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CMA INVESTMENT CONSULTANCY AND FIDUCIARY MANAGEMENT MARKET INVESTIGATION

MERCER'S RESPONSE TO ASSET MANAGER PRODUCT RECOMMENDATIONS WORKING PAPER

This is the response by Mercer Limited (**Mercer**) to the Asset Manager Product Recommendations Working Paper (**WP**) dated 22 March 2018.

1 Executive summary

1.1 Mercer welcomes the opportunity to comment on the WP. Mercer is not included in the CMA's eVestment analysis; however, we consider that we can make a valuable contribution to the CMA's on-going work in this area and as such we are responding to the WP.

1.2 We note that the CMA's initial findings in this WP indicate that investment consultants (**ICs**) deliver substantial value to clients through their skill in identifying asset manager (**AM**) products that, on average, outperform their relevant benchmarks.

1.3 The CMA's eVestment analysis finds, for example, that for the majority of the ten year period studied, the ICs were successful in identifying Buy-rated products that, on average, outperformed their relevant benchmarks and the performance of thousands of other 'Unrated' products available.

1.4 Indeed, the WP indicates that the CMA's key concern is that much of the outperformance identified by the ICs is absorbed by high AM fees in the adjacent AM market. The CMA's analysis suggests that average AM fees are around 79 bps per annum on Buy-rated products. The CMA's implied level of AM fees is too high in our view, as we explain in this response. However, irrespective of the assumed levels of AM fees (which will, of course, differ for individual pension schemes), it is the AM fees themselves that absorb the outperformance, not a lack of IC skill in identifying outperforming asset managers. In a world without investment consultants, pension trustees would still face AM fees if they wanted to access active management strategies, but without the benefit of the ICs' ability to identify high-performing products in the first place.

1.5 The evidence and emerging findings set out in the WP do not support an AEC finding in relation to ICs. The AM products recommendations process also needs to be seen in the context of the overall value-add clients receive. AM recommendations represent a small proportion of overall performance, with asset allocation being far more significant to client outcomes. The CMA must avoid the trap of giving too much weight to this one factor in its assessment of the IC market, simply because it is amenable to quantitative analysis.

1.6 At Mercer, AM product recommendations are one part of the way we serve clients. We are proud of a long track record of our top-rated products outperforming their relevant benchmarks:

(a) We invest in a global team of over 140 experienced researchers, maintain a proprietary Global Investment Management Database (GIMD), conduct over [✂] formal research meetings with AMs each year, and continually update the intellectual capital available to our investment consultants and clients (e.g. preparing over [✂] Research Notes each year on AM products). This breadth and depth of research supports our clients and investment consultants in decision making.

(b) We have measured and reported the performance of our top-rated product recommendations in the main asset classes (Equities, Fixed Income and Real Estate) for over 15 years. Our quarterly Value Added Reports are available to our clients, our investment consultants, and have been made available to the FCA and CMA. These reports set out our methodology and performance in a transparent and consistent way.

1.7 Our broad experience in measuring and transparently presenting results to clients informs our comments about the CMA's methodology and remedy questions in this WP. We consider that there are shortcomings in the methodological approach adopted by the CMA in its assessment of the eVestment dataset that risks understating the value added through this service by ICs and risks trustees making decision errors. In **section 2** of our response, we comment in detail on the following methodological areas that we consider of particular importance:

(a) We believe that performance gross of AM fees basis is a more relevant and reliable indicator for individual pension schemes than performance net of 'average' AM fees, where those 'average' AM fees do not reflect the fees the individual scheme could face.

(b) The CMA focuses on the 10 year time period Q1 2006 to Q4 2015, yet acknowledges that part of this period is distorted by the extreme system stress of the financial crisis. For the majority of the ten year period excluding the financial crisis, results are much more favourable than reported by the CMA in the WP.

(c) We do not consider that the CMA's testing of whether Buy-rated products perform better than 'Unrated' products is appropriate. It is not a reliable or practical test of performance, and it risks systematically understating the value added by ICs in a way that would be misleading for pension trustees. Should the CMA continue to pursue this approach, however, we consider that risk-adjusted returns should be evaluated to ensure a fair comparison.

(d) We agree that showing performance of IC's product recommendations at an asset class level is useful for trustees; however, value added should *only* be measured in product categories where there are investable, relevant and accepted benchmarks.

1.8 A **confidential annex** has been prepared by our advisers and submitted under separate cover to the CMA. The annex makes detailed submissions in relation to the points set out above, with specific reference to the underlying eVestment dataset and analysis conducted by the CMA. We are grateful to the CMA for offering greater transparency into its methodology and analysis through the confidentiality ring.

1.9 Finally, in **section 3** of the response we respond to the CMA's invitation to comment on the potential remedies set out on slide 53 of the WP.

2 The CMA's WP methodology and initial findings

2.1 The CMA's methodology in analysing the eVestment dataset has five key methodological features on which we wish to comment at this stage.[1] Each feature has a fundamental effect on the CMA's empirical findings.

2.2 We set out these five areas – and our concerns with each – in Table 1 below before turning to examine each in more detail. We examine each with a particular focus on the impact on pension trustee decision making.

2.3 We first, however, note that the CMA's emerging findings in the WP have some highly favourable conclusions on ICs' ability to add value. These findings must be given appropriate weight in the CMA's assessment of, and commentary on, the market.

Interpreting the emerging findings in the WP

2.4 The CMA analysed the AM product recommendations given by eight investment consultants that subscribe to the eVestment dataset. Mercer was not included in this analysis.

2.5 The CMA improved and corrected several features of the FCA's earlier analysis, and has found substantially more favourable results.[2]

2.6 The CMA's emerging findings are:

(a) Over the 10 years analysed, the ICs' Buy-rated products outperform their relevant benchmarks by **around 92 bps per annum** on average, before netting off AM fees.[3] This performance was statistically significant at a **99% level of confidence**.

(b) The outperformance on a gross basis of the Buy-rated products is even higher, on average, **at around 110 bps per annum** when looking at a four year period (2012-2015) that did not include the exceptional system stress of the financial crisis.[4] This performance was statistically significant at a **99% level of confidence**.

(c) During the same four years, the **Buy-rated products perform better than 'Unrated' products by 97 bps on a gross basis and 79 bps on a net basis**. Both results are statistically significant at a **99% level of confidence**.

