RESPONSE TO PROVISIONAL DECISION REPORT

ANNEX 2: COMMENTS ON REMEDY 8

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

1 The objective of this proposed remedy is to allow trustees to "*assess and compare historical performance of recommended asset management products*". The CMA proposes to implement the remedy by Order and for it to come into force six months after the Order being made.

2 The CMA asked for views on four questions. In this Annex, we give our detailed views on these issues. We focus particularly on whether the proposed remedy is likely to be effective and proportionate.

3 We welcome greater transparency and comparability of investment consultants' asset management (**AM**) product recommendations. The CMA's own detailed analysis shows that:

(a) ["];

(b) ["]; and

(c) ["].

4 We, therefore, have strong incentives to achieve greater comparability and transparency across IC performance to illustrate to clients our strong capability in this service area. However, as we explain below, there are also practical challenges, risks, and potentially significant financial costs associated with this proposed remedy.

5 The CMA must demonstrate that the remedy would be proportionate - and the PDR is silent on the extent of customer detriment that this proposed remedy is targeted to address. Quantifying the detriment caused by any AEC in relation to AM product recommendations is a necessary first step.

6 As will be explained below, as a very conservative estimate, implementing this remedy would have direct costs to Mercer of **over** ["] **in present value terms**. There would also be costs faced by many other parties.

Relevant context to assessing the remedy

7 As context, we set out some factors important to assessing the effectiveness and proportionality of the remedy.

The CMA's own experience

8 The PDR sets out evidence on the CMA's detailed work assessing the performance of six ICs subscribed to eVestment and Mercer's performance by reference to our own proprietary database (**GIMD**). This was a large and challenging piece of work, and the CMA will know first-hand the extent of inherent data issues, the diversity of approaches by ICs to making recommendations, and the spectrum of views on the appropriate measurement approaches to apply. Building consensus and a workable empirical approach (given data limitations and some ICs' small sample sizes) going forward would be challenging.

9 The CMA's analysis found that several ICs successfully identify asset manager products that, on average, outperform their relevant benchmarks on a gross of AM fees basis. This is

welcome evidence of ICs improving the prospects of pension trustees finding 'winners' amongst the thousands of active AM products available.[1]

10 However, the evidence was more mixed on a 'net of AM fees' basis.

11 Sample sizes were forced to be much smaller, as substantial amounts of track-record information had to be omitted (principally due to incomplete AM fee information in eVestment). The CMA's eVestment analyses was based on less than 30% of the original track record data available and only small subsets of the ICs' original lists of highly-rated products. Equity and Fixed Income products took a disproportionate share in the final analyses. It is clear also that many smaller ICs simply could not be included in the analyses at all.

12 The CMA's evidence showed that high fees in the adjacent AM market were absorbing much of the outperformance that ICs were helping trustees to identify. The CMA's analysis ended at 2015, however. Several initiatives are already underway to reduce AM fees,[2] and as these take effect so the value added by ICs from AM product recommendations will likely grow.

13 The PDR does not estimate the quantum of customer detriment said to be caused by the proposed AEC in this service area, nor how this detriment may evolve (and likely fall) over time given the actions being taken to address AM fees directly.

High-level benefits and risks of the remedy

14 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. Accordingly, the incremental gains to competition in the IC market from improving comparability of IC AM product recommendation performance would likely be relatively small.

15 We believe that any remedy 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) the breadth of research coverage the IC offers; and (iii) the potential merits of active management in different asset classes.

16 It is unrealistic, however, to believe that the remedy could meaningfully go beyond the baseline to help trustees choose between two successful ICs (i.e. two ICs that have both passed the baseline test). There would be significant challenges to determining that one IC is better than the other to a statistically significant extent.[3] Trustees would require significant amounts of data and analytical horsepower to make these further comparisons reliably. Therefore, careful thought would need to be given to how trustees should be advised to use the track-records in decision making.

17 Finally, if a mandatory remedy in this service area had burdensome costs, particularly for smaller ICs, there could be adverse effects on the research coverage and advice offered by ICs. ICs may step back from offering these services, or rationalise significantly the asset

1 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 AMs wishing to serve institutional clients.

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

3 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).

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.

a) Should basic standards apply to the reporting of recommended asset management ‘products’ and ‘funds’?

