CMA WORKING PAPER ON ASSET MANAGER PRODUCT RECOMMENDATIONS

RESPONSE FROM AON

INTRODUCTION AND SUMMARY

Aon welcomes the opportunity to respond to the CMA's Working Paper on investment consultants' asset manager product recommendations dated 22 March 2018 ("**WP**").

In this response we make submissions (based on analysis by RBB Economics conducted on its behalf using data released to Aon's professional advisors within a confidentiality ring) on several key areas, each of which are addressed in further detail below.

- **The CMA's analysis is based on an unrepresentative and biased sample, meaning that it cannot provide a basis for the CMA to draw meaningful conclusions in its WP.** The CMA's analysis omits around 74% of funds available to UK investors recorded by eVestment and around 80% of Aon rated funds. Further, the CMA's analysis does not include funds rated by Mercer, one of the largest ICs. This unrepresentative approach causes bias and does not provide a sound basis for drawing inferences about the degree to which Aon's IC services (or those of other ICs) provide value for money.
- **We have further significant concerns about the CMA's analysis due to numerous errors the CMA has made when preparing its data set**. These errors compound the unrepresentative and biased sample and thereby undermine yet further the grounds on which the CMA is assessing value for money in relation to the quality of IC services. Full details are provided below and at the ***Annex***.
- **The CMA's analysis, when corrected, in fact indicates that Aon buy rated funds, net of AM fees, outperform their respective benchmarks on average by around [✂] basis points (bps) per annum.**[1] This would equate to c.[✂] per annum based on the current level of Aon client investment in Aon buy rated funds. This benefit is many times IC/FM provider fee charges even before taking account of the value added from areas such as asset allocation, fee negotiation, risk management and implementation. **Aon's buy rated funds therefore provide substantial value for investors.**
- **Our research and due diligence checks are critical to ensuring our clients receive value for money**. This process is important. It means we provide each client with access to a professionally vetted pool of funds that are constantly monitored for their ability to deliver return and, importantly, manage risk. We improve performance among asset managers as a whole, whether buy rated or not.
- **The CMA's analysis gives no consideration to what might happen if consultants did not vet managers or encourage higher standards of performance.** By not doing so, the CMA is not able to assess fully the substantial investor benefits that IC and FM providers deliver (even if one ignores that the CMA's analysis, when adjusted where possible to address bias and errors, indicates that our recommendations do add substantial value).
- **Aon supports common standards to facilitate the comparability of IC and FM provider recommendations.** We emphasise, however, that the fact that information is presented differently does not reflect an absence of effective competition. Not all trustees have the same needs, values

[1] It has not been possible to correct for all errors and data omissions. While we firmly believe that our buy rated funds deliver value net of AM fees, the data set provided by the CMA does not permit us to calculate a precise figure based on a comprehensive assessment of all Aon buy rated funds.

or investment objectives and it is important that IC and FM providers have the ability to provide bespoke solutions to each client. The most effective approach to agreeing common standards for the presentation of asset manager data is likely to be an industry-led initiative.

The remainder of this response is set out as follows:

- Part A provides a summary of our critique of the CMA's empirical analysis of asset manager recommendations. This is supported by the Confidential Annex: "CMA WORKING PAPER ON ASSET MANAGER PRODUCT RECOMMENDATIONS, Response from Aon: Annex A" prepared by RBB Economics, 23 April 2018.
- Part B provides our response to the CMA's remedy proposals.

PART A

AON'S CRITIQUE OF THE CMA'S EMPIRICAL APPROACH

1. PART A: INTRODUCTION

1.1 This section provides our critique of the CMA's empirical approach to assessing manager recommendations. We address the following points in turn.

1.1.1 *First*, we explain that the CMA's sample is biased and not representative.

1.1.2 *Second,* we set out a number of errors made by the CMA which cast considerable doubt on the CMA's conclusions.

1.1.3 *Third*, correcting for a number of factors to improve the coverage of the sample and address CMA errors leads to the conclusion that Aon buy rated funds outperform their respective benchmarks on a net of AM fees basis by around [✂] bps per annum. This result is statistically significant.