2.7 These findings indicate that the ICs involved are able to identify AM products that reliably outperform their benchmarks from amongst the thousands of products available in the market.

2.8 The WP indicates that the CMA's key concern is that this outperformance is substantially absorbed by AM fees. The CMA's analysis suggests that AM fees are **around 79 bps per annum** on Buy-rated products.

2.9 The CMA's implied level of AM fees is too high in our view, and we consider this in detail at paragraphs 2.29 to 2.34 below. Irrespective of the assumed levels of AM fees (which will, of course, differ for individual pension schemes), it is the fees themselves that absorb the outperformance, not a lack of IC skill in identifying outperforming asset managers. In a world without investment consultants, pension trustees would still face AM fees if they wanted to

[1] In the Confidential Annex, our advisers have also provided a longer list of empirical issues identified in the data analysis disclosed in the Confidentiality Ring.

[2] Table 2 of the WP (slide 12), for example, shows the FCA's finding in its Final Report was that the ICs' highly-rated products outperformed their benchmarks on a gross basis by around 40 bps per annum. In contrast, the CMA's more comprehensive analysis finds outperformance of over 90 bps per annum on a gross basis. The outperformance is even higher when removing the distortive effects of the Financial Crisis.

[3] WP, slide 31.

[4] WP, slide 62.

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access active management strategies, but without the benefit of the ICs' ability to identify high-performing products in the first place.

2.10 Concerns about the levels and opacity of AM fees have already been identified by the FCA. The FCA and other relevant authorities are implementing remedies (e.g. MiFID II), and market forces are at the same time placing downward pressure on AM fees. These factors should, over time, help ensure that pension schemes retain more of the outperformance from the Buy-rated products identified by ICs.

2.11 The WP further acknowledges that investment consultants are already adding value to clients in helping achieve lower AM fees than they would otherwise face:

> "*Asset Managers told us that ICs are able to successfully negotiate discounts on clients' behalf, usually above the discount rates those clients could achieve individually*".[5]

2.12 ICs are, therefore, part of the solution to addressing high fees in the AM market. They are adding value to clients both in terms of lowering AM fees and in terms of identifying AM products that are more likely to outperform. Furthermore, the research and ratings processes by ICs also contribute value to clients in other ways, as recognised by the FCA, including reducing risk, reducing search costs and increasing choice.[6]

2.13 The AM products recommendations process also needs to be seen in the context of the overall value-add clients receive. The CMA accepts that there is evidence to suggest that asset manager recommendations represent a small proportion of overall performance. Asset allocation is far more significant to client outcomes. The CMA should avoid the trap of giving too much weight to this one factor, simply because it is amenable to quantitative analysis.

Comments on the analysis in the WP

2.14 We focus our comments at this stage on five key methodological features of the CMA's eVestment analysis that have a significant bearing on its emerging findings. We have summarised these in the table below, and discuss each in further detail in the following paragraphs. We also refer the CMA to the Confidential Annex submitted by our advisers.

[5] WP, slide 22. The innovation of fiduciary management solutions also delivers value to smaller pension schemes in achieving AM fee discounts they could not otherwise access.

[6] FCA's *Interim Report*, paragraph 8.59: "*It is important to note the benefits that clients can get out of this rating process. The due diligence done on the asset manager's business and systems and controls can reduce operational risk for the investor. It can reduce search costs and help investors streamline their selection process. Consultants' research on the universe of managers means that investors have a wider pool of managers to choose from, many of whom they may not have been aware of otherwise.*"

Table 1: Key methodological features of CMA analysis

Feature	Description	Mercer's View
i. The CMA places undue emphasis on performance 'net' of AM fees	The CMA notes that "*[f]or the purposes of this empirical exercise, we place more weight on the figures net of AM fees, as these are a better approximation of the return an IC client could expect to receive if it invested in a 'buy-rated' product*" (WP, slide 31). The 'average' implied asset manager fee across ICs and across active 'Buy-rated' products used by the CMA appears to be around 79 bps per annum (Table 4). No fees are mentioned in respect of the (passive) benchmarks used in the analysis.	We consider that performance gross of AM fees basis is a more relevant and reliable indicator for individual pension schemes. Calculating 'average' AM fees across products requires a complex methodology that would be difficult to maintain and is prone to errors. The average AM would not be representative to what the individual client would pay. Further, the CMA's adopted fee level appears high compared with our experience. It is also necessary to include the costs of investing in the passive benchmarks to achieve a fair comparison.
ii. The CMA focuses on the 10 year time period Q1 2006 to Q4 2015, yet acknowledges that part of this period is distorted by the extreme system stress of the financial crisis	The CMA conducted its analysis on the same 10 years of eVestment data as used by the FCA. The CMA chose not to collect new data for 2016 or 2017. It noted only that there was no evidence to believe that 2016 and 2017 were materially different in terms of IC ratings behaviour or performance. As a sensitivity analysis, the CMA, also conducted its analysis over the four years Q1 2012 to Q4 2015 "*to see if asset manager recommendations perform better outside of times of extreme 'system stress' (i.e. a number of years after the financial crisis of 2007-8)*" (WP, slide 62). The CMA finds that IC recommendations do indeed perform much better when excluding the period of extreme system stress.	We believe that the CMA should focus the analysis on the period of more normal market conditions (reflective of circumstances faced by trustees currently) and if necessary it should collect eVestment data for 2016 and 2017 to lengthen its sample period. We also find that for the majority of the 10 year period, the ICs achieved more favourable results than the CMA chooses to report or focus on – as shown in the Confidential Annex. Results from across the 10 year period are demonstrably <u>not</u> robust or representative if different results arise for significant subsets of that period.
iii. The CMA tests performance of Buy-rated products against 'Unrated' products	The CMA describes its test of Buy-rated product performance against their own relevant benchmarks as the "*baseline test*" (WP, slide 20). The CMA notes that: "*… this is the standard way in which the performance of asset management products is measured in the financial services industry.*" The CMA then goes on to test whether Buy-rated products perform better than 'Unrated' products to a statistically significant degree. This secondary test tends to reflect weaker results.	We support the CMA conducting and reporting the baseline test outcomes (on a gross of AM fees basis). We believe, however, that there are several reasons why statistical tests between Buy-rated products and Unrated products will be unreliable. These include data issues and biases in the Unrated products and issues with the statistical tests. We believe that these issues may lead to a systematic understatement of IC value added, which would be misleading to trustees. It would also be very costly for ICs to maintain a 'clean' dataset of Unrated products, with little added value to clients.
iv. The CMA presents results at an asset class level across several different asset classes	The CMA's analysis covers a broad range of different asset classes. Table 8 (WP, slide 57), for example, indicates that in the analysis approximately 69.8% are *Equity* products, 23.4% are *Fixed Income*, 4.1% are *Hedge Funds*, and 0.7% are *Alternatives*. As this comes to 97.9%, there are also other asset classes assessed but not be named in the WP (e.g. *Real Estate*).	We agree that showing performance of asset manager recommendations at an asset class level conveys useful information to trustees, and we indeed do this in our quarterly Value Added reports. We believe, however, that value added should be measured only in product categories where there are investable, relevant and accepted benchmarks. Absolute return and Hedge Fund product categories are particularly challenging in this regard, as often these products are benchmarked against cash only.

