Willis Towers Watson

INVESTMENT CONSULTANCY AND FIDUCIARY MANAGEMENT SERVICES MARKET INVESTIGATION

RESPONSE TO WORKING PAPER ON ASSET MANAGER PRODUCT RECOMMENDATIONS

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INVESTMENT CONSULTANCY AND FIDUCIARY MANAGEMENT SERVICES

WTW RESPONSE TO WORKING PAPER ON ASSET MANAGER PRODUCT RECOMMENDATIONS[1]

1. Introduction

1.1 This paper sets out Willis Towers Watson's (WTW's) comments on the analysis of asset manager product recommendations that the CMA has set out in its working paper of 22 March 2018 (the 'Working Paper'). It should be read alongside a supplementary submission from WTW's Authorised Advisers within the Confidentiality Ring.

1.2 We are keen to work together with the CMA in developing appropriate measures to demonstrate the value that is generated by the investment consulting sector and by WTW in particular. We agree that manager selection is an important consideration for clients and welcome the CMA's initiative to carry out further analysis on this subject to allow customers to assess and compare investment advisors and fiduciary managers.

1.3 However, based on our review of the materials that the CMA has shared in its Working Paper (along with the supporting Disclosed Materials that our Authorised Advisers have reviewed in the Confidentiality Ring), we have serious concerns about a number of aspects of the analysis that the CMA has carried out to date and the conclusions drawn from the analysis.

1.4 **First, we do not agree with the CMA's finding that WTW's Buy-rated products do not significantly outperform their respective benchmarks on average on a net of asset management fees basis.**

1.5 Having examined the evidence in the Working Paper, we have the following concerns:

(a) The CMA has severely restricted the sample of WTW's Buy-rated products on which it has conducted its analysis. In our view, many of the restriction criteria are not justified. The restrictions applied by the CMA's approach inevitably make it less likely that it will identify any statistically significant results.

(b) Moreover, as a result of the restriction criteria applied by the CMA, the resulting sample of WTW Buy-Rated asset management products do not represent the asset management products that are typically used by our UK clients.

(c) The asset manager fees which the CMA has used in its analysis to derive WTW's net of fees returns are not reflective of the fees that our clients actually pay. This is for two reasons. First, the standard fees being used are higher than the level that would be representative of our client base. Second, the discounts WTW is able to achieve are higher than those estimated by the CMA (for example, the fees that reflect our preferred implementation route for active equity are half the level that is assumed by the CMA in its analysis). For both reasons, the net returns analysed by the CMA are inappropriately low (at least as far as the analysis conducted on WTW's Buy-rated managers is concerned).

(d) The CMA's analysis of net outperformance also incorrectly assumes that the alternative option of investing in passive index-tracking products would be costless for a pension fund trustee. However, this is not correct, since passive products themselves incur fees.

[1] In this response and all responses to the CMA, Towers Watson Limited is the main regulated entity. We refer to both this entity and the relevant general business as "We", "Willis Towers Watson" or "WTW" throughout.

1.6 **Second, had the CMA applied the same range of statistical tests to WTW's data that it applied to the wider industry, the conclusion would have been that WTW's Buy-rated products do in fact outperform on a statistical significant basis, and on a gross and net basis, for the majority of the tests considered.**

1.7 In the working paper, the CMA conducted a range of statistical tests to inform its industry-wide conclusions, but did not extend these statistical tests to consultants individually. Instead, the conclusions that the working paper draws about the performance of individual investment consulting firms are based on the results of just one test (using an approach and data set we disagree with).

1.8 However, if the CMA had analysed the results for WTW using the panel data set (which the CMA agrees has more statistical power), and its wider range of statistical tests, it would find that for the large majority of these tests, WTW's Buy-rated products outperform their benchmarks on both a gross and net basis. Addressing the concerns we have outlined above about the CMA's approach would further strengthen these results.

1.9 Our Authorised Advisers have also developed an additional approach[2] to assessing WTW's performance, using the Disclosed Materials made available in the Confidentiality Ring. This approach is more intuitive and has attractive statistical properties that do not suffer from some of the concerns that apply to aspects of the CMA's approach (in particular the use of Driscoll-Kraay standard errors, which is inappropriate given the sample size available to the CMA). The results from this additional analysis again point to the conclusion that WTW's Buy-rated products significantly outperform their benchmarks. Moreover, it suggests that this outperformance is greater than that of other actively managed products that are available on the eVestment database.

1.10 For the purposes of assessing the impact of the issues listed above, and given time constraints, we have focused specifically on the results of the CMA's analysis of WTW's Buy-rated asset management products. A number of the problems we have identified – such as the need to consider the cost of investing in passive products – would in principle extend to the CMA's analysis of other investment consultants and of the investment consulting industry collectively. However, even if correcting for these errors of fact and assessment of evidence did not materially affect the CMA's findings for other investment consultants, this would not undermine the findings with regard to WTW. On the contrary, finding stronger evidence of outperformance for WTW's Buy-rated products would make sense given that WTW invests more heavily in asset manager research than many of its competitors. One would expect having deeper resources dedicated to asset manager research would lead to better manager product recommendations for clients.

1.11 **Third, the CMA's headline message – that there is no evidence of asset manager products recommended by investment consultants as a whole outperform their respective benchmarks on average on a net of fees basis – is misleading.**

1.12 Even taking the results of the CMA's analysis at face value, the conclusion is misleading because it combines the impact of consultants' selection (ie their skill, wholly within their control, and part of the service being procured by their clients) and the impact of managers fees (which consultants can influence but not control). Both the individual contributions of these factors and the combination have relevance to this review.

1.13 The CMA's findings consistently find statistically significant outperformance for investment consultants on average on a gross of fees basis. This provides strong evidence that investment consultants overall have skill in selecting outperforming asset managers (the accepted wisdom is that the average asset management product will have zero gross outperformance or negative

[2] This is a complementary non-parametric approach, rather than the regression-based approach used by the CMA.

outperformance taking into account trading costs). Provided asset management fees are low enough, this will lead to added value for clients.

1.14 We believe a balanced conclusion from the CMA's analysis would be as follows:

(a) The evidence suggests that on average investment consultants are able to add value and pick better asset management products which outperform their benchmarks on a gross of fees basis to a statistically significant extent.

(b) The outperformance of products recommended by investment consultants as a whole on a net of fees basis is positive but not statistically significant. Therefore, the focus should be on ensuring asset manager fees are low enough to have reasonable confidence that the skills of investment consultants in picking asset management products will translate into positive net of costs returns for clients.

1.15 However, in relation to this second conclusion we reiterate that there is strong evidence from the data that WTW – specifically – is able to outperform on a net of fees basis.