1.1.4 *Fourth,* we explain that even if the CMA were to ignore our findings that Aon delivers substantial investment outperformance for its investors, it has not taken into account a number of fundamental features which indicate that IC and FM providers deliver substantial investor value overall:

(a) Investors have differentiated needs and, importantly, asset managers are not picked purely to deliver returns relative to a benchmark. This is principally for four reasons: (i) the manager is chosen to manage risk relative to a benchmark, e.g. LDI; (ii) the manager is chosen to gain exposure to an asset which cannot be managed passively without exposure to other risks, e.g. property or infrastructure; (iii) the manager offers returns which cannot be easily replicated passively, which includes asset classes which do not have an easily investable benchmark such as private equity and hedge funds, but also those where passive strategies systematically underperform a typical active manager benchmark such as high yield;[2] or (iv) the manager's primary goal is to deliver either better risk-adjusted returns by seeking equity-like returns with lower volatility than equity or income (equity returns with higher dividend income). Performance against these goals will not be identified by considering returns alone, as one would expect these to be similar to benchmark. The CMA's approach is biased as it does not exclude these strategies whose objectives are not focused primarily on returns.

(b) Due diligence processes improve performance among AMs as a whole, whether buy rated or not.

(c) The CMA focuses its analysis on outcomes net of AM fees.[3] We highlight that any alleged failure by ICs to generate better outcomes net of AM fees must, at least in part, be a result of *AMs* having a strong negotiating position vis-à-vis IC and FM providers. While that may suggest weak competition

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2 See the Annex for further explanation.

3 Slide 31, WP.

among AMs, it should not be viewed as a sign of weak competition among IC and FM providers.

2. THE CMA'S SAMPLE IS BIASED AND NOT REPRESENTATIVE

2.1 The sample of funds used in the CMA's analysis is biased and not representative for the following reasons.

2.2 *First*, the CMA sample represents a small subset of both the universe of funds and of Aon's rated funds. Specifically, the CMA's original analysis omits around 74% of funds available to UK investors recorded by eVestment and approx. 80% of Aon rated funds. Further, the CMA's analysis does not include funds rated by Mercer, one of the largest ICs.[4] This narrow focus causes bias and calls into question the CMA's overall results: the CMA's sample does not provide a sound basis for drawing inferences about the degree to which Aon's IC services (or those of other ICs) provide value for money. It should also be noted that eVestment only covers a small and self-selected subset of the market.

2.3 *Second*, a key reason for the poor coverage of the CMA sample is its approach to backfill. While we acknowledge that it is important to control for backfill, there are three separate aspects to our concern:

2.3.1 In order to control for backfill bias the CMA excludes *entirely* from its analysis all funds that have any period of backfill, unless the fund's inception date was before 2007. It is unclear why the CMA opted to use this approach when all ICs' submissions state that only the periods prior to being added to eVestment suffer from a backfill bias.[5] If the concern is that a fund will not be added to the eVestment database unless it has a good track record of beating its benchmark then it makes sense to exclude the period *prior* to the fund being added. However, once added to the database there is no reason to expect bias to arise and, therefore, no sound reason to exclude the fund.

2.3.2 The CMA's approach to the backfill bias has the unintended effect of removing the vast majority of products that were incepted since 2007, approximately 88%.[6] The only products which remain in the CMA's analysis with an inception date after 2007 are those which are listed on eVestment in the same quarter as their inception.

2.3.3 Further, it is important to note that the eVestment database did not become the preferred database until around 2012.[7] Therefore it is likely that managers would not have prioritised the uploading of data to eVestment before this date.[8] Put another way, failure to register funds with eVestment would not reflect backfill bias but rather that eVestment was not the database of choice. This would be a reason not to be concerned about backfill bias (in some cases) even prior to the product being added to eVestment.

2.4 These factors provide strong support for the view that funds should be included in the CMA sample from the date at which they were listed with eVestment. Failure to do so means using a

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4 Slide 14, WP.

5 Slide 15, WP.

6 This figure does not include products without inception date information, which accounts for 15% of the total eVestment sample.

7 See Aon's comments accompanying its response to Question 87 of the CMA's market information request, submitted January 8th 2018.

