110 Bishopsgate
19th Floor, Suites 19-06 and 19-07
London EC2N 4AY, UK
+44 (0) 207 961 0830
www.iciglobal.org

Suite 715–717, Level 7
Two Exchange Square
8 Connaught Place
Central, Hong Kong
+852 2168 0882

1401 H Street, NW
Suite 1200
Washington, DC 20005, USA
+001 202 326 5800
www.ici.org

17 February 2017

Becky Young
Competition Division
Financial Conduct Authority
25 The North Colonnade
Canary Wharf
London E14 5HS

RE: Asset Management Market Study Interim Report (MS15/2.2)

Dear Ms. Young:

ICI Global[1] appreciates the opportunity to comment on the Financial Conduct Authority's ("FCA's") Asset Management Market Study Interim Report (the "Report"). ICI and its members have a strong interest in well-functioning, competitive markets. We seek to engage actively with policymakers and provide meaningful input on policy initiatives and studies, such as this one, that may have significant implications for regulated funds,[2] their investors and the markets.

As explained in the Report's executive summary, the FCA has reviewed the asset management sector to ensure that the market is working well and that consumers are using products that offer value for money. In the Report, the FCA claims that evidence suggests that there is weak price competition, as well as other issues, which together raise concerns about how effectively competition drives value for investors. The FCA raises specific concerns that certain types of funds, both active and passive, do not deliver value for money. The Report also includes various references to the US market and research on US funds. In

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[1] ICI Global carries out the international work of the Investment Company Institute, serving a fund membership that includes regulated funds publicly offered to investors in jurisdictions worldwide, with combined assets of US$20.2 trillion. ICI Global seeks to advance the common interests and promote public understanding of regulated investment funds, their managers, and investors. Its policy agenda focuses on issues of significance to funds in the areas of financial stability, cross-border regulation, market structure, and pension provision. ICI Global has offices in London, Hong Kong, and Washington, DC.

[2] For purposes of this letter, the term "regulated investment fund" means any collective investment vehicle that (1) primarily invests in securities, (2) is substantively regulated, and (3) is eligible for public sale. Generally, such funds are regulated to make them eligible for sale to the retail public, even if a particular fund may elect to limit its offering to institutional investors. Such funds typically are subject to substantive regulation in areas such as disclosure, form of organisation, custody, minimum capital, valuation, investment restrictions (*e.g.*, leverage, types of investments or "eligible assets," concentration limits and/or diversification standards). Examples of such funds include: US investment companies regulated under the Investment Company Act of 1940 ("ICA"), "Undertakings for Collective Investment in Transferable Securities," or UCITS in the European Union, non-UCITS retail schemes ("NURS") in the United Kingdom, Canadian mutual funds; and Japanese investment trusts.

addition, the FCA has considered US regulated fund governance under the Investment Company Act of 1940 ("ICA"). Based on its interim findings, the FCA proposes several recommendations to address its competition concerns, including options to strengthen a manager's duty to act in the best interests of investors and reforms to improve fund disclosure related to fund objectives, fees and performance.

We have the following key comments:

The UK fund management industry is highly competitive. For the reasons detailed in Annex 1, we believe the UK regulated funds market has the hallmarks of a highly competitive industry, with a large number and variety of funds and fund providers competing for assets. This conclusion is consistent with much of the evidence in the Report itself. Fund providers do compete on the basis of price and a range of other characteristics. UK investors have incurred lower fund charges over time, in both active and passive funds. In addition, comparing fund charges and expenses in the United Kingdom with those in the United States supports this assessment.

Active and passive funds compete head on and provide choice to the benefit of investors. The primary goal of most investors is not narrowly to "beat the benchmark." Rather, it is to build a portfolio that delivers favorable returns and meets their financial objectives consistent with their risk tolerances, preferences and other individual circumstances. Among other things, this involves weighing returns against risks, protecting against market downturns, and maintaining an appropriate asset allocation. Inevitably this involves some level of active management – such as in the form of asset allocation within a fund (*e.g.*, a hybrid fund) or allocation and rebalancing across a group of funds (*e.g.*, a portfolio of index tracker funds). Active and passive funds both can help investors meet these objectives, and as recognised in the Report, many investors use both types of funds. The rise of passively managed funds as widely available investment options undoubtedly has introduced significant competitive pressures and dynamics in the industry. Active funds compete with other active funds and also index funds and exchange-traded funds ("ETFs"). UK investors are fortunate to be able to choose from a wide array of active and passive funds, giving them maximum flexibility in pursuing their investment objectives. We describe this market dynamic in Annex 1.

Regulators need not "tip the scale" toward one type of product or another. The market at large, consisting of myriad investors acting in light of their own needs and preferences, is best placed to determine what fund offerings are appropriate. Thus, given that fund providers compete vigorously for investor business, regulators should resist imposing their judgments on the market as to which fund products are better or worse for investors – or represent "value for money." To do so, risks reducing choice, eroding efficient capital allocation and price discovery and degrading competition and innovation.

The intermediation of funds must be assessed to better understand investor choice and competition. An understanding of how funds are purchased and sold by investors would seem to be essential for the overall assessment that the FCA has undertaken, and it is appropriate that the FCA does intend to do more work on the retail distribution of funds. This should include the role and activities of intermediaries, including platforms, and financial advisers who provide recommendations and manage portfolios. In undertaking this work, the FCA

should remain cognisant that relatively little time has passed since the Retail Distribution Review was fully implemented and competitive dynamics continue to evolve.