Feature	Description	Mercer's View
v. The CMA proposes risk-adjusting the returns as a future work stream	The CMA notes that it may, in subsequent work, explore incorporating risk into the analysis with measures such as the information ratio or Sharpe Ratio. It would, therefore, compute risk-adjusted returns.	We agree that the potential size of outperformance is not the only factor considered by trustees when assessing which products to invest in. Products with lower volatility, and so more predictable returns, are attractive as they lower risk. When we undertake AM product research and ratings, we take risk factors into account. We, for example, report the Information Ratio for products in our quarterly Value Added Report. We agree that risk-adjusted returns should be evaluated. It is particularly important if the CMA seeks to benchmark Buy-rated products against other Unrated products (although as noted above we do not believe this comparison will be robust).

(i) The CMA places undue emphasis on performance 'net' of AM fees

2.15 We consider that performance gross of AM fees basis is a more relevant and reliable measure for individual pension scheme decision making.

2.16 We explain below:

(a) how trustees may make decision errors by using a net of AM fees approach;

(b) the data issues in compiling an average AM fee that make a net of AM fees approach unreliable;

(c) the assumed level of AM fees used in the CMA's analysis; and

(d) the unintended consequences that could result from a net of AM fees approach.

2.17 As noted above, more detailed comments on the CMA's methodology for calculating AM fees are also included in the Confidential Annex.

How trustees may make decision errors by using a net of AM fees approach

2.18 When evaluating an IC, a pension scheme is interested in the IC's track record in recommending AM products to understand whether the IC has a reliable system in place to identify products that could be expected to outperform on a forward-looking basis. The track record helps illustrate to trustees whether or not the IC in question has the skill and capabilities to identify, on average, outperforming products in a specific AM product category, or whether the pension scheme would be better placed to: (a) pick the active management product itself; (b) ask for advice from another IC; or (c) avoid active management altogether and invest in the passive option (i.e. the benchmark). We believe that a performance track record on a gross of AM fees basis allows the pension scheme to make these decisions more reliably.

2.19 First, we note when considering the IC's track record, the pension trustees will know that:

(a) They will face AM fees irrespective of whether or not they pick the active product themselves or engage an IC to assist in the selection process. Indeed, involving an IC may actually result in them paying lower fees.[7]

(b) They will face fees in investing in the passive option (if a passive option is available in that product category). There will also be no outperformance opportunity when investing in the passive option (so funding growth relies more heavily on asset allocation).

2.20 What trustees may *not* know when considering an IC's track record is that the 'average' AM fee for a product / asset class may not be representative of the AM fees that their specific scheme could achieve in practice. This is because different clients pay different AM fees due to a variety of factors (e.g. scale of AUM, nature of the product, global relationship or negotiating ability). By relying on net of fees performance information, trustees may make a decision that is not appropriate for the specific circumstances of their scheme.

2.21 The CMA's initial results show that, on average, ICs exhibit skill in identifying products that outperform on a gross basis from amongst the thousands of products available. IC recommendations, therefore, improve the odds that the trustees will invest in an outperforming product. The pension trustees are placed in a better position than if they had picked the active product themselves, in which case they would also <u>still</u> face AM fees and the necessary search/due diligence costs.

2.22 Pension trustees, therefore, gain valuable information from the IC's track record on a gross of AM fee basis. It assists them to decide whether the IC's recommendation is likely to improve their odds of finding outperformance or whether to pick the product themselves.[8] The AM fees will be present in both cases, in effect 'netting off' in this decision between using the IC or not. Embedding an 'average' AM fee into the IC track record, not representative of that scheme's AM position, would actually confuse this decision for the trustees.

2.23 The CMA's initial results also show that certain active management products can, and do, deliver outperformance against their relevant benchmarks. Therefore, passive options are not appropriate for all pension schemes in all cases, particularly for those schemes that can achieve lower than 'average' AM fees from the outperforming AMs. Here again, the gross of AM fees basis is more relevant to the pension scheme than a track record embedding an 'average' AM fee that is not representative for that scheme. The pension trustees would be better served by seeing the performance on a gross of fees basis, and then netting off their own expected AM fee levels as required.[9]

2.24 We, therefore, believe that the track record on a gross of AM fee basis is more useful to an individual pension scheme in its decision making (and will reduce decision errors). It is also more reliable as a net of AM fee basis faces significant risks in data issues.

Data issues in compiling the 'average' AM fee make a net of AM fees approach unreliable

2.25 To construct a net of AM fees analysis for use by trustees, the IC would need to calculate representative fee levels across all products and product categories to be included in the analysis.

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7 The CMA's roundtable with asset managers found that: "*Asset managers considered that investment consultants were able to successfully negotiate discounts and are well-placed to do so … Asset managers believed that investment consultants have the potential to achieve better price reductions than institutional investors could do otherwise*."

8 Clearly, if the IC cannot demonstrate a track record of outperformance on a gross basis, then the trustee gains valuable insight.

9 There would also be an advantage for smaller schemes, who would themselves face higher AM fees (holding all else equal), as it would help them understand whether outperformance was possible if, for example, they used fiduciary management options to mitigate the AM fee levels.

