. Additionally, it is also a marketing tool that has not previously been used for regulatory type analysis and so does not have enough data checking or controls over data contributors to rely solely on it. We highlight specific examples where we believe that misunderstanding or misuse of eVestment data has the potential to skew the results of your analysis:

    - We disagree with the decision to exclude products that have not been entered in the database within a quarter of their inception. This would seem to rule out any products with very long track records preceding the existence of eVestment, if they were not added within a quarter of the inception of eVestment. We performed a screen using these terms and found that it excluded more than 14,000 of the 21,500+ products in the eVestment database. We find it implausible that this could not affect results, particularly when it left less than 50 eligible funds in several universes.
    - As we understand it, this decision was taken to minimise the impact of backfill bias, but this needs to be set against the requirement to incorporate sufficient data. We believe that the focus on backfill bias is inappropriate given the way that eVestment is utilised by asset managers. We do not believe that asset managers deliberately manipulate their reporting to eVestment, indeed many are unaware of its existence until notified by a consultant that they need to report to the database.
    - Even before the impact of this exclusion, eVestment is far from an exhaustive source of information on fund data, and has a disproportionate focus on listed liquid asset classes. To gain a more complete market analysis, it would be important to utilise other common sources of fund information, such as Camradata, Financial Express, Morningstar, Preqin and even Mercer GIMD.
    - Multiple products under one fund name, funds appearing in multiple universes, inappropriate universes etc. There are multiple cases where products are incorrectly mapped or classified. Without a substantial prior knowledge of the investment space, it is virtually impossible to distinguish these cases; so a substantial expert scrub of the data is always required. For these reasons, we maintain our own proprietary fund peer universes for each asset class and sub-asset class. It could be implied from the CMA's presentation of the analysis that there is little value add from asset manager research and that therefore trustees could achieve similar outcomes by selecting passive funds themselves. We do not believe that this is a suitable approach for a lay client to take, since it would be far from certain that a client would even end up with an appropriate fund for the outcome

being sought, and ignores the positive impact of softer hygiene factors on minimising fund turnover and unnecessary transactions costs.

If any remedy were to use these same flawed methods for calculation and presentation of performance, we believe that they could lead to incorrect conclusions being formed by both existing and prospective clients, regarding investment consultant value add, both collectively and individually.

MISINTERPRETATION OF THE ANALYSIS

- In the FCA analysis, returns were weighted by product AUM. It is unclear from the working paper whether the CMA has applied the same methodology. Our Authorised Advisers Oxera will comment further in their confidentiality ring submission. See also our comments below proposing the use of client AUM weighting.
- Even though your results showed quite significant value add, this was discounted because it was not statistically significant. We do not understand the basis on which the CMA has done so – To be statistically significant, the timeframes would need to be substantially longer or the value add would have to be extremely high. We feel that ~80 basis points of annual pre-fee alpha is extremely appealing, and in excess of what we assume, particularly when taken against the fees that our client base typically pays.
- The average consultant negotiated fee of ~80bps is substantially higher than the average asset weighted fee that our clients pay. We would be happy to provide more information on this, but our analysis suggests that our clients pay an aggregate asset weighted fee of between 5 and 30 basis points to asset managers.
- The analysis simply looks at raw returns against a broad benchmark but ignores the reality of modern investment risk budgets and decisions, for example the separation of investment universes by style and not just asset class, hygiene factors such as corporate alignment and the fact that risk-adjusted returns from investment consultant recommendations are as important if not more important in many manager recommendations. You note that you may explore the possibility of incorporating risk into your analysis and we support this, but it is clearly impossible to quantify the impact of softer risk analysis, about the governance and reduced transactions costs impact that smaller numbers of manager transitions will deliver. We believe that our track record of less than 5% manager turnover per annum is of considerable comfort to our clients in delivering the strategic outcomes that they require.
- Finally, it could be implied from the way in which the CMA presents the results of its analysis that there is little value add from asset manager research and, therefore, that trustees could achieve similar outcomes by selecting passive funds themselves. Although our clients are already very significant users of passive, quantitative and "smart beta" products, particularly across liquid listed equities, these asset classes make up a smaller and smaller share of pension fund assets as de-risking continues, with fixed income and more dynamic, multi-asset type products taking a greater share. The latter cannot be replicated effectively using passive products, and we would caution strongly against widespread use of passive product in fixed income, where this often leads to an investor holding disproportionately high weights in the countries or companies issuing the most debt. We do not judge this an effective approach given our clients' focus on risk. As active investors are the marginal providers of capital and effectively provide an important source of risk-pricing in capital markets, we believe active and passive are most effective when utilised with a keen understanding of what each approach is best for. We would urge the CMA to reflect this when presenting its findings and the results of any updated analysis it may carry out.

COMMENTS REGARDING POTENTIAL STANDARDISED PERFORMANCE

We believe that investment consultant advice on manager research is a key component of value add and risk management for pension schemes and we support comparable and transparent information on both total fund performance and manager research; including the provision of net performance.