1.16 **Fourth, we also have concerns about the narrow scope of the CMA's performance analysis.**

1.17 As we have explained in previous submissions, asset manager selection is only one of the many components – albeit an important one – of the service we provide to our clients. The results from the CMA's Trustee Survey (as set out in the Trustee's Engagement Working Paper), setting out the reasons why pension fund trustees use investment consultants, show that risk management was ranked substantially higher as a reason than achieving improved investment returns.

1.18 Hence it is important to consider not only manager selection but also portfolio management capabilities, asset allocation and liability hedging strategies to assess the value added by the investment consulting industry as a whole and by WTW in particular. This was the approach we took in our paper on Performance Measurement[3], where we provided evidence on several aspects of our performance, including most importantly the performance of our Fiduciary Management service, which provides a holistic view of our capabilities.

1.19 The CMA provided no indication in its recent Progress Update paper that it is planning to publish any other working papers that will seek to assess other areas of value added by investment consultants, or the value added by the service as a whole[4]. The CMA states that it has decided to focus specifically on asset manager recommendations because this is an area that "can reasonably be measured, and where claims are commonly made".[5] However, while this is true of product recommendations, it is equally true of the wider value of investment consultants' services. We have shown that it is possible to measure the value of these wider services in our Performance Measurement paper, and that the holistic performance of WTW's Fiduciary Management clients outperformed that of the average UK pension fund in a statistically significant manner, particularly by reducing the level of risk.

1.20 We would strongly encourage the CMA to consider this wider evidence of value-add by investment consultants and fiduciary managers. Indeed, if the CMA does not carry out a wider analysis, it will not be able to draw any conclusions about the overall value of the services offered by investment consultants, or to justify any remedial action outside very narrowly targeted remedies relating to manager selection activities alone.

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[3] WTW *Submission on Performance Measurement Issues*, 16 January 2018.

[4] Working Paper, page 6. The CMA's Progress Update paper of 21 February 2018 listed a number of working papers that the CMA was planning to publish. However, there was no indication that any of these working papers will consider how to assess or quantify the broader ways in which investment consultants create value for their clients.

[5] Working Paper, page 6.

1.21 **In summary, we strongly believe in the value of our services, including, but not limited to asset manager product recommendations.**

1.22 Having said this, we would welcome well-designed initiatives to improve the ease with which clients can assess and compare the performance of different investment consultants. We recognise and welcome the role that the CMA could potentially play in helping to coordinate and standardise best practice across the industry in this regard.

1.23 The remainder of this response paper is structured as follows.

(a) We explain our views on the errors of fact and assessment of evidence that underpin the CMA's quantitative analysis of asset manager product recommendations and show how the results change once these errors are addressed. We also explain the likely impact of any errors that our Authorised Advisers have not been able to address directly because of the limited nature of the Disclosed Materials made available in the Confidentiality Ring.

(b) We provide comments on questions about potential remedies that the Working Paper has set out for discussion.

2. Evidence of outperformance by WTW's Buy-rated asset manager products

2.1 The CMA's Working Paper focuses almost entirely on the collective performance of investment consultants as a group, and presents little evidence on the individual performance of investment consulting firms beyond the results for one specific run of its analysis on slide 55. We consider the results for individual firms to be of interest because some investment consultants – such as WTW – invest more heavily in asset manager product research than others. We have therefore conducted a more in-depth assessment of the performance of WTW's own Buy-rated products using the information that the CMA itself used to carry out its analysis. [6]

2.2 Our assessment of the CMA's data points to the following conclusions with regard to WTW's Buy-rated products:

(a) the CMA's analysis has excluded a substantial proportion of the available data on WTW's Buy-rated products, and much of this data has been excluded without good reason – thereby making it harder to identify statistically significant results;

(b) despite this, as described in 1.6, had the CMA carried out the same tests on WTW as it had on the industry, it would have found that WTW's Buy-rated products statistically significantly outperform their respective benchmarks on both a gross and net basis;

(c) addressing errors of fact and assessment in the CMA's analysis further strengthens this finding; and

(d) analysis of the CMA's data also provides strong evidence that WTW's Buy-rated products outperform their respective benchmarks to a greater extent than other actively managed products that have data on eVestment.

2.3 We discuss each of these findings in turn.

(i) The CMA's analysis has excluded a substantial proportion of the available data on WTW's Buy-rated products, and much of this data has been excluded without good reason

2.4 The CMA contends that it has not been able to find statistically significant evidence of outperformance net of fees for the majority of specifications it has considered. However, it has severely restricted the sample on which it has conducted this analysis – thereby making it harder to identify statistically significant results.

2.5 Table 1 below compares WTW's own data on Buy-rated products for the 2000-2016 period (which formed the basis of previous WTW submissions to the CMA) against the more restricted WTW Buy-rated product data set that the CMA ultimately used for its analysis. As the table shows:

(a) after appropriately filtering the data (for example to remove passive products), there were more than 1,700 WTW Buy-rated products over the period as a whole;

(b) multiplying each of these products by the number of quarters in which they were Buy-rated generates more than 30,000 observations;

(c) however, the CMA ends up conducting its net returns analysis on less than 25% of this data – with 378 products and 7,409 quarterly observations. By comparison, WTW's analysis of the net returns of our Buy-rated products contains more than double the number of observations contained within the CMA's net analysis;

[6] In line with the CMA's practice, we have interpreted a WTW 'FREX-1' rating to be equivalent to a 'Buy' rating for the purposes of this analysis.

(d) the time series results that the CMA has presented for WTW restrict the data even further, collapsing the 7,409 observations into just 39 average quarterly observations.

Table 1 – comparison of WTW's original Buy-ratings data set and restricted data set that the CMA ended up using for its analysis

WTW Buy-rated universe		**Number of products**	**Number of quarterly observations**
Full WTW data set for 2000-2016		2,196	36,665
Appropriately filtered WTW dataset for 2000-2016*		1,768	32,050
WTW dataset after restricting to 2006-2015 period		1,656	23,217
CMA's final panel data set for WTW	Gross returns analysis	479	8,940
	Net returns analysis	378	7,409
CMA's final quarterly time series data set for WTW	Gross returns analysis	479	39
	Net returns analysis	378	39

Source: analysis undertaken by WTW's Authorised Advisers.