2.26 No IC has perfect insight into 'actual' AM fees paid across all AM products, nor could they maintain this on an ongoing basis. At most, ICs might have some insight into the actual fees paid by their own existing clients and may be able to conduct periodic fee surveys. They could not observe actual AM fees paid by investors who are not their clients or for AM products that their clients do not regularly interact with. Smaller ICs in particular will have limited visibility, and may find it more difficult to compete.

2.27 This lack of visibility means performance reported on a net of AM fee basis will be unreliable as it will be subject to the assumptions made by individual ICs as to the appropriate fee levels to incorporate into their reported calculations.

2.28 The CMA's own analysis shows the significant challenges of calculating the average AM fee. Several assumptions were required to be made by the CMA (and the choice of these assumptions – e.g. in how the simple averages across vehicle types were used to determine a product's average fees – had a material impact on results) and incomplete fee information resulted in very large amounts of product data being dropped out of the analysis. This is discussed further in the Confidential Annex.

The assumed level of AM fees used in the CMA's analysis

2.29 The WP suggests the average AM fees are around 79 bps per annum for Buy-rated products. This appears high given that around 94% of the CMA's sample is in the *Equity* and *Fixed Income* asset classes. This level is significantly higher than our own experience of AM fees, or the 23 bps used by the FCA in its Final Report.

2.30 Critically, we also note that the CMA's analysis does not appear to assume any costs to the pension scheme of investing in the passive option (i.e. the benchmark). The passive option, if available, is likely to attract a management fee of its own. Therefore, if the CMA wishes to examine performance on a net of AM fee basis, it must include appropriate fees for each passive benchmark to ensure a fair comparison.

2.31 Our experience is that, for most institutional clients, passive options would tend to attract management fees of around [✂] depending on the product category.[10]

2.32 Table 2 below shows the results of a survey of Mercer UK client fees conducted in 2017. It calculated (unweighted) average fees paid across a range of *Equity* and *Fixed Income* product categories. The median clients paid around [✂] per annum for active Equity products and [✂] for passive products, resulting in an average differential around [✂]. Fixed Income products had lower fees, and for the median client the differential between active and passive would be around [✂].

2.33 We would therefore expect the CMA analysis of Buy-rated products versus their passive benchmark to have **a fee differential of less than** [✂]. This is much lower than the approximately 79 bps currently used in the CMA analysis.

[10] There is a broad range of passive fees which largely depend on the product category and universe. For example, emerging market equity passive can cost around [✂], while UK fixed income passive could cost around [✂] for larger clients.

Table 2: Survey of AM fees paid by Mercer UK clients, 2017

		Client count	25%	Median	75%
Equity	Active products	[✂]	[✂]	[✂]	[✂]
	Passive products	[✂]	[✂]	[✂]	[✂]
	Indicative Active v Passive difference		[✂]	[✂]	[✂]
Fixed Income	Active products	[✂]	[✂]	[✂]	[✂]
	Passive products	[✂]	[✂]	[✂]	[✂]
	Indicative Active v Passive difference		[✂]	[✂]	[✂]

2.34 We note also that the FCA used a 23 bps AM fee which it had directly observed as fees on segregated mandates from market evidence. The CMA, however, says that it "*considers that this approach risks misstating the fee discounts achieved by clients if those using segregated mandates are not representative of the broader client base for ICs*".[11]

(a) First, the logic of the CMA's concern about whether or not the fee will be representative illustrates the concern we have about any approach that applies an "average" AM fee that may not be representative to the pension trustee making a decision with the track record (see paragraphs 2.18 to 2.24 above).

(b) Second, based on the CMA's dataset, we consider that using segregated mandates is a representative approach. More detailed consideration of this point is included in the Confidential Annex.

The unintended consequences that could result from a net of AM fee basis

2.35 As noted above, applying a net of AM fees basis could result in decision errors for trustees. Furthermore, we have concerns that this approach could also result in the following unintended consequences:

(a) ICs may choose to rationalise the product categories in which they conduct research and ratings to only those that have very low AM fees so not to distort any 'average' AM fee that they have to include in their track records; and/or

(b) ICs that serve smaller clients may be disadvantaged, so distorting competition. Their clients may face higher AM fees - achieve smaller discounts - due to the fact they have lower levels of assets to invest. As a result, smaller ICs would appear to have worse asset manager recommendation performance than larger ICs as their 'average' AM fee is likely to be higher. It would seem misleading that smaller ICs performance may *appear* worse purely because of the composition of their existing client base, rather than their relative skill in identifying outperforming managers.

[11] WP, slide 22.

(ii) The CMA's analysis focusses on Q1 2006 to Q4 2015

2.36 The CMA acknowledges that its analysis focusses on a 10 year period that is affected by the extreme system stress of the financial crisis. Despite this negative distortion, the CMA's initial results show that the ICs were, on average, able to identify outperforming AM products across the ten years. The results were even more compelling when the CMA removed the period of extreme system stress and focussed on Q1 2012 to Q4 2015.

2.37 In the Confidential Annex, our advisers have used the CMA's methodology and data to show that the more favourable results visible in the sensitivity test, in fact, exist for the majority of the ten years. Therefore, the more favourable results are more representative of performance across the period, and particularly when the known distortion of 2007/08 is removed.

2.38 Despite this, the CMA places more weight on the Q1 2006 to Q4 2015 period, saying: (i) it is "*more robust*"; and (ii) "*more representative of the time horizon over which an IC client would likely invest*".[12]

2.39 In response to these comments we note:

(a) The CMA does not explain on what basis the 10 year period is considered to be "*more robust*". It may be that there are more observations for the statistical testing in a 10 year period than a four year period. However, when the 10 year period has a known exceptional disturbance – not reflective of market conditions that pension trustees face today – it is less clear that the larger (but more disrupted) dataset necessarily has greater statistical power.

As shown in the Confidential Annex, the period of more favourable results covers the majority of quarters in the 10 year period. Therefore, the 10 year results are demonstrably less robust because they are driven by a minority of exceptional negative quarters in 2007/08.

(b) The CMA suggests that a 10 year horizon is "*more representative*" than a four year horizon in terms of IC client investment decisions. We agree that pension schemes should have longer term journey-plans that guide investment decision making. However, we also see clients re-evaluating their investment allocations, asset management products, and, indeed, investment consultant relationships more frequently than every 10 years. They will typically re-evaluate their investment strategy at least every three years to coincide with the triennial revaluation of the scheme liabilities.