We would be very pleased to see GIPS-type rules and restrictions around calculating and presenting the performance of recommended managers, however, we would caution that the various challenges that we have highlighted with the eVestment data-sets and universes would make them inappropriate for usage without substantial user-input.

1. Risk adjusted returns and not just raw returns

In practice, value is clearly added if the client's investments deliver the same return as the benchmark but do so in a less risky manner and, therefore, it is an assessment of risk-adjusted return rather than only return that typically drives manager recommendations. In addition to risk due to investment style, assessing hygiene factors such as alignment with investors or corporate stability is an important part of manager selection. Investment consultants can add value by reducing costs for pension schemes by way of lower switching and therefore transaction costs as well as fewer changes and lower governance requirements. All of these lead to trustees, with limited bandwidth, being able to spend less time on manager selection and more time on strategic asset allocation, risk management, regulatory change etc.

When assessing the value added by investment consultants, the analysis should, therefore, look at risk-adjusted returns rather than raw returns. Depending on the asset class, the analysis should review the Information Ratio (relative returns) or the Sharpe Ratio (absolute risk).

2. Weighting of returns

Redington, like other smaller consultants, is able to recommend smaller products (perhaps portfolio managers moving to a new firm, perhaps more innovative products) than is possible for large consultants who by their nature need to be able to recommend products that a significant percentage of their client base will be able to invest in.

We would recommend that performance of asset manager recommendations should be weighted by the amount of AUM clients invest in the relevant products (rather than for example the total AUM of the products themselves). We believe that this methodology would be more reflective of the actual results that clients of a specific consultant have experienced and would be a much better methodology, not just for smaller consultants like ourselves but for all consultants.

3. Presentation of data

As highlighted in previous submissions, helping trustees to interpret accurately and understand the data is equally as important as standardisation and comparability of data.

It is our experience that whilst almost all trustees will understand much of the numerical data at some level, unless given clear context they may be unable to extract relevant meaning that will allow them to make good choices.

Whilst the context will be different for each choice, we believe that it is sensible to provide clear guidance in the following areas:

- **Clarity on whether any differences are meaningful.**
  Whilst we can rank order the outcomes of manager performance, or some measure of consultant 'value-add', the differences may not be significant statistically. This needs to be made clear in language that all trustees can understand.

- **Help for trustees to focus on what is important.**
  In the context of manager recommendations and performance for example, the importance of risk levels should be highlighted in addition to raw performance comparisons.

- **Keep the guidance close to the data.**
  We think it would be helpful if core principles and explanations are required to be produced right next to every output of data so that they are front of mind as trustees are analysing any data rather than enclosed in a document that is rarely referred to.

RESPONSES TO YOUR QUESTIONS

Are trustees easily able to compare claims regarding the impact of AM product recommendations made by different firms during a tender for instance?

As a relatively new participant in manager research (i.e. since late 2013), we have generally not provided aggregate performance return data as the time periods are too short to make it meaningful.

We have been providing clear and detailed explanation of our manager research in practice, including how we work with clients when choosing and reviewing managers according to the clients' objectives, and the triggers that we have in place for creating potential sell decisions.

Would trustees benefit most from information on returns achieved by recommended AM products on a gross or net basis?

We believe that any performance comparisons should be on a net of asset-weighted fee return basis. Risk-adjusted returns should also be shown.

How could the presentation of the impact of AM product recommendations be made more comparable, comprehensive, relevant and useful?

As we have highlighted above, we would be very pleased to see GIPS-type rules and restrictions around calculating and presenting the performance of recommended managers and recommend that they:

- Allow flexibility of universe/benchmark to match the investment strategy
- Include risk-adjusted returns and not just returns
- Are weighted by client AUMs rather than by product AUM
- Guidance is provided with any data to help trustees to understand its importance and meaning

What are the challenges of developing a common methodology? Should this be mandatory and, if so, should there be scope for divergence in specific circumstances?

A common methodology has many merits, but equally a common framework to which a particular consultant's methodology must subscribe could be as advantageous but more flexible. We believe that the real issue is where firms make false or misleading claims, and a regime which came down hard on those making these would perhaps eliminate the need for as much commonality of methodology.

Should any claim in relation to the impact of a firm's recommendations be subject to external benchmarking or scrutiny and should this be assessed against a common methodology for presenting impact?

It is unclear where the cost of this would be borne. Managers are currently responsible for their adherence to the GIPS standards and it seems that only a similar practice could work without increased costs for investment consultants which would in most cases presumably be passed on to clients or increase barriers to entry or expansion.

We believe, on balance, it is more sensible to penalise bad actors via severe penalties available in response to false or misleading claims rather than impose a high cost externality on the market as a whole.

How should any change in presentation be implemented and enforced?

It would make sense to identify a "core" sub-set of asset class universes, perhaps around 5 in number, which could be covered as part of a testing phase. This would allow the regulator and the consultant community to identify any challenges and flush out data issues before a full launch. It would be helpful for peer groups to be agreed either between the consultant community or in conjunction with the regulator. It is not obvious that adherence should be enforced – if a particular consultant prefers not to provide information on a track record then they should be allowed to do so, but they should clearly also not be allowed to market their track record in this way.