A robust fund governance regime is important to address and mitigate conflicts of interest. While a robust fund governance structure can promote competition, it is primarily a tool to address and mitigate conflicts of interest. US regulated fund governance has been a successful framework for US regulated funds and investors. We encourage the FCA to consider carefully the traditional structure of US funds and the laws and regulations that define the responsibilities of a US fund's board of directors, including its independent directors, within that structure. Equally important, the FCA must consider the significant differences in fund structure and governance that exist between the United States and the United Kingdom. These include the presence of trusts and depositaries in the United Kingdom as well as the many laws that influence the operation of funds sold in the United Kingdom. As IOSCO has observed, there are a range of approaches to fund governance globally that are calibrated for specific local laws and circumstances. We briefly describe some fundamental aspects of the US fund governance system in Annex 2.

Given the scale and complexity of changes posed by Brexit, along with current regulatory changes, we urge caution. We have serious reservations with the timing of this work. As noted in the Report, the UK asset management industry is the second largest in the world and UK asset managers serve the entire EU market – including retail investors – through passport arrangements and delegations, which allow significant assets to be managed from the United Kingdom. There currently are numerous regulatory initiatives impacting funds and investors in the United Kingdom, some implemented and some underway or planned. At the same time, Britain is poised to begin negotiations to leave the European Union. Even though details are unclear, Brexit promises to bring far reaching impact on financial markets, including to the funds industry. While well intended, new regulatory initiatives during a period of unprecedented disruption could harm rather than benefit competition and investors.

* * * * *

If you have any questions or would like additional information, please contact me (dan.waters@iciglobal.org or +44-207-961-0831). More specifically, for questions on our competition assessment in Annex 1, please contact Sean Collins, Senior Director, Industry and Financial Analysis at sean.collins@ici.org or +1-202-326-5882 and for questions on US regulated fund governance in Annex 2, please contact Amy Lancellotta, IDC Managing Director, at amy@ici.org or +1-202-326-5824.

Sincerely,

/s/ Dan Waters

Dan Waters
Managing Director
ICI Global

Annex 1: Assessing Competition in the UK Fund Management Industry[1]

This annex comments on certain aspects of the Report's analysis. Our comments in this annex are intended to refer solely to asset managers as investment fund providers, especially in respect of investment funds held by retail investors. Our focus is thus primarily on publicly available regulated funds that substantively invest their portfolios in securities. These funds include authorised UCITS and non-UCITS retail schemes (NURS) and recognised funds.[2] We recognise that competitiveness in the distribution channel is also extremely important and note that the FCA has proposed further work on the retail distribution of funds, particularly on the impact that financial advisers and platforms have on value for money.

With respect to competitiveness of the market for fund provision, ICI Global supports proposals likely to help bolster informed investor choice and competition in the industry. The Report bases the need for its proposals on its assessment that there is a lack of competition in the UK fund industry[3] and that certain types of funds (both active and passive) do not deliver "value for money." The Report seeks comment on its analysis and conclusions.

The FCA indicates that it intends to consider further a number of the aspects studied in the Report. Our comments are intended to help the FCA clarify and sharpen any future analysis. As this annex details, the Report's analysis and interpretations are in many cases either misleading or partial, in important cases internally inconsistent, and in other cases represent a highly restrictive view of how fund investors invest and why.

We have two main points:

• **In respect of provision of investment funds, the UK fund industry has the hallmarks of a highly competitive industry**. Much evidence in the Report itself is consistent with this.[4]

• **The primary goal of retail investors is to build portfolios that deliver favorable investment returns while meeting their financial objectives**. UK investors are fortunate to be able to choose from among a wide array of investment funds, including both active and passive funds. Investors should be free to select the strategies and funds that best suit their needs. So

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[1] This Annex was prepared by Sean Collins, Senior Director, and James Duvall, Assistant Economist. For questions on our competition assessment, please contact Sean Collins, Senior Director, Industry and Financial Analysis at sean.collins@ici.org or +1-202-326-5882.

[2] The annex uses the term "fund," to mean a regulated investment fund, as defined in footnote 2 in our main comment letter.

[3] Report at 11 arguing that "The evidence suggests there is weak price competition in a number of areas of the asset management industry." *See*, also, Report at 20 arguing that "these interim findings raise a series of concerns about how effectively competition drives value for investors in the asset management sector," and Report at 119 stating "we conclude that the results of our analysis are consistent with competition not working as effectively as it could."

[4] We are not alone in this critique of the Report. *See*, for example, Ian McVeigh, "Asset Management Industry Is Just the Sort of Global Winner We Need," *The Telegraph*, 3 December 2016, stating that "From my reading of the report, fund management appears to be a study of price regulation through competition and of an industry evolving in response to low-cost entrants."

long as the market for fund provision is competitive, as evidence indicates it is, regulators should exercise caution when determining whether and how they intervene in this dynamic.

1. Textbook Definition of a Competitive Industry

Textbook economics describes a "perfectly competitive" industry as one characterised by a number of features, including (a) a large number of firms all competing with one another; (b) low barriers to firms entering or leaving the industry; (c) an inability of individual firms or groups of firms to wield significant market power; (d) all firms providing a single, identical good or service; and (e) an inability of any firm to charge a price higher than the market-going rate.

