Response to the CMA Provisional Decision Report

In this paper we provide both an overview and our response to some of the specific questions posed by the CMA in their provisional decision report following the investment consultants market investigation.

Overview

IC Select welcomes both the report and comprehensive investigation undertaken by the CMA. We believe the report and the process of discussion with the industry has changed attitudes towards transparency for the better by both investment consultants and fiduciary managers. The remedies proposed will help to ensure that as the process moves forward from here, these transparency gains are not lost. However, we feel more needs to be done to improve investment governance decisions taken by trustees.

Investment advice

Our experience and academic research tell us that good governance generally results in higher returns for pension schemes [Reference: Urwin Clark and other papers]. Under the Pensions Act 1995 trustees need to take advice for investment decisions, however small, such as investing 5% of their assets in a passive investment product. However, the suggested remedies, do not have a similar requirement to take advice for major decisions, such as delegating 100% of the management of a pension scheme's assets to a fiduciary manager.

We accept that from the CMA's perspective, only holding a tender process would address the competition issues identified. However, the unintended consequence of this will be that the standard of governance required of trustees to appoint a fiduciary manager for all the assets of a scheme will be less than the Pensions Act 1995 requires for the appointing of a fund manager to manage part of the assets. This makes no sense when considered in the context of the trustees' responsibilities to the members of their scheme and ensuring that appropriate governance is applied to all decisions.

In addition, the Pension Regulator encourages trustees to receive investment training and to take appropriate advice when overseeing their investments. Good governance demands that a Section 36 advice letter should be issued to support either decision. The alternative to this anomaly would be to repeal the 1995 Act and not require trustees to take advice when investment decisions are being made.

Definition of fiduciary management

The definition of fiduciary management used in the provisional decision report we believe includes funds that should not be included and yet fails to include approaches to fiduciary management that should be included.

The current definition of investment consultancy and fiduciary management shown in the Glossary of the Appendix of the report are:

> *Investment consultancy services means the provision of a service to institutional investors where the provider advises the investor in relation to the investors' investment strategy in the United Kingdom. This service may include, but is not limited to, advice on strategic asset allocation, fund/manager selection, advice on whether fiduciary management services are appropriate for the investor, and advice to employers in the United Kingdom.*

Fiduciary management services means the provision of a service to institutional investors where the provider makes and executes decisions for the investor based on the investor's investment strategy in the United Kingdom. This service may include responsibility for all or some of the investor's assets. This service may include, but is not limited to, responsibility for asset allocation and fund/manager selection.

We find it is extremely difficult to arrive at a precise definition of these services that does not exclude competitor services or include what we believe are unintended services.

Since the start of the CMA investigation we have seen a significant growth in 'implemented consulting' a hybrid between advisory consulting and fiduciary management. We believe this has happened as investment consultants can benefit from higher fees associated with implemented advice whilst avoiding any restrictions imposed by the CMA review or subsequent legislation. In implemented consulting, the consultant carries out all changes to the portfolio including changes to asset allocation and the hiring and firing of asset managers based on either pre-agreed guidelines (as with fiduciary management) or with a power veto exercised by the trustees. The power of veto is typically based on providing the trustees with 24 hours notice of changes to the assets. Depending on the arrangement, the trustee have to typically notify the consultant in writing if they do not want the change made, or formally confirm in writing within 24 hours that the change should be made. Legally the decisions are still made by the trustee, so it is seen as an advisory relationship, although effectively the decisions are delegated to the consultant.

Implemented consulting is also now being offered by some investment consultants that are not fiduciary mangers. Indeed, we have heard, that where these firms are being retained to run a tender exercise for a fiduciary manager, they are using this as an opportunity to sell their own implemented consulting service to the client.

Consequently, we believe the definition of fiduciary management needs to be extended to include implemented consulting to ensure the effectiveness of the proposed remedies.

The definition of fiduciary management, in our opinion, includes a range of asset management products that clearly should not be there, such as diversified growth funds, alternative funds and even global equity and bond funds. This is perhaps not surprising, since partial fiduciary management appeared to be little more than a marketing label that avoided the investment consultants having to compete with asset manager products when selling specific asset funds. Finding a definition that achieves the focus the CMA are seeking whilst excluding true asset management products will consequently be difficult.

Oversight

The report focuses upon the importance of competitive tendering when selecting a fiduciary manager for the first time to counter the conflicts posed by clients using their existing adviser. However, the importance of proper oversight to investment arrangements, whether in an advisory or fiduciary management approach, is largely ignored. Investments are one of the most complex areas facing trustee boards and so monitoring investment arrangements seems vital to ensure trustees are getting value for money.

High level performance information is most valuable

Providing information on a consultants or fiduciary manager's ability to add value from manager selection will detract trustees from focusing on the key areas of added value from strategic advice. Numerous academic studies have shown that manager selection is of significantly less importance than strategic decisions to the long term returns of a pension fund. We therefore believe that the key measure for reporting added value should be the total return net of all fees relative to a liability benchmark. Manager selection will be one component of this return, however, it will also include strategic and tactical asset allocation decisions and represent the total advice of the investment consultant firm.