** Excludes specialised products, passive products.*

2.6 As noted above these restrictions to the data set make it harder to identify statistically significant results. Moreover, our analysis of the data set remaining after the CMA's process of restrictions also suggests that:

(a) The resulting asset class mix of the CMA's sample is not representative of either the original WTW Buy-ratings universe provided to the CMA or the portfolio exposure mix of WTW's UK clients.[7] For example, mainstream mandates (i.e. equities and bonds) account for approximately 95% of the CMA's analysis, whereas they only account for around 80% of WTW's ratings and 50% of UK client exposure. Additionally, the split within the mainstream asset classes is not representative: equities are given more than twice the weight of bonds in the CMA's sample, whereas the split is close to equal both for WTW's full Buy-ratings universe and in terms of the exposure of its UK client base.

(b) The mix of UK and US mandates in the CMA's sample is similarly unrepresentative of either WTW's Buy-ratings universe or UK client portfolio exposure.

(i) Within bonds, the weight for UK bond products drops from 18% for the WTW ratings or 43% for UK client exposure to 0% weight in the CMAs net analysis. By contrast, the weighting of US bond products increases from 23% for WTW Buy-ratings and 9% for UK client exposure to more than 50% of the bonds weight in the CMA's net analysis.

(ii) Within equities there is a significant bias to US equity products – a market segment that is considered to be highly efficient with few managers outperforming – with 45%

[7] Based on a count of investible primary portfolios (excluding specialist mandates like indexation) for clients of WTW's UK Investment line of business.

of the products being assessed by the CMA on a net basis being in US equities. This is markedly higher than the share for the WTW ratings universe (28%). US equity products are arguably of little interest to WTW's UK clients, who only have 3% exposure to these as UK clients access the US equity market almost exclusively through global equity products. Therefore, the most important segment to analyse for WTW's UK clients is global equity products – which account for nearly half of their equity portfolios – yet this only accounts for around 16% of the CMA's sample.

2.7 As a result, the representativeness of the data on which the CMA is drawing its conclusions is questionable.

2.8 We recognise that in creating its data set, the CMA in some instances had limited choice but to restrict the sample due to a lack of available data (e.g. missing returns information on eVestment due to the database's limited coverage of asset classes and products – though in some cases gaps can be filled using information from other sources). Nonetheless, the CMA has also excluded much of the WTW information that is available on eVestment without justification, for the reasons we explain below.

The CMA has restricted its analysis to the 2006-15 period when more recent data is available

2.9 The CMA has restricted its analysis to the 2006-15 period, despite data being available for additional years. WTW itself has access to data for 2000-16. As shown in Table 1 above, this restriction alone removes approximately one quarter of the WTW data set, reducing the number of observations from more than 32,000 to less than 24,000.

2.10 The CMA appears to have decided not to update the FCA's data set to take account of the more recent data for 2016 on the basis that neither investment consultants' approach to rating nor market conditions have "changed significantly" since 2015. Irrespective of whether this is the case, adding relevant additional observations to the analysis is still likely to increase the robustness of the results. Indeed, the CMA itself recognises this on slide 62 of its Working Paper when explaining why it has itself placed more weight on its results for 2006-15 than the results for the 2012-15 period (which are statistically significant on both a gross and net basis).

2.11 Similarly, the CMA has not explained why it has not taken account of information prior to 2006. The same logic would suggest that it should take account of information from earlier years to the extent that it is available.

The CMA has excluded a substantial proportion of products without justifiable reason

2.12 We understand from our Authorised Advisers that the CMA put the following restrictions on the dataset:

(a) **Only using USD returns** – The CMA uses returns which have been entered onto eVestment in USD or converted into USD by eVestment or the manager, but excludes returns not converted into USD. We understand that the CMA may have decided to exclude non-USD returns on the basis that it is not possible to convert return data if the product in question is hedged. The CMA has not explained its specific concern here[8], but we do not believe that the step of excluding non-USD returns would be appropriate, since one cannot address concerns around hedging simply through choice of reporting currency. Since the CMA has not disclosed the non-USD data set, we (and our Authorised Advisers) cannot precisely quantify the extent to which this has restricted the CMA's product sample. However, we are concerned that in removing a subset of products which do not report in USD – including, for example,

[8] Instead, the CMA has indicated that it was simply advised of this issue by the FCA and other parties.

GBP-denominated products – the CMA may have removed a number of products that would be of particular interest to UK clients.

(b) **Only using USD fee scales –** It appears that the CMA has downloaded fee information from eVestment in USD. The majority of managers only choose to enter their fee scale information in the product base currency and these are not systematically converted into other currencies by eVestment, hence if you only download USD fee scales then you will mainly get fees for products with a USD base currency. This appears to be a key reason for the difference in the sizes of the CMA's gross and net universes and is probably one of the drivers of the US bias within the CMA's dataset.

(c) **Only reporting products with benchmark returns on eVestment** – The CMA appears to have excluded products where the index returns are not available in USD on eVestment rather than using other sources for index returns or comparing these products to another suitable index which they did have returns available for.

2.13 Since the CMA has not disclosed the non-USD data set, we cannot precisely quantify the extent to which this has restricted the CMA's product sample. However, we are concerned that in removing a subset of products whose base currency is not USD – including, for example, GBP-denominated products – the CMA may have removed a high proportion of products that would be of particular interest to UK clients.

The CMA has converted a rich panel data set to a quarterly time series without good reason

2.14 For both the "baseline" analysis that it has presented in the main body of the Working Paper and the limited WTW-specific analysis that it has presented in the appendices, the CMA has followed the FCA in averaging all observations in each quarter. As Table 1 above shows, in following this approach, it has in effect converted a panel data set with many thousands of observations to a time series with just 39 observations. This reduces the richness of the data by removing potentially useful cross-sectional information.

2.15 The CMA recognises that the panel data approach provides "greater statistical power"[9], precisely because of the greater number of observations. If so, it is surprising that the CMA has chosen as its base case an approach with less statistical power. It would seem more appropriate to use the panel data approach as the base case, and treat the quarterly averages approach as a sensitivity (albeit one with less statistical power).

(ii) If the CMA conducted analysis on WTW's Buy-rated products in the same way it analysed the wider industry, it would have found these to statistically significantly outperform their respective benchmarks

2.16 As noted above, the Working Paper only presents WTW-specific results on the basis of a time series regression that collapses the performance of all WTW's Buy-rated products into 39 quarterly average observations. Conducting a regression on the richer panel data (using the same approach that the CMA has itself used elsewhere in its Working Paper for the market as a whole) significantly strengthens the WTW-specific results.

2.17 The table below presents WTW-specific results from regressions of gross and net returns on a constant, using the full panel data set rather than the quarterly mean time series approach. To generate these results, our Authorised Advisors have used the same approach as that used by the CMA to generate the panel results presented on slide 59 of the Working Paper, but have restricted the analysis

[9] Working Paper, slide 59.

to WTW's Buy-rated products. In line with CMA's own approach, backfilled observations have been excluded (although we don't think this is optimal). The table shows not only the results using robust OLS standard errors, but also the results using the three types of standard errors considered by the CMA in its Working Paper (Newey-West, Clustered and Driscoll-Kraay).