(c) If the CMA wishes to lengthen the period of the analysis, it could do so by (i) requesting the additional two years of data (i.e. 2016 and 2017) from eVestment,[13] or (ii) narrowing the period of data excluded because of the financial crisis. This would allow the CMA an assessment period of eight or more years.

2.40 In our view, neither reason provided by the CMA supports placing less weight on the more representative period excluding the financial crisis, which shows more favourable results.

(iii) The CMA tests performance of Buy-rated products against 'Unrated' products

2.41 We support the view that, as a baseline test, an IC must be able to demonstrate a track record of, on average, its Buy-rated products outperforming their relevant benchmarks on a gross of AM fees basis. However, we do not believe that the secondary test applied by the CMA – a

12 WP, slide 62.

13 It would be inappropriate to order remedies if more recent data is readily available, and is likely to present a more favourable picture.

comparison between Buy-rated products and Unrated products (on either a gross or net basis) – is reliable or practical.

2.42 We explain below:

(a) The biases and errors in 'Unrated' performance returns. These returns are less likely to be reliable and may exhibit a systematic upward bias in performance returns. These factors make it more difficult to identify, from a statistical perspective, a difference in performance between Buy-rated and Unrated products, even when Buy-rated products are in fact more appropriate for pension clients.

(b) Why the statistical testing techniques themselves may fail to reliably detect differences in performance between these two ratings groups, particularly when conducted for individual ICs or individual asset classes.

The biases and errors in 'Unrated' performance returns

2.43 There are various reasons why the Unrated category's performance may be biased upwards and therefore not be an appropriate benchmark for Buy-rated products.

2.44 There is the risk that incomplete reporting or reporting errors in the Unrated category would bias results:

(a) We carefully monitor the performance of our 'A'-rated products to ensure records are complete and, where necessary, anomalies in performance reported by AMs are queried. The CMA will have seen, however, that there are tens of thousands of Unrated products available globally (given that it is open to all AMs to list their products on GIMD) and it is not possible for any IC to police the performance reporting of these thousands of products to the same degree. [✂].

(b) The CMA recognises that "*the performance of products in the eVestment database may appear to be strong when compared to that of products in a hypothetical database which is 'perfect' in that it covers every product which has existed at some point in time and has completely accurate performance data on those products*", and further that *"[t]o the extent this is the case, the performance of sell-rated products is likely overstated, meaning it is less likely that we would find 'buy-rated' products to outperform 'sell-rated' products"*[14]. This bias can affect all rating categories but will likely particularly affect the 'Unrated' category. If a product exists that has realistic prospects of being included in Mercer's recommended list, it is highly likely the AM will register it on GIMD (which is open to all AMs free of charge). It is less likely that products of lower quality (and so more likely to remain Unrated) have the same incentive.

2.45 There are also risks of more fundamental differences between the products in the Buy-rated and Unrated categories that make them weaker comparators for each other.

2.46 The Unrated category, in our experience, is more likely to comprise products with lower AUM and with shorter average lifespans. [✂].[15]

2.47 For example, a small boutique AM may choose to employ an investment strategy to exploit niche market imperfections (e.g. in illiquid asset classes). If the fund becomes too large in terms of AUM, it may no longer be able to execute this investment strategy successfully. The capacity constraints embedded in its strategy would be identified in our research and ratings,

14 WP, slide 32.
15 [✂].

and the product may not be included in the recommended list because it is not a viable investment solution for our clients.[16]

2.48 The smaller scale of many products in the Unrated category means that they may achieve higher, but often more volatile, performance. Many studies have found that smaller AUM funds can achieve higher performance than average, but that as AUM rises so constraints to investment strategy arise and less risk is taken.[17] Yet these smaller funds may not be viable investment solutions for larger pension clients.

2.49 If these smaller funds were not viable investment solutions for the ICs' clients, then they should not be included in the benchmark.[18] At a minimum, the CMA would need to risk-adjust the returns to account for the higher volatility of returns (and shorter lifespans) of products in the Unrated category.

Why the statistical testing techniques may fail to reliably detect differences between Buy-rated and Unrated products

2.50 There are also risks in the tool used to determine whether Buy-rated products perform better than Unrated products. The CMA applies a t-test to determine whether the mean of the Buy-rated products is different to the mean of the Unrated products. The null hypothesis is that the population means of the two groups are the same (i.e. there is zero difference), with the analysis testing whether this null hypothesis can be rejected with particular level of confidence (i.e. there is a difference evident between the sample means).

2.51 T-tests are vulnerable to Type II errors.[19] As the 'statistical power' of the test decreases so the chances of Type II errors increase. All else being equal, the statistical power of t-tests tends to decrease: if sample sizes become smaller; if the effect size between the means narrows (even if it is, in fact, non-zero); or, if the means come from different underlying distributions. These factors would make the test less likely to find a difference between the Buy-rated products and Unrated products, even if a difference was in fact present (i.e. the test would 'miss' the difference).

2.52 It is clear that data samples are small for certain asset classes and individual ICs (and certain ICs have shorter track records). Significant amounts of performance data is also dropped as part of the CMA's 'net' of AM fee analysis. The small amount of data decreases the viability of individual ICs using these tests on an ongoing basis.

2.53 Even for the 'pooled' analyses across ICs and across asset classes, we believe there are features and biases within the Unrated group that make the products within it a poor comparator for Buy-rated products. Upward biases in the Unrated performance data would increase the risks of Type II errors and differences in underlying features of the products in the two groups must be controlled (e.g. through risk-adjusting returns).

2.54 There are, therefore, several reasons why t-tests are less reliable (have lower statistical power) in these circumstances and may lead to errors in decision making by trustees (whereby the trustees incorrectly discount IC recommendations even when Buy-rated products are, in fact, superior for their investment needs). We do not believe this type of secondary test could be a viable part of any remedy / industry standard in this area, and may in fact be misleading to pension schemes about the value added of ICs.

16 Resource and governance constraints faced by trustees tend to prevent them from maintaining small investments in a large number of separate AM products.