Besides these high level points we also respond to the questions asked in the report around the remedies and highlight areas where we believe more needs to be done.

Remedy 1 – Mandatory competitive tendering on first adoption of fiduciary management

Box 1: Consultation questions for <u>mandatory tendering on first appointment</u>.

Questions

• *Should trustees be required to hold a competitive tender process when first choosing fiduciary management?*

- Yes, this is a significant decision, as trustees are generally delegating management of 100% of assets to one firm. Furthermore, any subsequent retendering of the fiduciary services should be subject to the same requirement.
- Mandatory tendering is a necessary but not sufficient way of dealing with conflicts of interest that arise when an investment consultant offers fiduciary management to existing clients. This enshrines the best practice followed by many trustee boards who recognise the value that can be gained from a competitive tender process. However, the quality of a tender will be dependent on the quality of the people running it. For trustees that have never had a fiduciary manager before it is unrealistic to expect them to understand all the issues they need to consider for an appropriate selection exercise without advice.
- Best practice would suggest that trustees get written advice from an independent third party organisation, so that they can demonstrate appropriate due diligence and process, whenever they appoint a new a fiduciary manager or adviser. We accept that from the CMA's perspective, only holding a tender process would address the competition issues identified. However, the unintended consequence of this will be that the standard of governance required of trustees to appoint a fiduciary manager for all the assets of a scheme will be less than the Pensions Act 1995 requires for the appointing of a fund manager to manage part of the assets. This makes no sense when considered in the context of the trustees' responsibilities to the members of their scheme and ensuring that appropriate governance is applied to all decisions.
- Therefore, receiving written advice, analogous to the section 36 letter trustees require when they appoint any other fund manager, should be required in addition to the requirement to run a tender process.

• *Should the tender process be open? In what circumstances would a closed tender process be an effective alternative and how should we define the minimum standard for a tender process?*

- We do not believe a tender process needs to be open (i.e. publicly advertised so that all potential providers can participate). However, trustees need to have access to consistent information on all potential fiduciary management providers to select a shortlist of preferred providers that meet their requirement for their search.
- Closed tender processes significantly reduce both the time required and the cost for trustee boards and also for providers in responding to tenders and therefore should always be the preferred option. The minimum standard for a closed tender should be

- that all providers have been considered in arriving at the firms included on the short list
- At least three firms are included on the shortlist and invited to provide client specific written tenders. In our experience, it often becomes clear at an early stage that one provider is inappropriate for the requirement and is removed from the process. If there are only two firms on the shortlist this then leaves trustees with no alternative.
- At least three firms should be invited to present their proposal to the trustees at a selection meeting or site visit.
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• *Should there be a minimum threshold either for size of schemes or scope or scale of the mandate?*

- This should be aligned with the Pension Act 1995 which requires all schemes classified as institutional investors to comply with the requirements of the Act.

• *Should trustees be required to hold an additional tender process for any expansion in the scope of fiduciary management?*

- If the initial tender process was only for a part of the assets, then an additional tender process should be held for a significant expansion in scope (e.g. changing to full fiduciary management)
- Voluntary, oversight and demonstration of good governance to support expansion in scope of mandate will generally be sufficient for non-material changes in the scope of the mandate.

• *How should trustee compliance be monitored?*

- Trustees should be required to report in writing to members and the TPR that a robust governance process has been followed and what that process entailed.

Box 2: Consultation questions on <u>mandatory tendering for existing fiduciary management mandates</u>

Questions:

• *Should trustees be required to hold a competitive tender process if they did not previously do so?*

- There should not be a requirement for a competitive tender process where trustees can demonstrate that proper independent oversight of the arrangement has taken place, particularly in areas of performance, fees and quality of advice. We share the frustration of many in the industry that proper selection processes were not completed at some schemes before changing to fiduciary management. However, given the strong performance of assets in recent years, many of these schemes are currently outperforming their objectives and therefore would be unlikely to change provider even if a tender process were held. A tender process under such circumstances would therefore increase costs for both the pension schemes and providers with no realistic prospect of a change.

• *Should the nature of the competitive tender process be the same as for those schemes adopting fiduciary management for the first time (eg should this be an open or closed tender process)?*

- Trustees may wish to follow this route but should be free to decide a governance approach that is proportionate and stands up to scrutiny.