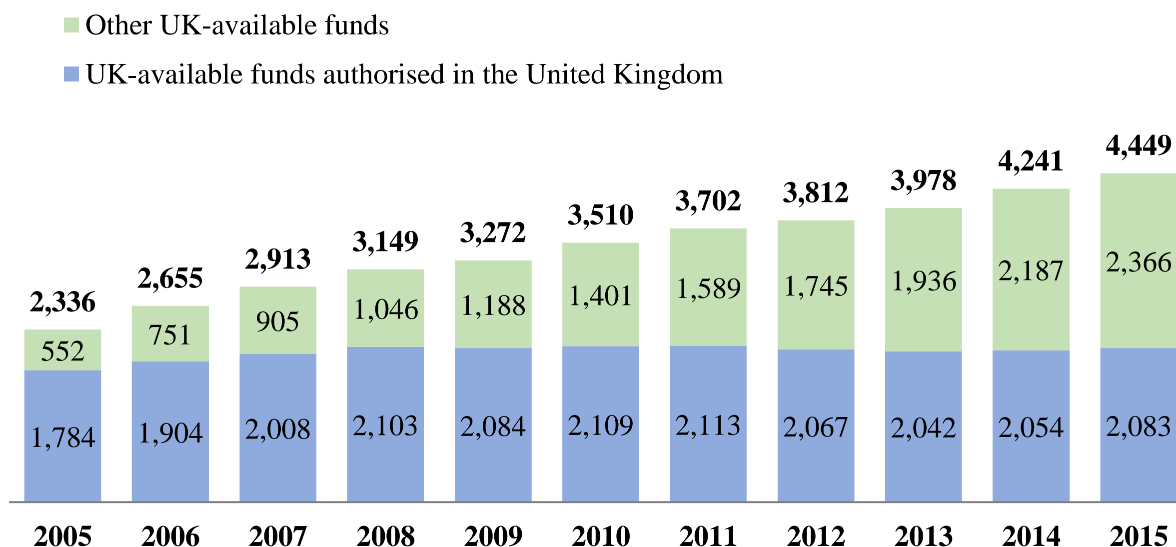
In reality, perfectly competitive markets are the exception rather than the rule, generally occurring only in wholesale commodity markets such as spot or futures markets for coffee or wheat. In markets for retail goods and services, firms compete for customer business on the basis of price, but almost always on a range of other factors as well, such as product types, styles, features, quality, convenience, service, reputation, and brand. Firms may differ in how they market or distribute their products. Customers differ in terms of preferences and circumstances. They are free to choose the products and distribution channels offering the features or characteristics they value most. Thus, their choices depend on price, but also reflect and take into account product features. Firms also typically compete with each other through product differentiation, capital investments, services, and innovations that consumers value.

2. UK Fund Industry Has the Hallmarks of a Competitive Industry

From the standpoint of providing funds, the UK fund industry exhibits the hallmarks of a highly competitive industry: a large number of funds and firms compete for investors' pots. Much of the evidence in the Report itself is consistent with, and indicative of, a highly competitive industry where fund providers compete along a number of avenues including price.

For example, barriers to entry appear low. Almost 4,500 different funds were available for sale in the United Kingdom in 2015 (Figure A.1). This alone indicates that competition among funds is brisk. If anything, competition among fund providers must be strengthening. The number of funds competing in the UK market has grown significantly in the past 10 years. Moreover, competition has been bolstered by passporting arrangements: much of the increase in the number of funds available for sale in the United Kingdom in the past decade is due to funds domiciled outside the United Kingdom, primarily in Ireland and Luxembourg.

Figure A.1: Number of UK-Available[5] Regulated Funds Has Grown Sharply Since 2005
Number of UCITS with at least one sterling-denominated share class; year-end, 2005–2015



Note: Data represent UK-available funds with at least one sterling-denominated share class. Data exclude funds of funds and ETFs.
Source: Investment Company Institute tabulations of Morningstar Direct data

Competitive industries are generally characterised by a large number of firms and the ability of new firms to enter the market. The nearly 4,500 funds available for sale in the United Kingdom are offered by over 150 firms with headquarters in the United Kingdom, Ireland, Luxembourg, the United States, or other locations. UK-based firms increasingly must compete for business with foreign fund providers. Several foreign providers that have entered the UK market are generally thought of as "low-cost providers," offering either index funds, exchange traded funds (ETFs), or both.

In a competitive market, a leading firm may have difficulty maintaining its market share. With free entry, other firms may enter, taking away the market leader's share. This appears to be true among fund providers in the United Kingdom. As Figure A.2 suggests, the overall rankings (by assets under management) of the top 10 providers have changed significantly over the past several years.

[5] References to UK-available funds refer to those funds that have been authorised or recognised for sale to UK retail investors.

Figure A.2: Fund Assets Under Management of Top 10 UK Fund Providers[6]
Total net assets in millions of pounds sterling; year-end, selected years

	2008		2015	
Rank	**Complex name**	**Assets**	**Complex name**	**Assets**
1	Invesco	£25,517	M&G	£65,081
2	Fidelity	19,722	Standard Life	50,047
3	M&G	15,645	Invesco	49,169
4	Legal & General	15,588	BlackRock	47,957
5	Henderson	15,244	BNY Mellon	31,246
6	Scottish Widows	15,077	Columbia Threadneedle	31,239
7	Schroders	15,061	Henderson	30,710
8	Columbia Threadneedle	12,746	Legal & General	30,430
9	BNY Mellon	11,484	Fidelity	30,068
10	BlackRock	11,420	Schroders	29,192

Note: Data include UK-authorised open-end funds, but exclude funds that invest primarily in other funds and ETFs.
Source: Investment Company Institute tabulations of Morningstar Direct data

Industries may be less competitive when business is concentrated in a small number of firms. Regulators often measure the ability of firms in an industry to wield market power by measures of industry concentration. There is no evidence that fund providers wield substantive market power in the United Kingdom. As the Report itself shows, the UK fund industry is not concentrated. Standard measures indicate that concentration in the fund industry (in terms of firms' assets under management) are well within the range for competitive industries.[7] Furthermore, concentration appears to have remained stable over time. Figure A.3 shows that the market share of the top 10 fund providers, as measured by assets under management, remained at about 50 percent from 2008 to 2015.

[6] There are a number of data sources that can be used to compute a ranking of firm size. Our ranking is based on the Assets Flows tab in Morningstar Direct for UK-domiciled open-end funds. Our ranking excludes funds of funds and ETFs. As such, it is not survivor-bias free and could differ from rankings produced from other data sources.

[7] Report at 33 states that "The [UK] asset management industry does not appear particularly concentrated." A standard measure of industry concentration, often used by regulators as an indicator of market power, is the Herfindahl-Hirschmann index. Report at 33 finds "a Herfindahl-Hirschmann Index of 780 which indicates that the asset management industry is not particularly concentrated."