Table 2 - gross and net relative quarterly returns for WTW's Buy-rated products for a panel-data specification

	Quarterly Gross Relative Return				**Quarterly Net Relative Return**			
Standard Error Estimation	OLS Robust	Newey-West	Clustered	Driscoll-Kraay	OLS Robust	Newey-West	Clustered	Driscoll-Kraay
Constant	0.223***	0.223***	0.223***	0.223***	0.070**	0.070*	0.070*	0.070
p-value	(0.000)	(0.000)	(0.000)	(0.010)	(0.048)	(0.060)	(0.063)	(0.449)
Observations	8,940	8,940	8,940	8,940	7,409	7,409	7,409	7,409

Source: WTW Authorised Advisers' analysis of the CMA's Disclosed Materials.
*Notes: *** = p<0.01; ** = p<0.05; * = p<0.1.*

2.18 These regression results suggest that WTW's Buy-rated products outperform their benchmarks both gross and net of manager fees (as indicated by the positive constant terms in the table). Furthermore, the outperformance is statistically significant (with >99% confidence) across the board for the gross returns, and statistically significant (with >90% or >95% confidence) for the net returns for three of the four standard error estimations considered.

2.19 The only specification that is not statistically significant is that which uses Driscoll-Kraay (DK) standard errors. The working paper explains that DK standard errors control for the possibility that there may be both autocorrelation and cross-sectional correlation in the performance data. However, Driscoll-Kraay standard errors require a large panel data set with a high ratio of time periods to cross-sectional observations.[10] In this instance, however, the ratio is low – with just 39 time periods, but several hundred WTW Buy-rated products in each time period. The academic literature cautions against applying DK estimators in this context.[11] In fact, we understand that the use of DK estimators generates standard errors which are almost two and a half times the size of the OLS standard errors, whereas the Newey-West and Clustered standard errors, which control for potential autocorrelation and cross-sectional correlation individually rather than jointly, are only 5%-6% larger than OLS standard errors. This suggests that the concerns in the academic literature are borne out in practice. [12]

2.20 A more efficient way to address issues of autocorrelation and cross-sectional correlation jointly in this context is to adopt a non-parametric approach. We discuss these types of approaches further in section (iv) below.

(iii) Addressing errors of fact and assessment in the CMA's analysis further strengthens the WTW-specific results

[10] For further explanation on this, please refer to the separate report of our Authorised Advisers from the Confidentiality Ring.
[11] In short, this is because there is insufficient time series information with which to reliably compute a large residual covariance matrix for cross-sectional observations.
[12] For further explanation on this, please refer to the separate report of our Authorised Advisers from the Confidentiality Ring.

2.21 As the foregoing analysis shows, many of the CMA's own tests indicate that WTW's Buy-rated products statistically significantly outperform their respective benchmarks. Moreover, we believe that the CMA's analysis suffers from errors of fact and assessment that – if corrected – would further strengthen these results. We discuss each of these issues in turn below.

(a) The CMA's net outperformance analysis fails to take account of passive fees

2.22 The CMA's analysis of net outperformance incorrectly assumes that the counterfactual of investing in passive tracker products would be costless for a pension fund trustee. This is not correct. Passive products themselves incur fees. Table 3 below provides the typical range of fee rates charged by passive index products, based on WTW's experience. As the table shows, passive fees vary between 3bps and 40bps, depending on the size of the mandate (typically the larger the mandate, the lower the fee rate) and the asset category in question.

Table 3 – Typical annual fee ranges for passive products

Asset class	**Passive fee (bps)**
UK equities	5-10
US equities	6-25
Europe equities	9-35
Japan equities	6-30
Global equities	9-30
EM equities	16-40
UK gilts	3-20
UK corporate bonds	6-20
Global IG corporate bonds	12-28

Source: WTW.

2.23 The relevant counterfactual passive fees should be netted off the active fee for the purposes of assessing the net outperformance of WTW's recommended products.

2.24 The tables below show the impact of building 5bp, 10bp and 20bp passive fees into the WTW-specific panel data analysis. This clearly strengthens the net-of-fees results, both in terms of the estimated level of net outperformance and in terms of the statistical significance of a number of the estimates, with the exception of the Driscoll-Kraay results, which remain unreliable for the reasons above.

Table 4: Net relative returns for WTW's Buy-rated products for a panel-data specification, with 20bp passive fee

	Net Quarterly Relative Return (with 20bp passive fee)			
Standard Error Estimation	OLS Robust	Newey-West	Clustered	Driscoll-Kraay
Constant	0.120***	0.120***	0.120***	0.120
p-value	(0.001)	(0.001)	(0.002)	(0.198)
Observations	7,409	7,409	7,409	7,409

Source: WTW Authorised Advisers' analysis of the CMA's Disclosed Materials.
*Notes: *** = p<0.01; ** = p<0.05; * = p<0.1.*

Table 5: Net relative returns for WTW's Buy-rated products for a panel-data specification, with 10bp passive fee

	Net Quarterly Relative Return (with 10bp passive fee)			
Standard Error Estimation	OLS Robust	Newey-West	Clustered	Driscoll-Kraay
Constant	0.095***	0.095**	0.095**	0.095
p-value	(0.007)	(0.011)	(0.012)	(0.306)
Observations	7,409	7,409	7,409	7,409

Source: WTW Authorised Advisers' analysis of the CMA's Disclosed Materials.
*Notes: *** = p<0.01; ** = p<0.05; * = p<0.1.*

Table 6: Net relative returns for WTW's Buy-rated products for a panel-data specification, with 5bp passive fee

	Net Quarterly Relative Return (with 5bp passive fee)			
Standard Error Estimation	OLS Robust	Newey-West	Clustered	Driscoll-Kraay
Constant	0.083**	0.083**	0.083**	0.083
p-value	(0.020)	(0.027)	(0.029)	(0.373)
Observations	7,409	7,409	7,409	7,409

Source: WTW Authorised Advisers' analysis of the CMA's Disclosed Materials.
*Notes: *** = p<0.01; ** = p<0.05; * = p<0.1.*

(b) The CMA's assumed active manager product fees do not reflect reality

2.25 The level of asset management fees being paid by clients is a key area of focus for WTW and we spend significant time engaging with the industry and individual asset managers to negotiate lower fees. Our Authorised Advisers' analysis of the approach that the CMA has taken to calculating both rack rate fees and discounts from these rack rates suggests that the active asset management product fees being assumed by the CMA in its analysis are unlikely to be reflective of the fees that our clients are actually paying in practice.