8 Indeed, the number of products added to the CMA's eVestment database was c.6,000 in 2009, c.12,000 in 2010, c.4,000 in 2011 and 2012, and c.3,000 or fewer from 2013 onwards.

sample that is not representative.[9] Indeed, correcting for the CMA's approach to backfill increases the number of products included in the sample substantially.[10]

2.5 *Third*, as explained above, the CMA omits around 80% of Aon rated funds in its final analysis dataset. [11]

2.6 *Fourth*, the CMA has omitted a large number of fixed income strategies as the benchmarks are not listed in its version of the eVestment database (i.e. the version it has shared with our advisors on the confidential hard disk) even though the strategies have well known market benchmarks, which are included in Aon's version of the eVestment database. Examples include: JPM EMBI Global, JPM EMBI Global Diversified, Libor 3 month, JPM GBI unhedged, JPM GBI – EM Broad Diversified Unhedged, JPM GBI – EM Global Diversified Unhedged. In addition, there are a number of well-known market benchmarks that are not currently listed in eVestment (such as BofAML Sterling non gilts). This causes the CMA's analysis to be non-representative and may significantly further bias the analysis.

2.7 *Fifth*, the CMA has omitted a large number of UK fixed income strategies as they could not be mapped to its dataset even though they exist in Aon's version of the eVestment database. It is not clear why the CMA does not have access to these strategies.

3. ERRORS IN THE CMA'S ANALYSIS AND APPROACH

3.1 In addition to the poor and unrepresentative coverage that we have explained above, the CMA's analysis and approach in processing the data contains a number of significant errors. We provide some illustrative examples below, but set out a fuller, more comprehensive explanation in the ***Annex***.

3.2 *First,* the CMA does not properly consider eVestment's asset manager fee information, resulting in the understatement of gross returns and the omission of products from the analysis. We believe that some of the net return information used by the CMA in its analysis is provided by managers to eVestment by subtracting each fund's <u>highest</u> fee reported by eVestment from its gross return.[12] The CMA converts these net returns back to gross by adding each fund's <u>average</u> fee. The gross return on these funds is therefore understated by an amount equal to the difference between each fund's average and maximum fees.

3.3 *Second*, the CMA does not always categorise Aon rated funds correctly. Explanations of how the CMA should treat Aon's ratings data are set out in detail in the ***Annex***.

3.4 *Third*, the CMA states the following: "*We found that 4.1% of 'buy-rated' product/quarter combinations appear in the worst performing 5% of product quarter combinations. This undermines, to some extent, the assertion that ICs are unlikely to assign 'Buy' ratings to 'very' poorly performing products*."[13] However, the CMA's statement is not correct. A basic principle is that higher return comes with higher risk. As such, any unconstrained strategy (i.e. a strategy that pays little attention to the benchmark but focuses on higher returns) is likely to entail greater risk and so feature in the worst 5% of strategies over a quarterly time horizon at some point in

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9 If the CMA is to retain its approach to excluding all funds entirely when they have some period of backfill then Aon considers that the analysis should cover only 2011/2012 to 2015 so as to avoid skewing the sample towards unrepresentative funds.

10 Specifically, the number of products included for at least one quarter increases from c.12,000 to c.16,000, i.e. an increase of approximately 35%.

11 This is because the CMA used information on USD fees only. The CMA should have included information on GBP fees where available and USD fees only where GBP fees were not available.

12 The highest fee corresponds to the institutional fee that relates to the smallest mandate size provided by eVestment, typically 10 million GBP or USD.

13 Slide 29, WP.

time. The analysis is therefore misleading: to score highly on the CMA proposed metric would require recommending closet trackers (i.e. active funds that are little different from passive funds but typically with higher fees, and have been severely criticised by the FCA).

4. AON BUY RATED FUNDS OUTPERFORM THEIR RESPECTIVE BENCHMARKS NET OF AM FEES ONCE CMA DATA OMISSIONS AND ERRORS ARE ADDRESSED

4.1 Aon's advisors have been able to correct for a number of factors to improve the coverage of the sample and to address the CMA errors. So doing leads to the conclusion that Aon buy rated funds outperform their respective benchmarks on a net of AM fees basis by [✂] bps per annum. This finding is statistically significant.