• *What should be the qualifying criteria of a previous competitive tender process, such that trustees are not required to hold an additional tender process?*

- If it was decided to mandate an additional tender process then qualifying criteria for the previous tender should be either:
  a) At least three firms being invited to complete a written tender document and present to trustees.
  b) Independent advice being provided in writing prior to the selection that the provider was appropriate for the needs of the scheme.
  c) Completion of a subsequent independent oversight exercise, particularly in areas of performance, fees and quality of advice

Remedy 4 – Requirement on firms to report disaggregated fiduciary management fees to existing customers

Box 4: Consultation questions for fiduciary managers reporting disaggregated fees to existing customers

Questions:

• *Should fiduciary management firms be required to provide disaggregated fee information and how should they do this?*

- Firms should be required to provide disaggregated fee information. This should include information on the cost of strategic advice and investment implementation as separate items

• *Should asset manager fee information be based on the IDWG templates?*

- Information should be consistent with the IDWG templates

• *What should the frequency of reporting such fee information to customers be?*

- Annually

Remedy 5 – Minimum requirements on firms for fee disclosure when selling fiduciary management

Box 5: Consultation questions for fiduciary managers reporting disaggregated fees to new customers

Questions:

• *Should firms be required to provide a fee breakdown to prospective customers?*

- Firms should be required to provide a fee breakdown to prospective customers.
- Trustees will need to be aware that the fee quotes will not be comparable between fiduciary managers since the total fees will depend on the asset assumptions used by each fiduciary manager.
- For example, consider two fiduciary managers. Manager A has a fiduciary management fee of 0.16% and the cost for matching assets are 0.20% and for growth assets 0.45%.. By

contrast manager B has a fiduciary management fee of 0.15% with the cost for matching assets at 0.18% and for growth assets 0.42%. It would appear that manager B has the lower cost in all respects.

If we look at the actual costs these two managers might provide a prospect seeking a return of liabilities plus 2% then the return assumptions of the two managers become important. Let us assume that manager A, assumes that the return on their growth fund will be cash + 6% and that manager B expects growth assets to return cash + 4%. (This is within the differences between managers assumptions).

Manager A would invest 33% in growth and the balance in matching producing a total cost of 0.44% (33%x0.45+66%x0.2+100%x0.16), whereas manager B would have to invest 50% in growth and the balance in matching producing a total cost of 0.45%.

After the two managers had created a portfolio for the prospect based on their return assumptions the more expensive manager is now cheaper! Unless a methodology can be found to adjust for return assumptions, templates could lead trustees to the wrong conclusions.

Remedy 6 – Standardised methodology and template for reporting past performance of fiduciary management services to prospective clients

Box 6: Design questions for fiduciary management performance reporting

- See our joint response with the CFA Institute

Remedy 7 – Duty on trustees to set their investment consultants strategic objectives

Box 7: Consultation questions for setting strategic objectives for investment consultants

Questions:

• *Should pension trustees be responsible for setting objectives for their investment consultant?*

- We fully support the call for trustees to set clear objectives when hiring an investment consultant. In our discussions with consultants to improve demand side challenge we have addressed this by requiring consistent reporting of performance as the returns net of all fees relative to a liability benchmark. Standardising performance, and costs, in this way will help trustees better understand whether they are receiving value for money from their investment adviser.

• *Is review and agreement of objectives every three years a suitable timeframe?*

- Yes, three years ties in with triennial actuarial and SIP review

• *Should there be a minimum threshold based on pension scheme size or the scale of the consultancy contract?*

- This should be aligned with the Pension Act 1995 which requires all schemes classified as institutional investors to comply with the requirements of the Act.

• *When do you consider that the formal review of an investment consultant against the scheme's strategic objectives should take place?*

- As a minimum every three years, however, performance should ideally monitored on an annual basis

Remedy 8 – Establish basic standards for how investment consultants and fiduciary managers' report performance of recommended asset management 'products' and 'funds'.

- Providing information on a consultants or fiduciary manager's ability to add value from manager selection will detract trustees from focusing on the key areas of added value from strategic advice. Numerous academic studies have shown that manager selection is of significantly less importance than strategic decisions to the long term returns of a pension fund. We therefore believe that the key measure for reporting added value should be the total return net of all fees relative to a liability benchmark. Manager selection will be one component of this return, however, it will also include strategic and tactical asset allocation decisions and represent the total advice of the investment consultant firm.
- Furthermore, the recent paper by Cookson, Jenkinson, Jones and Martinez "Investment Consultants' Claims About Their Own Performance: What Lies Beneath?" has shown that

    > "*investment consultants market their services by claiming that their fund manager recommendations add significant value. Using detailed data from the leading investment consultants we find no such evidence. A forensic analysis of consultants' disclosures reveals a number of practices that explain their claims: comparisons to benchmarks rather than to peers, inclusion of simulated and backfilled returns, use of rating survivorship conditions (survivorship bias), and unexplained exclusions of products from the analysis. We find that recommended products have similar return and risk characteristics to products that are not recommended, but deviate less from their benchmarks.*"

- Consequently, we believe that consultants and fiduciary managers should be discouraged from providing any information on their manager selection capability unless:
    a) they can also show their added value from strategic advice and
    b) they can control for all the effects identified in the Cookson, Jenkinson, Jones and Martinez paper

Recommendation A) Extension of FCA regulatory perimeter

Box 9: Consultation questions on extension of the regulatory perimeter

Questions:

• *Should the FCA regulatory perimeter be extended and what activities should be included?*

- The FCA regulatory perimeter should be extended to include all activities undertaken by investment consultants and fiduciary managers. It should also include any firm offering selection and oversight of fiduciary managers and investment consultants.

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