2.26 We understand that the CMA has calculated a standard fee by taking a simple average of the fee calculated at various asset levels ($10m, $25m, $50m, $75m, $100m, $200m, and $500m) based on the fee scales entered onto the eVestment database for each of Separate account, Comingled fund and Mutual fund. The CMA has then applied an IC-specific discount based (for WTW) on a limited analysis of client specific fee information previously provided by WTW.

2.27 The fees our clients pay will be lower than this simple average for the following two reasons:

(a) **The assumed standard fees are too high –** Our clients will generally invest either by a pooled/co-mingled fund or a segregated/separate account and very rarely will UK clients invest in a Mutual Fund. We therefore think that Mutual Fund fees should be excluded from the assumed client fees. However, we understand that the CMA has placed as much weight in Mutual Fund fees as fees for the segregated and pooled fund categories. This matters because – according to our own analysis – the average fee for the products that we have Buy-rated is 22 basis points lower for co-mingled/separate accounts than for mutual funds.

(b) **The fee discounts being typically achieved by our clients are better than the CMA has assumed –** The fee discount calculated by the CMA appears to be simple average of data collected for WTW clients. This means that the CMA has based its discount estimate in part on products that are not relevant to their analysis, such as passive products and products that are not on WTW's Buy-rated list. This is likely to have resulted in too low an average discount being applied. In reality, with our assistance, in many cases our clients have been successful in negotiating very significant discounts to the standard fees. This is particularly true for clients who use our delegated/fiduciary and fund solutions as we collectively have a strong bargaining position here, but can also benefit advisory clients who invest with these managers. For example, with our preferred active equity implementation route, the fees being paid to underlying managers are around half the discounted fee rate which the CMA appears to have assumed. Based on an examination carried out in 2016 of US$ 32 billion in client investments where WTW has fee savings in place across advisory, fiduciary and delegated assets, WTW has been able to reduce asset management fees by more than 30%. This is nearly twice the level of discount assumed by the CMA.

(c) The CMA should consider the WTW-specific results both gross and net of fees

2.28 In light of the fact that fees vary widely by client – and considering the concerns outlined above with respect to the difficulties that the CMA has encountered estimating fees – we think it is important to make both gross and net performance figures available, with the net performance being as reflective as possible of what fees WTW clients typically pay. The gross performance results do not suffer from this problem.

2.29 We therefore disagree with the CMA's decision not to present the WTW results both gross and net of fees in its Working Paper. We also disagree with the suggestion that more weight should automatically be placed on the CMA's net results given these concerns about the way in which fees have been calculated.

2.30 Moreover, the CMA's treatment of manager fees for its analysis implicitly assumes that if clients did not invest in Buy-rated actively managed products, they would choose to invest entirely in passive index products. However, this is a strong assumption which is not investigated by the CMA and – if it is not correct – leads to the CMA making incorrect inferences as to the appropriateness or otherwise of reporting gross returns. For example, for some types of asset class there may simply be no suitable passively managed products that can fulfil the client's needs. This is particularly true of alternative assets that clients often use to diversify away from equities and fixed income.[13]

(iv) Non-parametric analysis provides clear evidence that WTW's Buy-rated products outperform their benchmarks to a greater extent than other actively managed products

2.31 The Working Paper bases its conclusions on manager outperformance on the results of a series of parametric regressions. However, as illustrated above (see, for example, Table 2) the choice of assumption made around how to calculate the standard error associated with the effects has a substantial impact on the statistical significance of the results. Moreover, as our Authorised Advisors have explained in their supplementary submission from the Confidentiality Ring, the Driscoll-Kraay approach to modelling standard errors – which tends to provide the least significant results - requires a large panel data set with a sufficiently high ratio of time periods to cross-sectional observations, which is not available in the CMA's panel data set.

[13] Even if some passive benchmark indices exist for alternative assets (e.g. REITs for real estate investments and hedge fund indices for hedge funds), these are limited in variety and there may be no suitable investment products that passively track these indices.

2.32 Along with our Authorised Advisers, we think that there are more efficient ways of circumventing possible autocorrelation and cross-sectional correlation, using non-parametric techniques based on a re-randomisation process. We consider this approach to be more intuitive than the parametric approach used by the CMA, and that it also has a number of statistical advantages. Most importantly, it does not require one to make assumptions around the presence or absence of serial correlation/cross sectional correlation, nor does it require a data set with a high ratio of time periods to cross-sectional observations.

2.33 This re-randomisation methodology can be used to assess whether WTW's Buy-rated products outperform their benchmarks to a significantly greater extent than other actively managed products on eVestment (we show below that this provides a conservative estimate of the extent to which WTW's Buy-rated products outperform their benchmarks). The re-randomisation process involves two steps:

(a) Repeated random resampling of the 'treatment' variable, in this instance the provision of a WTW 'Buy' rating to a particular investment product, to generate alternative samples of Buy-rated products.[14] We have carried out this random redistribution process a total of 2,500 times.

(b) For each sample, calculating the degree of out- or under-performance relative to the remaining population of products listed on eVestment (for which returns data are available).

2.34 This 'Monte Carlo' method enables one to build a distribution of values for the outperformance coefficient estimate. One can then measure where the performance of WTW's actual Buy-rated products sits on this distribution to assess how likely it is that this level of outperformance could have been generated if WTW had assigned its Buy-ratings at random.

2.35 Our Authorised Advisors have run such an analysis using the disclosed materials that the CMA has made available in the Confidentiality Ring. The table below summarises the results of this analysis for the relative return of WTW's Buy-rated products.

- For the reasons explained above, we have considered the results both gross and net of manager fees.
- The constant term reports the average level of outperformance by the real WTW Buy-rated products.
- 'n' reports the total number of times that Buy-ratings were randomly re-assigned.
- 'c' reports number of instances in which the randomly-assigned Buy-ratings were found to outperform the real sample of WTW 'Buy' rated products.
- 'p' reports the proportion of cases where a randomly generated sample of Buy-rated products outperformed the real WTW Buy-rated sample.

[14] To ensure a like-for-like comparison, we have fixed the mix of assets in each generated random sample to include the same composition of asset types in the real list of WTW 'Buy' rated products.

Table 7: Re-randomisation analysis results summary for WTW Buy-rated products

	Gross Quarterly Relative Return	Net Quarterly Relative Return
Constant	0.223	0.070
c	187	243
n	2,500	2,500
p = c/n	0.075	0.097

Source: WTW Authorised Advisers' analysis of the CMA's Disclosed Materials.