4.2 This would equate to c.£ [✂] per annum based on the current level of Aon client investment in Aon buy rated funds. This benefit is many times IC/FM provider fee charges even before taking account of the value added from areas such as asset allocation, fee negotiation, risk management, efficient and implementation.[14] On this basis, we refute in the strongest terms any suggestion that we fail to deliver value for our clients.

4.3 We further find that Aon buy rated funds outperform unrated funds on a net of AM fees basis by [✂] bps per annum (again this finding is statistically significant). However, we place far greater weight on the first outcome – we do not consider a comparison with unrated funds to be meaningful.[15] Further details are provided in the ***Annex***.

5. THE CMA'S ANALYSIS IS FLAWED BY NOT TAKING INTO ACCOUNT A NUMBER OF FUNDAMENTAL FEATURES WHICH INDICATE THAT IC AND FM PROVIDERS DELIVER SUBSTANTIAL INVESTOR VALUE

5.1 As explained above, correcting for CMA data omissions (but otherwise retaining the CMA's approach) leads to the conclusion that Aon buy rated funds do deliver substantial value on a net of AM fees basis. Aon therefore disagrees with the CMA's view that buy rated funds do not deliver statistically significant outperformance of their respective benchmarks on a net of AM fees basis. However, even if the CMA were to estimate that ICs as a whole do not outperform their benchmarks on a net of fees basis, the inference cannot be drawn that IC and FM providers fail to add substantial value on a broader basis.

5.2 *First*, investors are differentiated and not all of them seek returns to outperform market returns.[16] For an acceptable return (which may be *below* the benchmark) investors may have objectives such as minimising relative or absolute risk. For example, a scheme which is already fully-funded would tend to look for managers that take low risk positions, thus sacrificing returns in order to protect the scheme's existing funding level. Some funds are buy rated because they

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14 Calculated by applying [✂] bps per annum to Aon's active buy rated equity, fixed income and hedge fund product AUM, as of 30 June 2017. Value is relative to earning returns on a par with the respective benchmarks.

15 Fund managers identify specific benchmarks against which their performance should be judged, taking into account the specific strategy they adopt (return seeking, risk minimisation, etc.). In contrast, unrated funds are a somewhat amorphous group of products that may include strategies very different from those pursued by the fund in question. As a comparator, therefore, they are arbitrary.

16 This is supported, inter alia, by the findings of Leeds University Business School which concluded: "*In looking at fund management, trustees are focused on risk-adjusted performance. Moreover, they have a longer term view with respect to investment performance and reviewing mandates. This is again consistent with the view that trustees focus on strategy first. Moreover, trustees are regularly reviewing both their investment strategy and their investment managers.*" http://www.aon.com/unitedkingdom/attachments/aon_hewitt/Selecting-Fund-Managers-And-Consultants-June-2017.pdf

serve such needs of such investors, meaning that the CMA's approach is biased because it does not exclude strategies whose objectives are not focused primarily on returns.[17]

5.3 This is supported by the CMA trustee survey (**the Trustee Survey)** which identifies the features of IC services considered "very important" by trustee boards, noting that increasing investment returns (49%) is only *fifth* on the list behind reducing/managing risk (72%) in third place.[18] Likewise, features of FM services considered "very important" by trustee boards are reducing risk (72%) is in second place above increasing returns (54%), again ranking low down in fifth place.[19]

5.4 *Second*, the process of manager rating is important. We conduct substantial research and carry out due diligence checks before assigning (and reviewing) a buy rating. This process adds substantial value. It means we provide each client with access to a professionally vetted pool of funds that are constantly monitored for ability to deliver return and, importantly, manage risk. These checks are important in incentivising asset managers to adopt processes that better protect investors and in protecting investors from taking on risk (i.e. investing in funds with poor operational controls or processes) for which they are not compensated. In turn, we believe that this improves performance among AMs as a whole, whether buy rated or not.

5.5 The value of such due diligence would, in principle, be measured by: (i) investors avoiding funds that fail for non-performance related reasons; and (ii) preventing the latter funds existing. The first reason should be observable in returns although this would not necessarily materialise on a quarter by quarter basis; the second is not observable. In short, the fundamental value generated by due diligence is not captured by the CMA's approach.