Figure A.3: Fund Market Share by Top UK Fund Providers[8]

Percentage of total assets under management at all UK fund complexes; year-end, 2008–2015

Year	Largest 5 complexes	Largest 10 complexes	Largest 25 complexes	Total number of complexes
2008	31	53	82	118
2009	32	54	82	128
2010	30	51	83	127
2011	30	51	82	128
2012	31	53	81	137
2013	32	51	79	143
2014	32	50	78	152
2015	30	49	76	151

Note: Data include UK-authorised open-end funds, but exclude funds that invest primarily in other funds and ETFs.
Source: Investment Company Institute tabulations of Morningstar Direct data

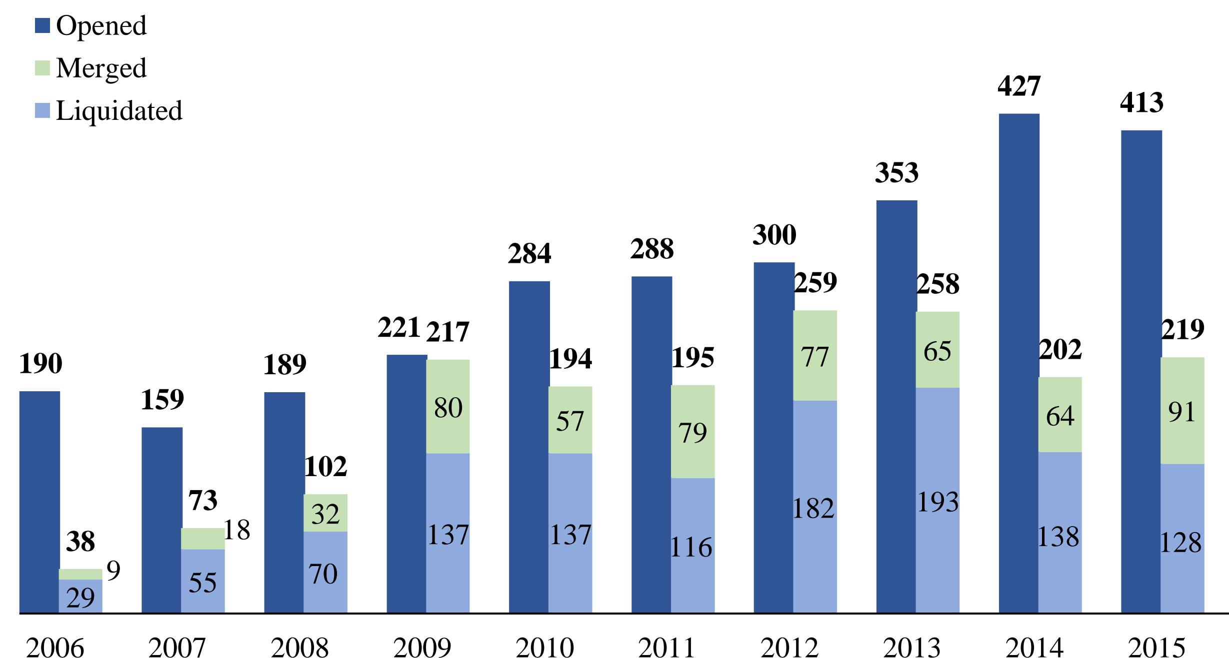
Economists have noted that industries, although not necessarily "perfectly competitive" according to textbook definitions, can still be extremely competitive if competitors are free to enter or leave the market.[9] Even the mere threat that other competitors *might* enter the market helps keep it competitive. That is clearly the case in the United Kingdom. Individual funds come and go regularly (Figure A.4). Over the years 2006 to 2015, 2,824 new funds were created that were available for sale in the United Kingdom. Our analysis indicates that over the same period, 1,757 funds available for sale in the United Kingdom were merged or closed (i.e., liquidated). Funds that underperform, and thus fail to attract or sustain investor interest, are often merged or closed. The Report itself found that over one-third of the funds that underperformed from 2005–2010 were subsequently merged or closed.[10] That is strong evidence of Darwinian competition.

[8] Market share is based on the Assets Flows tab in Morningstar Direct for UK-domiciled open-end funds. It excludes assets in funds of funds and ETFs. As such, it is not survivor-bias free and could differ from rankings produced from other data sources.

[9] William J. Baumol, John C. Panzar, and Robert D. Willig (1982). *Contestable Markets and the Theory of Industry Structure*.

[10] Report at 106 stating the FCA's analysis found that "35% of the funds that were in the bottom-performing quartile over 2005–2010 subsequently closed or merged over 2011–2015."

Figure A.4: Number of UK-Available* Funds Leaving and Entering the Market
2006–2015



*Data represent UK-available UCITS with at least one sterling-denominated share class.
Note: Data exclude funds of funds and ETFs.
Source: Investment Company Institute tabulations of Morningstar Direct data

3. Do Fees Indicate Weak Competition Among Fund Providers?

As noted, firms in competitive industries generally compete on the basis of price as well as other features. The Report questions whether funds compete on the basis of price: “The evidence suggests there is weak price competition in a number of areas of the asset management industry.”[11] The Report raises concerns about “fee clustering,” levels of ongoing charges, whether (and how) funds pass along economies of scale, and fund tracking error.

We urge the FCA to revisit these issues. The evidence the Report presents is in cases consistent with competition, in some cases internally inconsistent, in other cases contradicted by new evidence we present, and in still other cases not susceptible to critical analysis by stakeholders because the Report provides insufficient detail.