17 See an overview of recent literature by Novus Research, "How AUM Growth Inhibits Performance", May 2014.

18 As the CMA analysis does not involve AUM weighting of funds, the high performance of a fund too small to be a viable investment vehicle for a pension scheme client will carry the same weight as a larger fund.

19 A Type II error (a False Negative) occurs when the null hypothesis is, in fact, false but the analysis of the sample data does not reject the null.

iv) The CMA presents results at an asset class level across several different asset classes

2.55 We agree that showing performance of AM recommendations at an asset class level conveys useful information to trustees. Indeed, we report our own value-added at more segmented levels (which we refer to as 'universes').[20] This more granular segmentation allows our investment consultants to explain to clients the universes where outperformance may be possible, but also the universes where prospects of outperformance are weaker and so passive options may be superior.[21]

2.56 Notwithstanding this, there are product categories where we do not believe that value added (in terms of outperformance) can be appropriately measured. Value added should be measured only in product categories where there are investable, relevant and accepted benchmarks. Absolute return and Hedge Fund product categories are particularly challenging in this regard, as often these products are benchmarked against cash only.

2.57 Our research objectives in these asset classes focus on allowing clients to diversify away from equity and fixed income markets. [✂].

v) The CMA proposes risk-adjusting the returns as a future work stream

2.1 As discussed above, we do not believe the CMA will get reliable results when testing performance between Buy-rated products and 'Unrated' products. However, should the CMA continue to apply this comparison in its analyses going-forward, we agree that the CMA must risk-adjust returns between the rating categories. We would advocate applying risk adjustments using the information ratio and the Sharpe Ratio.

2.2 The CMA's trustee survey clearly showed that managing risk is very important to trustees.[22] We account for risk factors in our ratings of products and in how we recommend products to clients:

(a) Clients and our consultants can access various risk metrics – including information ratios and Sharpe Ratios – on asset manager products using *MercerInsight* (Mercer's proprietary software). The risk metrics are used to inform and explain in greater detail our product recommendations.

(b) Metrics of risk/volatility on a particular product are reported in our manager selection Research Reports made available to clients.[23]

(c) Information ratios are reported for our A-rated products in our quarterly Value Added Reports. It is our experience that our A-rated products exhibit lower volatility in performance than our unrated products.

[20] For example, Mercer reports value added in [✂] separate Equity universes in our quarterly Value Reports.
[21] For example, [✂].
[22] The CMA survey found "*Reducing / Managing Risk*" and "*General due diligence*" were amongst the most important factors raised by trustees in relation to IC services (see Figure 3.13 on page 51 of the IFF report).
[23] For example, see the Research Report submitted in response to Question 81 of the Market Request.

3 Comments on CMA remedy questions

3.1 We support more transparency in how ICs perform in recommending AM products and the research coverage they offer clients.

3.2 We respond in this section to the six CMA questions on slide 53 of the Working Paper. In general, we consider that it is too early to discuss the design and proportionality of specific remedies in any detail, but we have set out below initial observations on any potential remedies contemplated in relation to asset manager product recommendations.

3.3 We first note three important points.

i) No AEC has been found

3.4 No AEC has been identified in investment consultancy, so any comments below are preliminary and we reserve the right to make fuller submissions in due course.

3.5 The evidence and emerging findings set out in the WP do not support an AEC in the specific area of asset manager product recommendations. The WP finds that many ICs successfully identify asset manager products that, on average, outperform their relevant benchmarks on a gross of AM fees basis. These ICs are improving the prospects of pension trustees finding 'winners' amongst the thousands of active asset management products available. Further, the due diligence processes that ICs undertake in forming their 'Buy'-lists have positive benefits in terms of lowering trustees' search costs and driving up the standards of asset managers wishing to serve institutional clients.

3.6 Indeed, what the WP evidence shows is that high fees in the adjacent AM market are absorbing much of the outperformance that ICs are helping clients identify. Several initiatives are already underway to reduce AM fees,[24] and as these take effect so the value added by ICs from asset manager product recommendations will grow. Therefore, we expect that any concerns that the CMA has in this area will dissipate.

ii) Any proposed remedy must be practical and proportionate

3.7 First, as we and other ICs have noted, AM product recommendations are a relatively small part of what drives funding growth and risk reduction for pension schemes. It is not, and should not be, the primary basis on which pension schemes select their IC.[25] Accordingly, the incremental gains to competition in the IC market from improving comparability of IC manager recommendation performance will likely be relatively small.

3.8 Second, any remedy must improve how trustees make decisions about ICs in practice. In this context, we consider that any remedies should help trustees understand: (i) whether or not an IC has a reliable track record of identifying AM products that outperform their relevant benchmarks (i.e. passes the CMA's 'baseline' test); (ii) what breadth of research coverage the IC offers; and, (iii) the potential merits of active management in different asset classes.

3.9 However, if a trustee is then assessing two ICs that have both passed the baseline test, it is highly unlikely that a trustee could go on further to differentiate the relative performance between these two ICs in any meaningful way. There would be significant challenges to

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[24] For example, there is increasing transparency on AM fees through the initiatives arising from the FCA market study and the implementation of MiFID II.

[25] Indeed, the CMA's survey found that "*trustee boards are far more concerned about bringing in expertise (85%) than they are about increasing investment returns (49%)*." (page 14 of IFF Research Report).

determining that one IC is better than the other to a statistically significant extent.[26] Trustees would require significant amounts of data and analytical horsepower to make meaningful comparisons.

3.10 It is, therefore, important to be realistic about how much additional empirical comparison could be done to differentiate ICs in terms of asset manager product recommendations, beyond assessing whether or not the IC passes the baseline test.

3.11 Third, if an enforced remedy in this service area had burdensome costs, particularly on smaller ICs, there could be adverse effects on the research coverage and advice offered by ICs. Such ICs may step back from offering these services, or rationalise significantly the asset classes or products in which they undertake research and ratings. This would leave trustees worse off. It could also create a barrier to expansion for smaller ICs.[27]

iii) Developments have affected the basis for the UIL offered to the FCA

3.12 Mercer, Aon and WTW suggested a more standardised approach to presenting information on the performance of asset manager product recommendations as part of a package of undertakings in lieu (UIL) of a market investigation reference put forward to the FCA.[28]

3.13 The UILs were made in circumstances where the parties involved in providing the data had not been consulted on the FCA's manager recommendations analysis (Mercer, for example, was not able to see how the FCA had treated Mercer's data in an eVestment analysis, where Mercer does not subscribe to or use eVestment) and there had not been any discussions on the effective and proportionate design of any remedy.