18 Yes – we agree in principle that ICs and FMs should apply basic standards to reporting to trustees on the performance of recommended products and funds. The basic standards, however, still need to be designed and agreed by the industry.

19 We are keen to participate in this process. We expect a large number of stakeholders would wish to participate given they provide AM product recommendation services and would be affected by the standard.

20 The standard should, however, focus on improving outcomes for trustees, not catering to the lowest common denominator of IC/FM requirements, and so the ‘customer voice’ must be present in the design process.

21 Paragraph 12.131 of the PDR sets out five issues the CMA has identified that should be part of the standard:

(a) excess return vs benchmark;

(b) net of fees;

(c) the inclusion of all relevant products and funds;

(d) survivorship bias; and

(e) simulated returns and backfill bias.

22 The approach to each in the standard needs to be assessed in detail, and we expect different parties to have substantially different views.[4]

23 We will comment in detail in a later section on the ‘gross’ versus ‘net’ of AM fee approach (issue (b)), and why the ‘net of AM fees’ approach is likely to be less effective and not proportionate.

24 We have little concern about the risks of survivorship bias (issue (d)) or backfill bias (issue (e)) in our own approach and GIMD dataset, but based on the CMA’s statements in the PDR both appear to be significant issues for the approaches of other parties.

25 We will provide further comment here on the choice of appropriate benchmark (relevant to issue (a)) and what products to exclude from the reporting (issue (c)).

Selecting an appropriate benchmark

26 Selecting the correct benchmark against which to measure return is clearly critical. This benchmark should be transparent, comparable across ICs (if the remedy is to allow fair comparison), and should not be open to ‘gaming’ by the AM or the IC. Once the benchmark is

[4] There would be areas of complexity in achieving a consensus standard, particularly as smaller or less established ICs with more limited research coverage or effectiveness may consider it to be to their disadvantage to present the information in a standard way that drives transparency and comparison.

selected, a decision would also need to be taken on what ‘average’ fees should be included to access the benchmark (as passive fees often relate to AUM size).

27 We understand from the CMA’s eVestment analysis that ‘manager-selected’ benchmarks were applied. ["].

28 However, if a basic standard is to apply across all ICs, we would likely need to ["].

29 For example, our Manager Research team has assessed GIMD and identified:

(a) ["].[5]

(b) ["].

(c) ["].

(d) ["].

(e) ["].

30 Therefore, on a very preliminary estimate, agreeing to move to manager-selected benchmarks could create direct costs to Mercer of around ["] (one off) and ["] on an annual basis. In present value terms, using our cost of capital, this could be **around** ["].

31 ["].

Relevant products to include

32 We broadly agree with the principle of an IC demonstrating the performance of its recommended AM products across all asset classes it covers. We would, however, propose the following exclusions where it is either not possible to measure excess return reliably or where the objective of the strategy is not to deliver excess return:

(a) **Exclude strategies that track an index**. Strategies that are designed to track an index are not designed to deliver excess return. ["].

(b) **Exclude strategies that provide bespoke client solutions**. For certain clearly specified areas we may wish to recommend a capability to meet bespoke client demands but where there is no specified uniform objective, benchmark or expected outcome. Examples include ["].

(c) **Exclude private market strategies**. Private market strategies do not have uniform payoffs and as such quarterly excess return numbers in isolation are likely to be misleading. Benchmarking private market strategies is likely to be misleading. Equally accessing quarterly performance data may be challenging for private market strategies.

(d) **Exclude strategies with no live track record** i.e. exclude simulated track records.

33 Further consideration also needs to be given to:

(a) How to treat the same product offered with different risk levels. The CMA would need to assess whether these duplicate track records should be included.

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5 ["].

(b) How to measure performance of recommended strategies with absolute return and/or cash benchmarks. There is a risk in using "cash" as a benchmark. For example, including cash benchmarked equity Hedge Funds is likely to lead to quarterly excess return numbers that vary significantly from the benchmark in magnitude compared to traditional benchmark strategies. This would skew the aggregate excess return figures. ["].

b) Are there any other areas that we should include in the reporting standards?

34 The standard may ultimately need to prescribe how the information is presented to trustees to improve transparency. The design of how the information is presented should include customer engagement and trials, and regulator guidance may be necessary on how trustees should then use the information in their decision-making.