For example, the Report expresses concerns that asset management charges for like funds are quite similar. As the Report puts it, there is considerable price clustering, the idea that asset management charges of funds tend to be similar. The Report states that fund providers indicate that “fund charges are typically set at [fund] launch, and these charges are generally set at the

[11] Report at 11.

same level as their competitors." [12] The Report further states "this suggests that charges are not regarded by firms as a key competitive parameter."[13]

But a hallmark of a perfectly competitive market is a large number of firms all charging identical prices for products with identical characteristics. That is precisely what the Report finds: as it hones in on groups of funds with more and more similar characteristics, it finds that asset management charges "cluster" more and more.[14] The same result is apparent in other markets. For example, in the United States, the portfolio management charges of S&P 500 index tracker funds "cluster" in a very small range, 2 to 3 basis points.[15]

3a. Cross-Country Evidence that Robust Competition Prevails Among UK Fund Providers

If competition were lacking among UK fund providers, one would expect fund charges to be "high" relative to some standard. One potential standard is the US market. The US fund market is generally thought be the world's most competitive market,[16] and thus the world's lowest cost fund market.[17]

Judging by that standard, UK fund providers must compete vigorously for clients' pots: our analysis indicates that on a commensurable basis, ongoing charges of UK-available funds are only modestly higher than those of funds available for sale in the United States. This modest difference likely owes to other features of the two markets, such as average fund size.

Comparisons of fund charges in different countries must be undertaken with considerable care. As Khorana, Servaes, and Tufano (2009) point out,[18] such comparisons need to adjust for a wide array of factors, including the sizes of funds and of their providers, average account balances within funds, differences in legal and regulatory structures across countries, differences in tax structures, differences in the types of funds residents invest in, and variation in how investors pay for distribution charges.

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[12] Report at 111.

[13] Report at 111.

[14] *See* Report at 112, stating that "We find that clustering of prices becomes more apparent when examining narrower investment categories."

[15] Here, "portfolio management charges" refers to the advisory or subadvisory fees of S&P 500 index mutual funds, rather than to their total expense ratios. *See* Investment Company Institute, "Are S&P 500 Index Mutual Funds Commodities," *Perspective*, 11(3), August 2005 for an explanation and discussion of the appropriateness of this measure of fund charges for assessing competition.

[16] *See*, David Ricketts, "Aberdeen Faces Challenge of US Market," *Financial Times*, April 11, 2010, suggesting that the US retail fund market is "the single most competitive market on the planet."

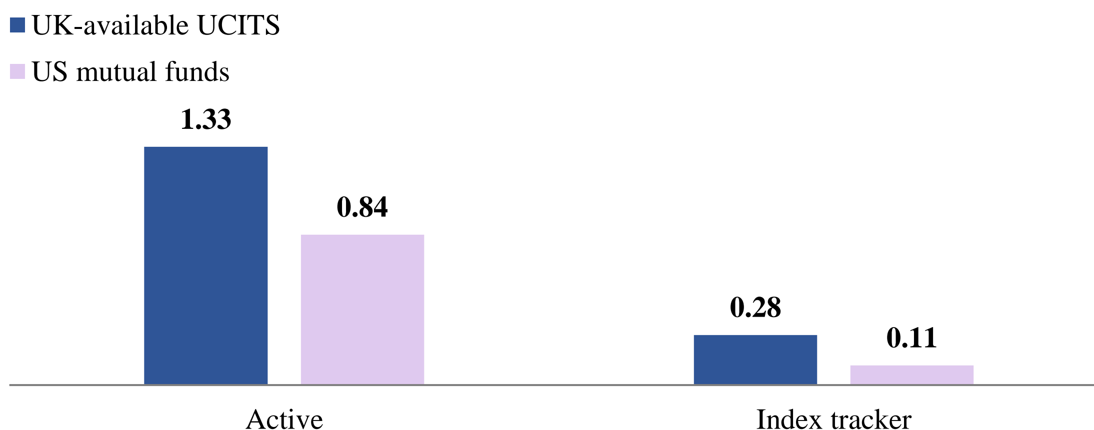
[17] *See*, for example, Ajay Khorana, Henri Servaes, and Peter Tufano (2009), "Mutual Fund Fees around the World," *Review of Financial Studies*, 22(3), 1279-1310. Their study examines fund charges in a range of countries across the world. They find that fund charges are the lowest in the United States (or in some select cases in Belgium).

[18] Ajay Khorana, Henri Servaes, and Peter Tufano (2009), "Mutual Fund Fees around the World," *Review of Financial Studies*, 22(3), 1279-1310.

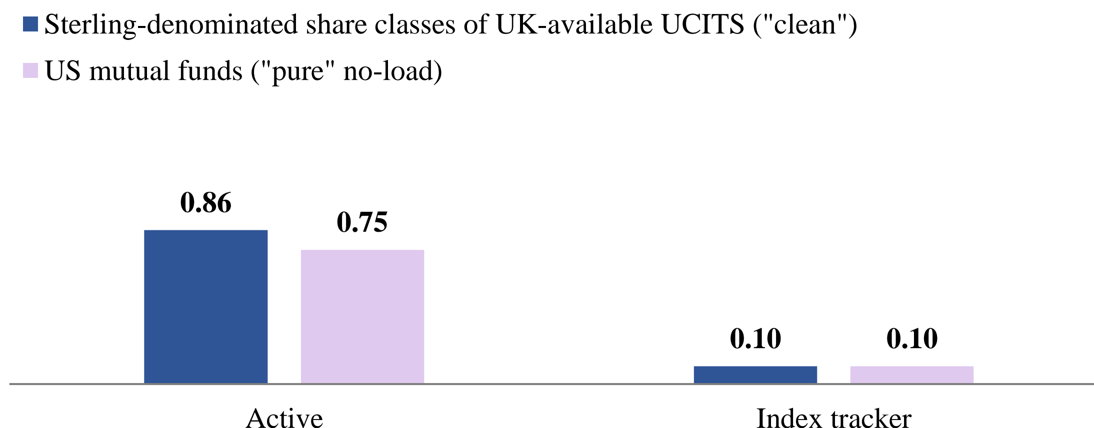
Figure A.5 compares the average level of ongoing charges on UK-available equity funds with those of US-authorised equity funds. Panel A compares the ongoing charges of active funds and passive funds in the two countries. As seen, on this "raw" basis, ongoing charges of equity funds available for sale in the United Kingdom are rather higher than those available for sale in the United States.