3.14 Various factors have changed since the end of the FCA market study such that this previous UIL proposal for asset manager product recommendations is no longer, in our view, an appropriate or proportionate measure. We recognise that, were the CMA to find an AEC in this area (which, to be clear, we do not believe the evidence in the WP supports), further thought and consultation would be required before an effective and proportionate standard to benefit trustees, and which could be implemented by all ICs,[29] could be designed.

3.15 [✂]. The analysis and results have changed materially since the FCA stage, with the CMA finding a substantially more favourable pattern of results.

3.16 Second, the CMA has offered greater transparency into its analysis through a Confidentiality Ring that has allowed our advisors to understand the challenges and complexities that the CMA has faced in undertaking its eVestment analysis. The precise details of these data concerns are covered in the Confidential Annex but as overall themes our advisors have recognised:

(a) there are a significant number of data issues and assumptions required to determine the AM fees when reporting performance 'net' of AM fees. The challenges with identifying representative 'average' AM fees - to apply across ICs - mean that we no longer believe a 'net' of AM fees reporting basis will work effectively or be proportionate;[30] and

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26 Trustees would not have the data to do this and, even if they did, it is highly unlikely that any meaningful statistical tests could be done (e.g. given sample size and compositional differences between the two ICs).

27 We note, for example, the response by Punter Southall to the first working paper in which they said that "Suggesting that trustees are able to request performance data in what format they wish may create a barrier for smaller Advisers who do not have the sophisticated IT systems to be able to efficiently supply this data".

28 See Mercer's submission to the FCA of 20 February 2017.

29 The WP notes at least 10 ICs involved in making product recommendations. The CMA's Trustee Survey indicated a far wider set of firms involved in providing IC services, many of which will also likely be making product recommendations.

30 For example, very large amounts of performance data had to be dropped because of missing fee data. The WP (slide 22) acknowledges that "*We acknowledge that the data used to compute these discount rates may not be fully representative. We do not have discount data for smaller clients, and due to returns containing missing or poorly*

(b) there are substantial differences in research coverage by the different ICs, which introduces challenges to carry out meaningful empirical comparisons being made between IC performance track records. This creates complexity in the design of any standard that could work effectively for all ICs in the industry and that would be practical and proportionate to administer.

3.17 We now turn to each of the CMA's questions on the design of any potential remedies as set out on slide 53 of the Working Paper.

Question 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?

3.18 We often provide evidence to trustees during tenders on the track record of our top-rated asset manager products in the key product categories of Equities, Fixed Income and Real Estate. Clients, including prospective clients, can also access the quarterly Value Added Reports that provide a clear explanation of our measurement methodology and track record.

3.19 We believe, therefore, that it is fairly easy for trustees to understand Mercer's ratings track record. We do not, however, see what information is submitted by other ICs in these tender processes, so we cannot comment meaningfully on the ease of comparison across ICs.

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

3.20 We believe that presenting performance on a gross of AM fees basis is more meaningful for individual pension schemes. There would also, in our view, be significant risks to enforcing a reporting standard on a net of AM fees basis.

3.21 From the perspective of individual pension schemes, reporting on a net of fees basis would require ICs to make an assumption on the 'average' (or median) AM fees actually paid by clients for the products involved (i.e. after AM discounts off rack rates).

3.22 These 'average' AM fees may, however, be a poor reflection of the AM fees that the individual scheme could itself achieve in practice. Schemes with smaller AUM may, for example, not be able to access the 'average' fee levels. Larger schemes may be able to access better than average fees. Further, the estimated 'averages' themselves may be distorted by various factors – as set out below and in the Confidential Annex.

3.23 Trustees would be exposed to the risk of decision errors if the performance reporting was premised on 'average' AM fees that were not realistic for their scheme. The pension scheme would be better served by seeing the performance on a gross of fees basis – which can be compared across asset classes and geographies – and then netting off their own expected AM fee levels as required.

3.24 There are also several risks in a net of AM fees reporting standard:

(a) Most ICs, in particular smaller ones, would not have sufficient reliable and up-to-date information on actual AM fees paid, particularly in asset classes / products in which they have few (or no) clients at the time, to give robust 'average' AM fee estimates across all product categories. This creates the risk of unreliable AM fees being used in the calculation of individual IC track records.

populated fields, we had to drop many records." In the Confidential Annex, our advisors provide more detailed analysis of what proportions of data are dropped at each stage and where this introduces biases into the comparisons.

(b) As the CMA has itself seen in the construction of AM fee estimates for its eVestment analysis, there were various challenges in the fees data that resulted in many assumptions being required to arrive at 'average' AM fees to include in the analysis. Very large amounts of product performance data had to be dropped due to incomplete or inconsistent AM fee data. Different ICs have differing degrees of product coverage which affects implied 'average' rack rate fee levels.[31] Separate data on average discounts was needed to bring rack rates closer to what clients may actually have paid. Any net of fees reporting standard would need to arrive at an agreed methodology for computing AM fees that was comparable and implementable across all ICs, and sufficiently flexible to evolve with changing AM fee structures and asset classes. This would create significant risk of complexity.

(c) ICs that serve smaller clients (with lower AUM) may face higher AM fees (lower achieved discounts), and so, all else being equal, appear to have worse asset manager recommendation performance than larger ICs, purely because of the composition of their existing client base rather than their relative skill in identifying outperforming managers. A net of AM fees basis would risk creating a barrier to their expansion in this service area.

3.25 In our view, therefore, it would <u>not</u> be reliable or practical for reporting to be done on a net of AM fees basis. If the CMA required reporting on a net of fees basis, this would impose significant additional requirements and costs on ICs, eVestment, and Mercer's Global Investment Manager Database (GIMD) to collect, maintain and compute appropriate adjustments for AM fees.

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

3.26 We support further transparency and comparability across ICs in the presentation of the impact of asset manager product recommendations.

3.27 We also, however, see some risks that increasing comparability may trade off some of the comprehensiveness, relevance and usefulness of the information given to trustees. We would have significant concerns if standardisation of presenting track records led to a reduction in innovation in research/ratings processes, research coverage, or the relevance of results to pension schemes.