5.6 *Third*, we highlight that to the extent that the CMA considers that performance across the market, as a whole (net of AM fees) should be better, the 'problem' must, at least in part, arise from *AMs* having a strong negotiating position vis-à-vis IC and FM providers. In other words, while this issue may suggest weak competition among AMs, it should not be viewed as a sign of weak competition among IC and FM providers:

5.6.1 It would be inappropriate to infer that IC and FM providers should have negotiated harder on behalf of their clients because there is no incentive for them to negotiate weakly. Indeed, Aon has provided the CMA with details on discounts it has secured for its clients and how the discounts off rack rates secured are substantial [✂]. Based on the data submitted to the CMA, Aon negotiates an average asset manager fee that is [✂]% lower than the relevant rack rates.[20]

5.6.2 The FCA has previously found weak price competition between AMs and is currently implementing remedies to increase transparency of fees in order to facilitate greater

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17 For example, in the equity universe, examples include those strategies that are focussed on lower volatility (such as Analytic Global Low Volatility) or income (such as Epoch Global Equity Shareholder Yield) or better risk-adjusted absolute returns (such as Wellington Total Return Intersection). In the fixed income space, a number of our recommendations (such as MacKay-Shields High Yield) in the High Yield space are biased towards strategies that focus on better risk-adjusted returns primarily.

18 Figure 3.13.

19 Figure 3.14.

20 Aon calculations based on "*Client Data Template 4 (investment product statistics) Jan 2018.xlsx*" submitted to the CMA on January 26th 2018.

competition.[21] Such remedies are by implication part of the solution to any alleged failure of buy rated funds to outperform their benchmarks net of AM fees.[22]

5.6.3 The CMA's survey results add support to the view that the issue lies more with AM fees than IC or FM provider performance. In relation to both IC and FM services, trustee boards appear to find it straightforward to monitor the overall investment performance of their scheme and the scheme's AMs, with over 90% finding it very or fairly easy. However, their ability to monitor *AM fees*, while still high, is less effective.[23]

5.7 *Fourth*, we emphasise that an assessment of the extent to which buy rated funds outperform their benchmarks does not capture the quality and breadth of service offered by IC and FM providers. The range of services provided is borne out by the Trustee Survey. This indicates that trustee boards purchase more than five services on average from their IC and FM providers.[24] Manager ratings, while important, are not the most critical aspect of the advice provided by ICs. Asset allocation is more important and is estimated to account for c.90% of the value created.[25]

5.8 In summary, any inferences drawn on fund manager ratings must be considered in a wider context and in light of other evidence on competition:

5.8.1 Aon demonstrably delivers value to its investors, net of AM fees, as explained above.

5.8.2 We operate in a highly competitive marketplace which drives quality, customer service and value. As the Trustee Survey identifies, the market structure in relation to the provision of IC and FM services is far from concentrated, with Aon accounting only for a small share of schemes in that survey.[26]

5.8.3 The Trustee Survey also found high satisfaction rates among trustee boards: 95% of trustee boards are very or fairly satisfied with their main IC provider and 95% are very or fairly satisfied with their main FM provider.[27]

21 Paragraphs 1.9 and 1.10 of the FCA's Asset Management Market Study Final Report.

22 Section 2 of the FCA's Asset Management Market Study Final Report.

23 In relation to IC services: 94% of trustee boards say that they find it very easy or fairly easy to monitor the overall investment performance of their scheme; 91% of trustee boards say they find it very easy or easy to monitor the investment performance of the scheme's asset managers; and 74% of trustee boards say they find it very easy or easy to monitor the fees they pay third parties (e.g. asset managers). In relation to FM services: 92% of trustee boards say they find it very easy or fairly easy to monitor the performance of their scheme or investments; 66% of trustee boards say they find it very easy or easy to monitor the fees they pay third parties (e.g. asset managers) in the case of trustee boards using ICs. (Working paper: information on fees and quality, slides 20, 21, 42 and 43.)

24 Paragraph 3.31. The Trustee Survey found that whilst 88% of trustee boards purchase asset manager selection services from their IC provider(s), several other services were also commonly purchased: strategic asset allocation (91%); reporting and operational service (79%); advice on setting scheme objectives (79%); monitoring de-risking strategy (74%); designing liability hedging (62%); and dynamic asset allocation (61%). The survey also found that whilst 79% of trustee boards delegated asset manager selection services to their FM provider, several other services were also commonly delegated: reporting and operational services (84%); dynamic asset allocation (77%); implementing de-risking strategy (76%); strategic asset allocation (74%); designing liability hedging (69%); and setting scheme objectives (45%).