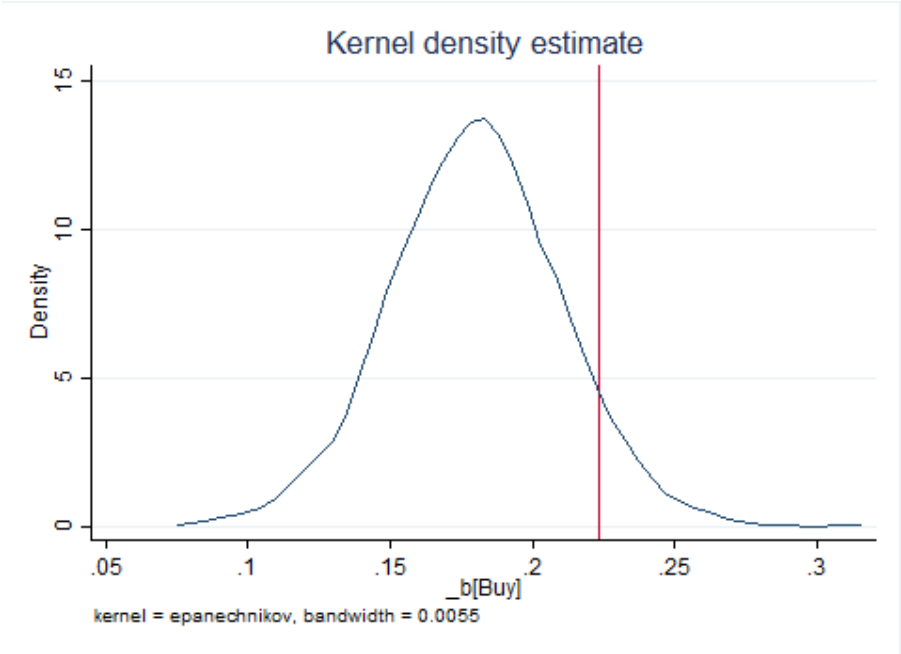
2.36 As can be seen from the results table above, the randomly-generated Buy-rating samples outperformed the real WTW Buy-ratings in less than 10% of the samples. Furthermore, these results are conservative because:

(a) they assume that clients would secure the same fee discount irrespective of whether they chose WTW's Buy-rated products or selected other products at random. As noted above, WTW is often able to secure larger discounts from asset managers than trustees would be able to achieve by themselves; and

(b) they focus on evidence of outperformance relative to other actively managed products, rather than simply outperformance relative to a product's passive benchmark. The results indicate that the average outperformance of randomly selected products on eVestment relative to their benchmarks is positive, which would in turn imply that the outperformance of WTW's Buy-rated products relative to their own benchmarks is even higher.

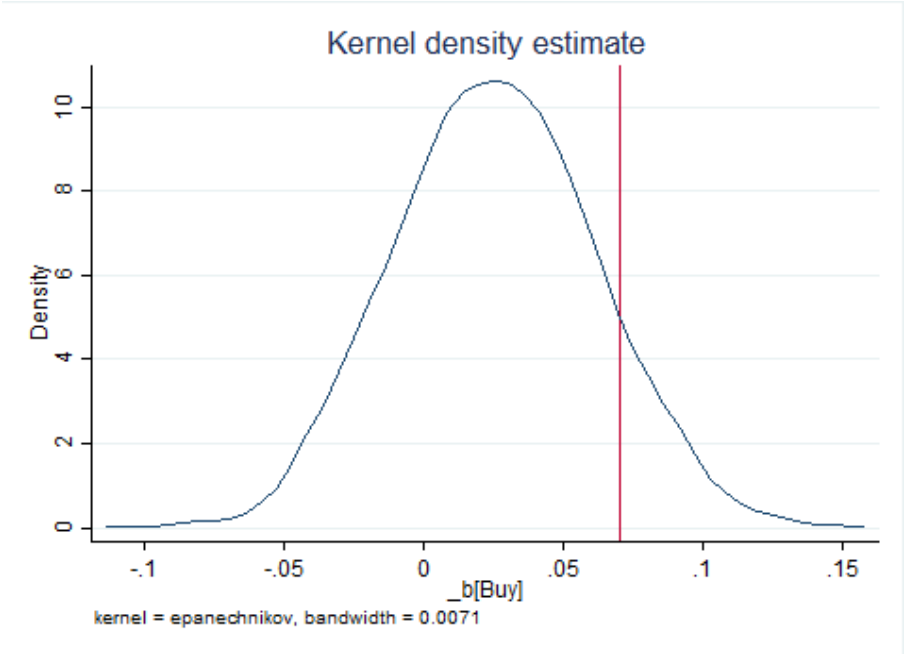
2.37 The distribution plots below also show these gross and net outperformance results graphically: the blue bell-curve distribution lines show the distribution of the returns of the randomly selected product samples, whereas the vertical red lines show the average outperformance of WTW's Buy-rated products.

Chart 1: kdensityplot – Distribution of gross relative quarterly returns vs. observed gross relative quarterly returns across WTW sample



Source: WTW Authorised Advisers' analysis of the CMA's Disclosed Materials.

Chart 2: kdensityplot – Distribution of net relative quarterly returns vs. observed net quarterly relative returns across WTW sample



Source: WTW Authorised Advisers' analysis of the CMA's Disclosed Materials.

2.38 In our view, these results provide strong evidence to support the proposition that WTW's Buy-rated products systematically outperform other actively managed products, on both a gross and net of fees basis.

3. Comments on the CMA's proposed remedies

3.1 We strongly believe in the value of our asset manager product recommendations and we would welcome well-designed initiatives to improve the ease with which clients can assess and compare the performance of different investment consultants in this regard. That said, asset manager product recommendations are only one aspect of investment consultants' performance, as described above. The CMA will be aware that we have previously submitted that there is already a risk that pension fund trustees focus excessively on manager selection at the expense of other aspects of performance (e.g. overall strategy, asset allocation, liability hedging). The CMA's approach in this Working Paper, and the proposed remedies, could exacerbate this concern by raising the profile of manager selection decisions to the detriment of other (often more important) aspects of performance, if care is not taken to ensure that pension fund trustees continue to assess performance in the round.

3.2 Notwithstanding this view, we provide comments on each of the six questions that the Working Paper has set out for consideration below.

(1) Are trustees easily able to compare claims regarding the impact of asset manager product recommendations made by different firms during a tender, for instance?