3.28 We have, for example, noted above that seeking comparable reporting on a net of AM fees basis may in fact introduce risk in relation to: (i) how individual schemes make decisions on products (thereby reducing the relevance and usefulness of results); and (ii) how ICs collect, maintain and compute average AM fees to include in the reporting. ICs may choose to reduce the comprehensiveness of research coverage simply to avoid making ratings in higher AM fee asset classes, which would leave trustees worse off.

3.29 We believe that our current reporting approach is relevant and useful to trustee decision making. For example, in our experience, trustees value seeing:

(a) performance in different product categories (a narrower segmentation than asset class[32]). At the asset allocation stage, trustees must identify product categories that can generate the required level of growth while offering diversification. Trustees then need to assess whether to pursue active management options in a chosen product category or whether

[31] For example, Hedge Fund products tend to have higher AM fees than Fixed Income products. This means that ICs that make recommendations in the Hedge Fund area would have higher 'average' fees implied in their performance calculations than an IC that focussed only on Fixed Income recommendations. This compositional effect would need to be taken into account in any reporting standard.

[32] Mercer segments the Equities asset class into over [✂] product categories (or Universes) that are more meaningful to clients making asset allocation decisions. [✂].

an investible, passive alternative is available and appropriate. It is therefore useful to see Mercer's track record in identifying outperformance-generating products in the chosen product category;

(b) the breadth of research coverage in terms of the number of asset classes/markets/geographies in which the IC has undertaken due diligence and formed a view on top-rated products; and

(c) the rate of turnover of top-rated products within different categories. As trustees are making investment decisions that will hopefully span many years,[33] such information should help in identifying suitable categories for active management, and strong individual performers for the long term.

3.30 We believe these types of factors increase the relevance and usefulness of the information presented to trustees, and should be considered in any standard.

3.31 We recognise, however, that a key challenge to creating a comparable standard will be fairly reflecting this relevant information where many smaller ICs will have narrower research coverage, smaller samples and less developed track records.

3.32 Finally, we also note a further challenge to comparability is that not all ICs subscribe to eVestment. We have, for example, innovated and invested in developing a proprietary database that gives our clients deeper insight into asset manager products. We would have concerns if any proposed measurement or reporting methodology unfairly penalised ICs that had not subscribed to eVestment.

Question 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?

3.33 We believe that care should be taken before mandating any 'common methodology'. There could be significant unintended negative consequences if a common methodology is incorrectly specified, ossifies IC research and ratings processes, or forces ICs to withdraw from offering a service (or level of research coverage) that clients value.

3.34 We would support greater comparability in how performance is "presented" to trustees – for example, ICs presenting their track records on whether their top-rated managers outperform their relevant benchmarks (on a gross of AM fees basis) in a standard format. Therefore a common methodology on how results are presented could be valuable to trustees.

3.35 We would not support (i) a common methodology in how underlying research or ratings is done by ICs, or (ii) a common methodology on presenting results that had the unintended effect of weakening the ability of ICs to compete or innovate in manager research.

3.36 First, we invest in a global team of over 140 experienced researchers, maintain a proprietary Global Investment Management Database (GIMD), conduct over [✂] formal research meetings each year, and continually update our intellectual capital available to our consultants and clients (e.g. preparing over [✂] Research Notes each year). We believe we research and rate a greater number of products and product categories than other ICs, which gives our clients greater choice and deeper insight.

3.37 Any mandated common methodology in how underlying research and ratings was done by ICs would weaken our value proposition to clients. Most ICs do not have the capabilities or scale to

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33 Trustees face resource constraints and transaction costs that mean they cannot frequently churn their AM products.

offer comparable research coverage to our own, which means that a common methodology would likely reduce our coverage (and that of the other larger ICs).

3.38 Second, while we believe a common methodology on 'presenting' the IC performance track record to trustees could be designed, it would need to be done with care. It would need to avoid a situation where ICs are incentivised to rationalise their research and ratings processes in an effort to cherry-pick only those product categories that had highest alpha-generating potential and so gave them the most favourable results according to the common methodology. ICs may be discouraged from undertaking research and making recommendations in complex product categories, which are precisely the product categories where trustees may need support.

3.39 We also acknowledge that there will be challenges in drawing up a common methodology, implementable for all ICs making product recommendations, on how results are presented to trustees. Different ICs have different sample sizes, lengths of track record, and research focus. Many ICs would not have sufficient sample size to undertake any meaningful statistical testing in their reporting. Therefore, significant thought and consultation will be needed in designing a standard.

Question 5. Should any claim in relation to the impact of a firm's recommendations be subject to external benchmarking or scrutiny …

3.40 We are open to our recommendations track record being 'scrutinised' on a periodic basis by a qualified external party provided that commercially sensitive information is protected. We stand by the robustness of our research, ratings and reporting processes. For over 15 years, we have published quarterly Value Added Reports that have allowed our clients and regulators to scrutinise our track record in asset manager product recommendations.

3.41 If this external scrutiny could give additional comfort to trustees – perhaps through a '*Kitemark*' of some form – on the robustness and integrity of our claimed performance, then this would be welcome. We would, however, need to better understand the mandate and likely costs of this external party scrutiny, should this be taken forward as a potential option, before commenting further.

3.42 External 'benchmarking' is more challenging to do reliably across the ICs. The CMA has itself seen that different ICs maintain different levels of research coverage, depth of rating processes and breadth of 'buy' lists. The CMA could not include several ICs (including Mercer) in its eVestment analysis because of challenges of different data and approaches. Any external 'benchmarking' across ICs would, therefore, face challenges.

… and should this be assessed against a common methodology for presenting impact?

3.43 We are open to ICs presenting in a common format their track records on whether their top-rated managers outperform their relevant benchmarks; however, as noted above, a common methodology on presenting results could have negative effects on research coverage and innovation. Therefore, we would need to better understand what common methodology the CMA was proposing before commenting on whether this should be used as a basis for external scrutiny or benchmarking.

Question 6. How should any change in presentation be implemented and enforced?

3.44 In our view, it is too early to respond to this question. No AEC has been identified. Furthermore, no specific 'change in presentation' has been proposed or designed. Therefore, it is too early to comment on implementation or enforcement processes.