35 We believe our current reporting approach is relevant and useful to trustee decision making and may help inform the level of granularity of information that should be presented. For example, in our experience, trustees value seeing:

(a) ["];

(b) ["]; and

(c) ["].

c) Should standards be developed and agreed by an implementation committee similar to Remedy 6?

36 There are several reasons why a clear, robust and properly resourced governance structure for the remedy would be important, including:

(a) The remedy would apply to a very large number of ICs and FMs providing manager recommendations services, each with a diversity of approaches. The CMA has seen first-hand that even for the subset of providers that subscribe to the same underlying dataset (eVestment) different approaches to recommendations mean that building consensus and comparability is challenging.

(b) The remedy could impose significant new costs on certain firms.

(c) The remedy must be designed with the end-users (i.e. trustees) at the centre, which could involve consultation and testing with them.

37 Accordingly, a steering committee would be welcomed but it would require independent regulatory involvement. The committee would need the ability to:

(a) Consult the industry and clients on the design of the remedy. There may be advantage, for example, in conducting behaviour trials on how the information is ultimately presented to trustees.

(b) Handle competitively-sensitive information from rival ICs / FMs making representations on the design of the remedy. Several FMs, for example, are also AMs being rated by other ICs. Given this, there would be constraints on what information they may be able to see from rival ICs. We expect also that there would be complexities in aligning the approaches to certain issues (e.g. comparable AM fee information or comparable benchmarks) of the underlying datasets: eVestment; GIMD; and, other proprietary datasets. There would need to be a mechanism for sharing relevant information between parties – or through the independent regulator involved – to design the standard, while not jeopardising commercially-sensitive information.

(c) Compel, if necessary, the participation by providers, including dataset providers, asset managers and others (e.g. on providing comparable AM fee information).

38 We are keen to participate in this committee.

39 We note also that there would need to be ongoing engagement by the committee. It would need to monitor the ICs' implementation of the remedy and then monitor ongoing reporting by ICs. Importantly, the committee might need to update the standard over time as AM products and fee structures evolve in the market.

40 There would be a resource cost to participating in this implementation committee.

d) What fees should be used to make the gross to net fees conversion?

41 We consider presenting 'net of AM fees' information is the aspect of this remedy that raises greatest risk and complexity. We are concerned that it would introduce unnecessary uncertainty for trustees, significantly raise IC costs on an ongoing basis, and may require the CMA to mandate engagement from third-party AMs and dataset providers.

42 Presenting returns on a gross of AM fees basis is a more effective and proportionate approach for the industry.[6] **A gross performance basis is transparent** as to the product performance and how it has changed over time, and is not complicated or obscured by how the IC or AM has chosen to incorporate AM fees (e.g. what 'representative' costs are included) or how AM fees have evolved over time.

43 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 in the gross to net conversion that make a net of AM fees approach challenging and unreliable. We provide some estimates of potential costs to Mercer in implementing this element of the remedy; and

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

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

44 For the remedy to be effective, it must improve comparison and decision-making for trustees. We are concerned that the 'net of AM fee' approach could be misleading to trustees and could create additional challenges / uncertainty in comparing product performance and comparing ICs. It could harm the effectiveness of the remedy.

45 Reporting on a net of AM fees basis would require ICs to make an assumption on the 'average' (or median) AM fees actually paid by its clients for the products involved (i.e. after AM discounts off rack rates). These 'average' AM fees may, however, be a poor reflection of the AM fees that the individual scheme could itself achieve in practice. As examples:

(a) Schemes with smaller assets under management (**AUM**) may not be able to access the 'average' fee levels. Larger schemes may be able to access better than average fees.

(b) Historical AM fees may be a poor reflection for future AM fees e.g. AM products at or near capacity may no longer give discounts.

(c) The 'average' AM fee for the IC may reflect the portfolio clients that the IC serves – if it serves larger AUM clients, on average, the average AM fee would appear lower. The composition of this portfolio of clients would be unknown to the trustee making the decision.

46 If a non-representative 'assumed' average level of AM fee is already 'baked' into the performance track record shown to the trustee, the trustee faces the challenge of how to strip out that fee in a way that allows them to make decisions relevant to their scheme circumstances (rather than an unknown 'average' scheme served by that IC).