3.3 Trustees are not able to easily compare claims regarding the impact of asset manager product recommendations by investment consultants. Luck plays a significant role in the short-term results delivered by asset managers and real investment skill (of both asset managers, and of investment consultants making recommendations as to choice of asset manager) can only be determined with a very long-time horizon.

3.4 As a result, we believe there is some room for improvement from the current state with a view to increase the transparency and comparability of the performance results of asset manager product recommendations by investment consultants. However, we would strongly caution against relying too much on performance metrics alone when trustees make selection decisions. Prior performance is a poor predictor of future returns, so any new decision in asset management should be based on a much more comprehensive analysis than just a performance track record. Proper performance analysis should include the break-down of the key drivers of returns and this activity is complex requiring an appropriate level of expertise from a third party such as professional intermediaries. Narrowing it down to simple performance headline numbers could potentially lead to unintended consequences of trustees making sub-optimal decisions.

3.5 We believe that the best approach for trustees to assess prior performance results and to compare across different investment consultants is either through:

(a) building relevant in-house expertise to select and monitor investment consultants; or

(b) using the services of an external professional intermediary to help in the selection and monitoring of the performance of investment consultants. These professional intermediaries can provide a wide assessment of the capabilities of a consultant, have the expertise to explore in-depth and probe any ratings performance figures and put them into context for the customer. Professional intermediaries are also in a position to probe other areas of investment consultant performance which are not easily comparable, such as client service quality, asset allocation views, innovation, execution ability etc., but are nonetheless extremely important.

3.6 Even if more consistency is introduced into the assessment of the performance of investment consultants, there should be caution regarding the weight placed on any track record and certain questions should be encouraged, for example:

(a) Is the period in question long enough to put much weight on? With short term periods (e.g. anything under 7 years) there is not necessarily a clear way to split out results based on luck and results based on skill.

(b) Have results been flattered by a particular style of the investment consultant which just happens to have been in favour in recent years and which may not be in favour in future?

(c) Is the sample size, i.e. number of managers, large enough to put much weight on?

(d) Have there been significant changes to the research team or investment process of an investment consultant?

3.7 To avoid customers placing too great a weight on past performance, caveats may be required – for example:

(a) past performance is no guarantee of future results

(b) any positive results could be due to luck rather than skill

(c) the appointment of an investment consultant should be considered fully and thoroughly, taking into account a number of aspects with limited weight placed on past performance results

(d) the likely fee payable should be considered on a value for money basis and alongside any gross of fee performance results

(e) risk management is key to any potential decision making process and total portfolio management should be taken into account.

(f) net performance figures are based on a fee which may not reflect what a particular customer of a certain size is likely to pay

(g) where a viable passive index is available at low cost, the aggregate universe of active manager products is expected to detract value versus this passive investment after fees and costs over the long term

(2) Would trustees benefit most from information on returns achieved by recommended asset manager products on a gross or net basis?

3.8 We would argue that customers should consider both gross and net returns, based on an approximate level of fees payable based on the typical level of fees payable, given that the level of asset management fees vary by client.

3.9 For the purposes of comparison across IC firms, gross return figures will be the most consistent. These are not sensitive to the level of fees charged by asset managers which tend to vary significantly across customers even within one strategy or product.

3.10 Net return figures are also important for customers as they demonstrate what trustees may see as a real investment outcome but need to be treated with caution because of fee assumptions that are used. In practice fees paid to asset managers often differ widely by customers, for example by size of mandate or pooled vs separate account implementation or execution model. Hence reported net of fee returns may be very misleading, either positively or negatively, for any given customer. One would also want to avoid giving the incorrect impression that the benchmark was freely available to the trustee given passive fees will need to be paid.

3.11 It is important that trustees consider the level of fees they are likely to pay. In particular, they should consider whether an investment consultant is able to negotiate lower fees, either through an FM execution model where assets are aggregated, or on a standalone basis, compared to those which could be achieved by the trustee.

(3) How could the presentation of the impact of asset manager product recommendations be made more comparable, comprehensive, relevant and useful?

3.12 Please see our response to Question 1 above.

3.13 Looking at just the performance of highly rated products gives only part of the picture of how the investment skill of various investment consultants compares to each other. As discussed in our response to Question 1, the assessment of an investment consultant's ability to deliver future returns in selecting asset manager products should be assessed comprehensively, including the quality of people, processes and investment beliefs held by a particular investment consultant.

3.14 We believe that the performance track record of total fund fiduciary mandates represents a more comprehensive assessment of an investment consultant's skill which goes beyond just pure asset manager product selection to include factors such as asset allocation, portfolio construction, risk management and hedging strategies, and will represent actual customer outcomes. The rules for the presentation of fiduciary track records could be made more consistent and transparent across investment consultants (please see our response to the "Fees and Quality" working paper for more suggestions in this regard).

3.15 Where a consultant does not offer a comprehensive investment solution to its clients and only focuses on investment advisory services, we believe that the use of model portfolios managed to strict rules with a clear audit trail could potentially be an option which allows consultants to demonstrate their performance results in the absence of fiduciary track records. We have run model portfolios to demonstrate our manager selection capabilities on an IC basis since 2000. The decision-making and presentation rules behind model portfolios to demonstrate consultants' capabilities in advisory manager selections could be made more consistent and relevant across different consultants which will make them more useful to trustees. These model portfolios provide a broader, more comprehensive picture of the manager selection service to customers than simply focusing on the collective performance of all Buy-rated managers. This is because model portfolios include the impact of:

(a) Performance of a selection of highly rated products (identified in advance, not with the benefit of hindsight)

(b) Portfolio construction demonstrating ability to identify and blend uncorrelated products which diversify to form a more resilient combined portfolio with improved risk management

(c) Ongoing portfolio management, such as regular decisions to hold/buy/sell/add/reduce product exposures to more closely replicate actual client experience than a full range of consultants' ratings can ever achieve.

3.16 WTW's Performance Measurement paper of January 2018 explored the performance of our model portfolios, alongside other measures of performance.[15]

3.17 In relation to performance reporting for highly rated products, different investment consultants have different approaches to covering and rating asset management firms so determining a consistent minimum reporting standard is not a trivial exercise. That said, we can see the case for exploring this

15 WTW *Submission on Performance Measurement Issues*, 16 January 2018.

further and it would seem helpful to customers to set some industry best practice principles which are encouraged, such as:

(a) **Product categories:** There is currently a wide range of product category definitions among investment consultants which tends to add to the lack of consistency in performance comparison. Our suggested categories for reporting on highly rated products are set out in Table 8 below. We feel this range provides a good balance between:

(i) being sufficiently granular to give a clear picture and capture difference in risk return profiles of various investment strategies; and

(ii) not having so many categories as to confuse customers.