Figure A.5: Fund Charges of UK-Available and US-Authorised Equity Funds, Compared
Ongoing charges and expense ratios expressed as asset-weighted averages, percent; 2015

Panel A[1]: Raw comparison



Panel B[2]: Excluding distribution charges



[1]Data for UK include share classes of all UCITS available for sale in the United Kingdom, irrespective of a share class's currency of denomination (i.e., we include share classes denominated in pounds sterling, euros, US dollars, Swiss francs, etc.). Data for UK and US include share classes that are "clean" as well as share classes that have distribution charges bundled in their fees.
[2] Data for UK include only the sterling-denominated share classes of UCITS available for sale in the United Kingdom. Data for UK and US include only "clean" share classes.
Note: Data exclude funds of funds and ETFs.
Sources: Investment Company Institute, Morningstar, and Lipper

For example, the asset-weighted average ongoing charge for active equity UCITS available for sale in the United Kingdom was 1.33 percent in 2015 compared to an asset-weighted average expense ratio of 0.84 percent for active US equity mutual funds. The same

pattern holds for index tracker funds: ongoing charges were 0.28 percent in the United Kingdom versus 0.11 percent for the United States.

This "raw" comparison considerably overstates the differences in charges across the two countries for at least two reasons: (a) distribution charges; and (b) whether funds were actually bought by UK investors (as opposed to funds that were offered for sale in the United Kingdom). Panel B abstracts from these two factors,[19] achieving something like an apples-to-apples comparison. Now, differences in ongoing charges between the two countries are modest. The ongoing charges of equity index tracker funds are identical in the two countries. Ongoing charges for active UK equity funds are only 11 basis points higher than expense ratios for roughly comparable US mutual funds.

Remaining differences can easily be explained by differences between the UK and US markets in terms of other factors, such as average fund size. For example, Figure A.6 compares the sizes of funds in the UK and US markets. US funds are generally larger than similar types of funds likely purchased by UK residents. For example, in 2015, the typical actively managed US mutual fund was 1-½ to 2 times larger than its UK counterpart (i.e., measured as assets in funds with a sterling-denominated share class that were available for sale in the United Kingdom).

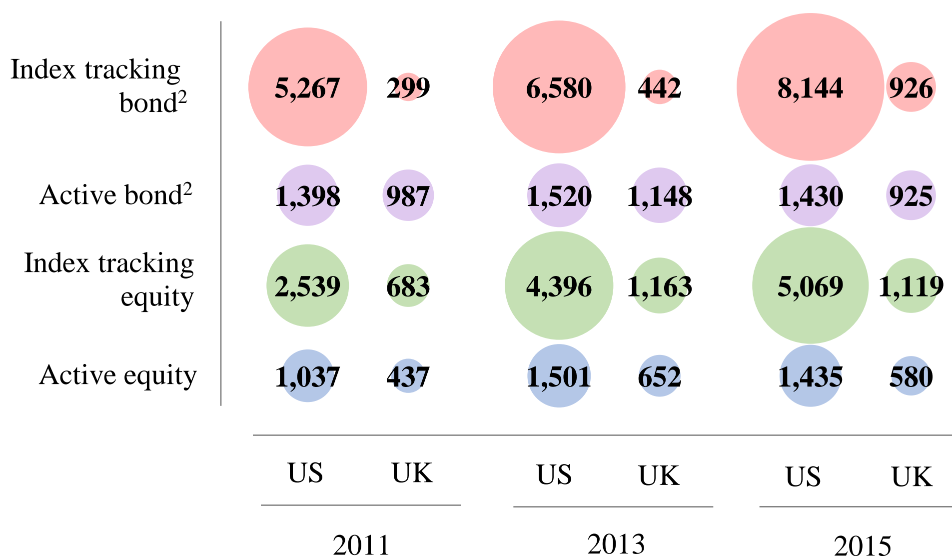
Relatively speaking, index tracker funds are even larger in the United States, roughly 4 to 9 times larger than their UK counterparts. In both countries, index tracker funds tend to be larger than active funds in similar categories.

This cross-country comparison of ongoing charges provides additional evidence that fund providers must be competing vigorously in the United Kingdom. It is worth emphasising that because our analysis strips out distribution charges (i.e., in the bottom panel of Figure A.5), it has no implications for the strength of competition among entities that intermediate the sales of fund shares.

[19] The bottom panel measures the ongoing charges of equity funds that were available for sale in the United Kingdom by: (a) including only the sterling-denominated share classes of UK equity funds available for sale in the United Kingdom in order to exclude share classes less likely to be owned by UK residents (e.g., Swiss franc–denominated share classes); and (b) including only share classes with inception dates after 31 December 2012, which are thus post-RDR and hence free of distribution charges. To try to create a reasonably comparable measure for the United States we: (a) include in the top panel all share classes of US-authorised mutual funds (i.e., open-end mutual funds); and (b) include in the bottom panel only share classes that are "true no-load" share classes (i.e., have a 12b-1 fee of zero and no front- or back-end load fee) and thus are free of distribution charges.