47 Further, the estimated 'averages' themselves may be distorted by various factors. In the Confidential Annex prepared by our advisers in response to the AM Product Recommendations Working Paper, evidence has been presented on the very significant amount of data loss and sample skew introduced through the methods applied to create 'average' AM fees estimates (that reflected discounts).

48 There were large gaps in reporting of AM fees in the underlying datasets, which in part reflects AMs not being mandated to provide fee data to the underlying datasets in a consistent way.

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6 We recognise that some AM products do report on a 'net of fee basis', but even here there can be a lack of transparency on what fees the AM has chosen to incorporate.

49 AMs have a diversity of ways of setting fee structures, and some of these are not well suited to creating comparable averages. For example, most hedge funds use 'performance fees', often with tiers for different levels of performance. It is difficult to capture the effects of these performance fees in the averaging approach.

50 Challenges and assumptions in constructing an average AM fee to apply for each individual IC, therefore, add additional uncertainty to the trustee on how to understand what they see and make comparisons between products, asset classes or ICs.

51 The trustee would be better served by seeing the performance on a gross of fees basis – which can be compared across asset classes, geographies and ICs – and then netting off their own expected AM fee levels as required.

Data and cost issues in compiling the 'average' AM fee

52 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.

53 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 in which their clients do not regularly invest. Smaller ICs, in particular, would have limited visibility and may find it more difficult to compete.

54 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.

55 We have a strong preference to show performance on a gross of fee basis. However, our Manager Research team has considered what would need to be done to our existing systems, data sources and processes to implement a net of AM fee reporting. ["]:

(i) ["].

(ii) ["].

(iii) ["].

56 Some practical challenges to the options (i) and (ii) are:

(a) ["].

(b) ["].

(c) ["].

(d) ["].

(e) There would need to be agreement on which fee-scale to use, depending on vehicle and asset size.

(f) It is unclear how performance-based fees would be taken into account. Further work would be needed by the CMA to agree a relevant approach to incorporating performance fee elements.

(g) If the peer group approach is used, there would need to be a consensus on peer groups.

57 Option (iii) is attractive in light of the challenges in collecting fee-scale data and calculating appropriate fee levels. Managers would be required to report net of fee returns. We could then report both net and gross of fee performance and calculate returns accordingly, with no fee assumptions. This would reduce some of the costs for ICs to implement the remedy, but would require the CMA to mandate AMs to participate.

58 Assuming, however, that ICs had to lead the collection of relevant AM fee data, the practical challenges identified include:

(a) It would be highly data intensive to collect net of fee returns and historical data may not be available. This is a non-trivial task and would require the commitment and support of the AMs.

(b) ["].

(c) ["].

59 At this stage, it is not possible to place any accurate figures on the time and cost involved in building a new process to calculate the net of AM fees analysis, as there are so many variables to consider and to be agreed.

60 However, as a preliminary estimate, we considered likely input for Mercer to address some of the issues above. Our estimates are set out in the table below.

61 Even on a very conservative basis, just to implement and maintain the net of AM element of the remedy on a going forward basis, we could face set up costs of over ["] and ongoing annual costs above ["]. **In present value terms, this could be costs of** ["]. Other ICs would also face costs, as would AMs.

Conservative cost estimates to implement and maintain 'net of AM fees' element of remedy

Action	Input	Indicative costs
["]	["]	["]
["]	["]	["]
["]	["]	["]
["]	["]	["]
["]	["]	["]

Important Notes:
- ["].
- ["].
- ["].
- ["].

62 In our view, it would not 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 GIMD to collect, maintain and compute appropriate adjustments for AM fees.

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

63 Applying a net of AM fees basis could result in decision errors for trustees, which would have indirect costs to the trustees. It is certain to raise direct costs for ICs, FMs and potentially AMs.

64 There could also be unintended negative consequences:

(a) ICs that serve smaller clients (with lower AUM) may face higher AM fees (lower achieved discounts), and so, all other things being equal, would appear to have worse AM recommendation performance than larger ICs. This could be purely due to 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.

(b) ICs might 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 must include in their track records. If implementation costs are too high for a smaller IC, it may retrench from offering the service entirely.

(c) The CMA might need to mandate AMs to provide information on AM fees to ICs in comparable formats. This would significantly extend the scope of the Order.

(d) The monitoring costs would likely be higher on those ICs that do not subscribe to eVestment, as they would need to monitor AM fees from across the market. This monitoring would be a fixed cost.