Table 8 – Categories for reporting on highly rated products

Bucket	**Notes**
Investment Grade Bonds - Global/Multi region	Includes Government, Credit and Aggregate mandates
Investment Grade Bonds - North America	Includes Government, Credit and Aggregate mandates
Investment Grade Bonds - Euro	Includes Government, Credit and Aggregate mandates
Investment Grade Bonds - UK	Includes Government, Credit and Aggregate mandates
Investment Grade Bonds - Australia	Includes Government, Credit and Aggregate mandates
Investment Grade Bonds - Emerging markets	Includes Asian mandates. Covers Government, Credit and Aggregate mandates
Sub Investment Grade Credit	Includes Loans and High yield across all geographies
Structured/Securitised Credit	Covers all geographies
Absolute Return Bonds	Includes Absolute return bonds and Unconstrained bond funds across all geographies
Equities - Global	Includes world/global mandates which exclude specific countries (e.g. world ex US or EAFE). Covers all market capitalisations (e.g. Small cap, Large cap) and styles (e.g. Value and Growth)
Equities - North	Includes all market capitalisations (e.g. Small cap, Large cap)

America	and styles (e.g. Value and Growth)
Equities - Europe	Includes all market capitalisations (e.g. Small cap, Large cap) and styles (e.g. Value and Growth)
Equities - UK	Includes all market capitalisations (e.g. Small cap, Large cap) and styles (e.g. Value and Growth)
Equities - Asia	Includes all market capitalisations (e.g. Small cap, Large cap) and styles (e.g. Value and Growth)
Equities - Australia	Includes all market capitalisations (e.g. Small cap, Large cap) and styles (e.g. Value and Growth)
Equities - Emerging markets	Includes all market capitalisations (e.g. Small cap, Large cap) and styles (e.g. Value and Growth)
Private equity	Includes direct funds and secondaries
Private debt	Includes Distressed, Real Estate Debt and Corporate Direct Lending
Hedge funds	Only direct hedge funds. Includes Reinsurance and alternative smart beta mandates
Infrastructure	Includes direct/unlisted and listed
Real Estate	Includes direct/unlisted and listed (i.e. REITs)
Multi Asset	Includes Diversified growth, Real return and Balanced funds

We would exclude the following product groups: non-mainstream active mandates (e.g. indexation, mainstream smart beta, cash/liquidity/stable value and target date funds), service providers (e.g. custody and transition managers), fund of funds/secondaries/multi manager or niche investments (e.g. agriculture, natural resources and convertible bonds).

The categories listed in the table above will provide trustees with more comparable mandates to assess performance across different consultants. We would allow some flexibility to show a more granular break-down of performance within each category as some of them include very wide ranges (for example hedge funds or real estate strategies span a wide range of risk-return targets).

(b) **Output format:** We suggest showing the following mandatory information for each category with the flexibility to provide more detail where warranted:

(i) average highly rated product gross return for the category

(ii) average corresponding product benchmark gross return for the category

(iii) typical asset manager fee for the category

(iv) average highly rated product net return (assuming typical fee) for the category

(v) the number of highly rated products in the category on average each quarter

(vi) product turnover within the category

(vii) average tracking error for products in the category

(viii) average absolute volatility (not relevant for private markets) for products in the category

(ix) inception date of category.

The primary practical difficultly here is determining the typical fee for each category, given that the fee charged by an asset manager for a product will often vary by asset owner and in some cases is not disclosed. This is a complex area which would require further thought.

(c) **Benchmark choice:** The products within a category are likely to have different benchmarks so we suggest that products are measured against each manager's default benchmark where this is available. It is important to match the reporting currency of the portfolio return to the reporting currency of the benchmark return. For private markets we recommend using a Public Market Equivalent method which compares performance to public indices and takes into account the timing of cash flows to / from the investment (i.e. aligns the private markets money weighted approach to performance measurement with the public market time weighted approach).

(d) **Time period:** Shorter term figures (for example, 7 year periods or shorter) are less than a full market cycle and luck plays a greater role than skill in determining performance outcomes. In addition, emphasis on such periods is likely to lead to shorter term focus by consultants/trustees/asset managers which is not going to be helpful for the industry as a whole and its ultimate beneficiaries, end savers. The negative consequences of short-termism in our industry have been very well documented. We would strongly encourage emphasis on longer term periods for performance measurement, such as rolling 10 year windows as well as since inception figures.

3.18 There are additional complexities not addressed above but we hope this overview above is a useful start.

(4) 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?

3.19 We believe developing a common methodology will be challenging and could lead to some unintended consequences which may not be helpful for the industry or its stakeholders but we do believe that there is some room for improvement from the current state. Please refer to our comments in response to the questions above.

3.20 We would like to caution against what we think is the main challenge that wider assessment beyond past performance is critical in selecting investment consultants (similar to selecting asset managers). There is a danger that a new standardisation process leads to a greater weight being placed on past performance, i.e. it may give customers false confidence as a measurement tool, and there should be mechanisms put in place which control for overreliance on past results.

3.21 Should a minimum best practice reporting standard be adopted, we advocate a 'comply or explain' requirement at the start. This should allow a sufficient incentive for investment consultants to bring

the presentation of their results to a more common standard but at the same time allow some flexibility. If the "comply or explain" approach does not have the desired impact after a certain period, there is always the option to enforce a fully mandatory disclosure of some minimum reporting requirements in future.

3.22 It would also be important for individual investment consultants to be allowed flexibility for additional disclosures on top of the prescribed base level.

(5) 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?

3.23 External audit would be a significant cost on the industry which is ultimately passed on to the trustees and the underlying members. We would argue that, in any case, limited emphasis should be placed on past ratings performance as a predictor of future results or a criterion for selecting an investment consultant. We doubt that the value of regular external scrutiny would outweigh the cost to the industry.

3.24 We instead support the practice whereby trustees are encouraged to use the services of professional intermediaries to help select investment consultants. These groups can apply expert scrutiny of any track record as part of a wider assessment. Their services could also be used more regularly by trustees as regular performance monitoring of their investment consultant rather than just at the point of tendering for fiduciary services. This would represent a better alternative for external scrutiny and allow a more comprehensive assessment rather than simple performance benchmarking or assessment against common methodology.

(6) How should any change in presentation be implemented and enforced?

3.25 If there is a requirement for a new standard of reporting, we suggest at least a 12-month grace period after the approach is finalised given that it would be a significant undertaking to implement. The best period for the inception would generally be early in a calendar year when the vast majority of asset managers report the annual year-end results to their clients.

WILLIS TOWERS WATSON

20 APRIL 2018