25 See, for example, paragraph 3 of "*Summary of hearing with Aon Hewitt Limited (Aon) held on 22 November 2017*".

26 Trustee Survey, Figure 3.2 and Figure 3.5.

27 Trustee Survey, Tables 3.8 and 3.9.

PART B

RESPONSE TO CMA QUESTIONS ON POSSIBLE REMEDIES

1. PART B: INTRODUCTION

1.1 We emphasise that the CMA has not established any basis for an AEC in this WP for the reasons set out above. The CMA states that "*we have found firms present information on the potential or actual impact of their asset manager product recommendations in different formats and using different terminology. If we were to find that this is a feature that constitutes an AEC we would need to consider potential ways to address this, for example by improving this information*".[28]

1.2 We consider that presenting information in different ways cannot, in itself, be an AEC. Clients differ in their objectives and in the way that they wish to consume information. The fact that information is presented differently does not reflect an absence of effective competition. Moreover, it is important to recognise that a degree of variety in the way that this information is presented is pro-competitive. Not all trustees have the same needs, values or investment objectives and it is important that IC and FM providers have the ability to provide bespoke solutions to each client. For example, a presentation of past returns will provide insufficient information on its own. Many clients will want to be able to access information on whether an IC or FM has an effective process in place that generates their returns. A standardised approach may damage innovation and reduce trustee choice.

1.3 Nonetheless we acknowledge that a greater degree of comparability of performance across the industry would benefit investors. Our views on the questions posed by the CMA are set out in the table below.

[28] Slide 53, WP.

TABLE 1

AON COMMENTS ON CMA POTENTIAL REMEDIES

Question posed by CMA	**Aon Response**
Are trustees easily able to compare claims regarding the impact of asset manager product recommendations made by different firms during a tender, for instance?	Based on our experience, trustees are generally sophisticated. Nonetheless, we consider that common standards would facilitate comparison as set out further below.
Would trustees benefit most from information on returns achieved by recommended asset manager products on a gross or net basis?	Information is useful both in terms of gross and net fees. This would permit investors, inter alia, to assess whether it would be better to switch fund (e.g. due to poor gross of fees performance) or to seek greater discounts from AMs (e.g. due to strong gross of fees performance but weak net of fees performance).
How could the presentation of the impact of asset manager product recommendations be made more comparable, comprehensive, relevant and useful?	We believe that we already provide comprehensive, relevant and useful information to clients. We consider that common standards would make product recommendations more comparable. UIL 2 offered by Aon, Mercer and WTW provided a reasonable framework for such a standard.[29] We have already adopted this standard in relation to performance measures published on our website. However, whilst it is important that trustees receive clear and comparable information regarding past returns, it is also important that they receive sufficient information to understand the process generating such returns.
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?	The main question that we foresee in seeking to develop a common methodology is whether these are developed and imposed by a regulator, or whether they are developed by the industry. The difficulty that may arise with a regulator-developed standard is that this may not reflect important nuances of approach in the market. Our view is therefore that any common methodology needs to be developed by operators in the market to capture the necessary technical issues and also to be sufficiently flexible to capture changing requirements. If a top-down approach is used, there is a risk that this becomes a tick-box exercise with information produced according to the common methodology not being as useful to customers as it should be. Any standard developed could potentially be accredited by a body such

[29] See "*Proposed undertakings in lieu of a market investigation reference given by the FCA by each of Aon Hewitt, Mercer and Willis Towers Watson*" dated 20 February 2017.

	as the CFA (Chartered Financial Analyst) Institute, for example as part of their Global Investment Professional Standards ("GIPS").
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?	We would be content for a firm's recommendations to be scrutinised by an external, independent reviewer.
How should any change in presentation be implemented and enforced?	Changes of presentation will need to be implemented in publicly-available information. This can be supported by a marketing literature campaign at the time of this implementation to make very clear to customers how the information that they will receive from their IC or FM provider going forward will change. We support enforcement of any requirements by way of an extension of the FCA's regulatory perimeter.