Figure A.6: Average Size of US Mutual Funds Is Larger Than UCITS with a Sterling-Denominated Share Class[1]

Average fund size in millions of US dollars; year-end, selected years



[1]Average US regulated mutual fund sizes represent all fund share classes, including "pure no-load" share classes. Average sterling-denominated UCITS sizes represent the total assets of every fund that has at least one sterling-denominated share class.
[2] US mutual fund data include both bond and hybrid funds.
Note: Data exclude funds of funds and ETFs.
Sources: Investment Company Institute and Morningstar

3b. UK Investors Are Incurring Lower Charges for Investing in Funds

According to the Report, the OCFs for certain actively managed funds have remained about unchanged since 2005. The Report thus infers that "there is limited price competition between active fund managers."[20]

For example, a key figure in the Report (Figure 6.14, reproduced below as Figure A.7) indicates that the asset-weighted average OCF for actively managed UK equity funds with bundled distribution charges hovered around 1.6 percent over 2005–2015. We are concerned that this key figure gives a misleading impression of the evolution of fund charges, and hence of competition, in the UK market. Our own analysis reveals something quite different. We find that the ongoing charges that investors paid for investing in such funds fell substantially from 2005 to 2015.

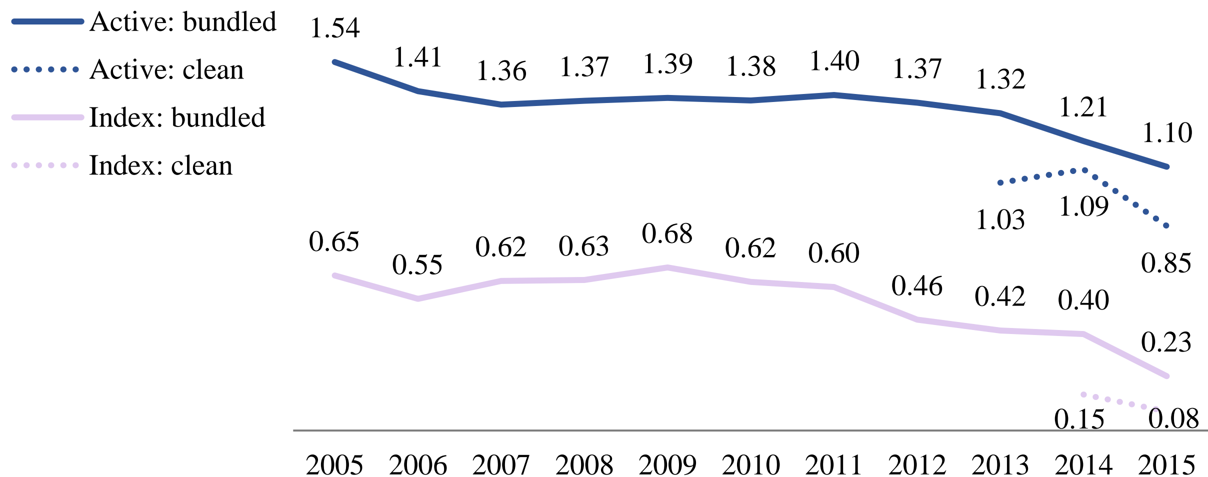
For example, Figure A.8 plots the asset-weighted average OCF for all sterling-denominated share classes of actively managed UK equity funds that were available for sale in the United Kingdom over the period 2005 to 2015.

[20] Report at 110.

Figure A.7: Trends in the AUM Weighted OCF for Active Share Classes over Time
As presented in FCA Report Figure 6.14

Source: FCA, *Asset Management Market Study*, Figure 6.14: "OCF data and information about the fee structure of share classes from a sample of asset managers enriched with information from Morningstar direct. AUM data from Morningstar Direct."

Figure A.8: OCFs for UK Equity Funds Available for Sale in the United Kingdom
Percentage of assets, 2005–2015



Memo: assets of the sample in billions of pounds sterling

	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
Active: bundled	11	18	40	65	88	95	87	94	121	103	81
Index: bundled	4	6	12	12	19	17	8	23	15	11	14
Active: clean									2	8	10
Index: clean										<0.05	2

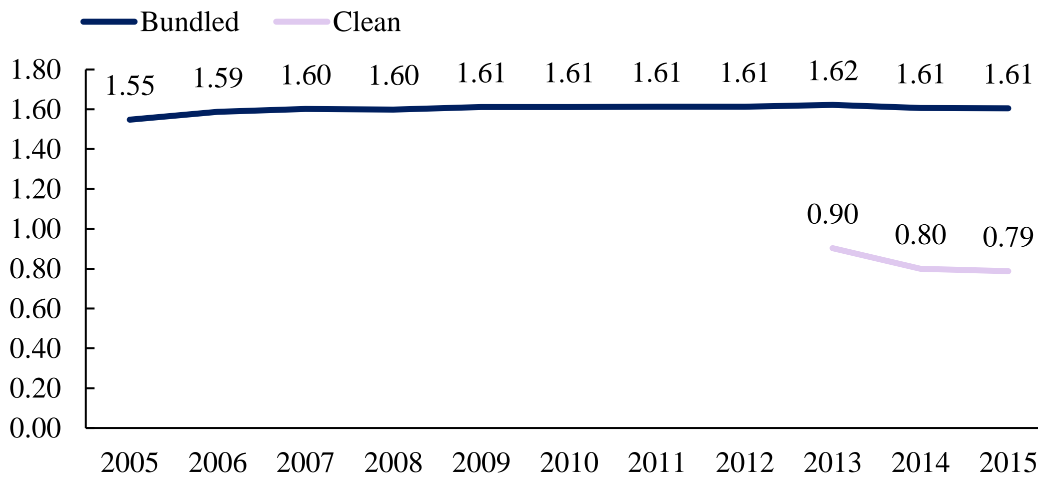
Note: Data include all sterling-denominated share classes of UK equity funds available for sale in the United Kingdom but exclude funds of funds. OCFs for each year are measured on an asset-weighted basis, weighting the OCF of a given share class by the assets in that share class.
Source: Investment Company Institute tabulations of Morningstar Direct data

In Figure A.8, the OCF for bundled share classes of UK equity active funds is 1.54 percent in 2005, nearly the same as the 1.6 percent level the FCA reports for the entire period 2005–2015. After 2005, however, our calculations indicate that the OCF for active equity funds falls more or less continuously, ending at 1.10 percent in 2015. For completeness, we also show OCFs for UK equity index tracker funds. While the ongoing charges of index tracker funds are lower than those for active funds in each year, OCFs for active and index tracker funds follow largely similar paths over time. Thus, our analysis suggests that fund charges across the board are responding to competitive pressures.

That begs the question of why Figures A.7 and A.8 look so different. The Report provides insufficient detail to determine the basis of the discrepancy. For example, the Report does not detail the number of funds and amount of assets included at each point in its chart, which makes it difficult for stakeholders to replicate its analysis. Consequently, we can only speculate as to what causes the difference.

Informed speculation, however, suggests that the Report may have focused on a highly unrepresentative sample of funds. Our analysis in Figure A.8 includes all share classes of funds that existed at any point from 2005 to 2015. We conjecture that the Report may have restricted its analysis to share classes of UK equity funds that were continuously in existence in each and every year from 2005 to 2015 and for which it could find OCF data.[21]

Figure A.9: OCFs for UK Equity Funds Available for Sale in the United Kingdom
Percentage of assets, 2005–2015



Memo: assets of the funds in the sample in billions of pounds sterling

4.6	5.2	5.6	3.9	5.1	5.5	5.0	5.2	5.7	5.7	5.4

Note: Data include all sterling-denominated share classes of UK equity funds available for sale in the United Kingdom that were continuously in existence over 2005–2015. Data exclude funds of funds. OCFs for each year are measured on an asset-weighted basis, weighting the OCF of a given share class by the assets in that share class.
Source: Investment Company Institute tabulations of Morningstar Direct data

[21] Language in the Report suggests this is what the FCA did. *See* Report at 111 stating that "In this analysis, we calculated the AUM-weighted OCF for UK equity share classes which were available *in each individual year*" [emphasis added].

Figure A.9 shows what happens we restrict the sample of funds used to create Figure A.8 to include only those continuously in existence over the period 2005 to 2015 for which Morningstar reports an OCF in each of those years. Now, the OCF for UK equity active funds (bundled) looks similar to that shown in Figure 6.14 of the Report. It remains flat at about 1.6 percent over the entire period 2005 to 2015.

Restricting the sample in this way (i.e., as in Figure A.9) biases upward the asset-weighted OCF. Restricting the sample as in Figure A.9 excludes any new funds created after 2005. But these newly-created funds may have had their OCFs set below those of pre-existing funds in order to attract investors. Restricting the sample as in Figure A.9 also means throwing out funds that existed in 2005 but that were subsequently closed, perhaps because their OCFs were too high to maintain investor interest. What is left is a sample with only 12 funds. The assets of these 12 funds grew only marginally, from £4.6 billion in 2005 to £5.4 billion in 2015. Thus, the average size of the funds in the chart grew only 17 percent in nominal terms (from £383 million to £450 million) and shrank slightly in real terms (over the period, the UK CPI ex food, energy, alcohol and tobacco rose 21 percent).[22] Consequently, it would not be surprising if the ongoing charges of the funds remained stable, or even rose somewhat.

Our own calculations indicate that the OCFs incurred by investors in UK equity funds—both active and passive—have declined considerably over time. This, as it happens, is consistent with results the FCA reports in its Annex 7, which indicate that OCFs for both active and passive funds declined from 2010 to 2015.[23] We urge the FCA, at a minimum, to provide more detail on how it arrived at the result in its Figure 6.14 that OCFs for active UK equity funds remained stable over time.

We also encourage the FCA to acknowledge that change takes time. RDR was only fully implemented by April 2016. Nevertheless, it seems clear from Figure A.8 that investors have within the past few years already been incurring lower charges through funds. If US experience is any guide, that trend seems likely to continue as the market adjusts more fully to RDR.

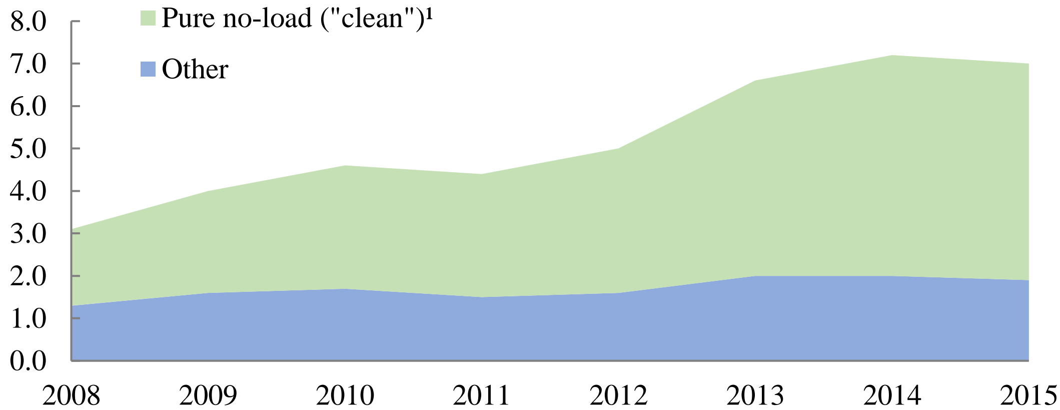
For example, panel A of Figure A.10 shows how the assets in US-authorised equity mutual funds are split between share classes that are "pure no-load" (i.e., "clean" share classes) and other share classes. In 2008, pure no-load share classes already held the lion's share of equity mutual fund assets. That share continued to rise over time, but only because assets in pure no-load funds rose. Assets in other share classes remained about unchanged. Panel B of Figure A.10 presents the situation in the United Kingdom. Although it is apparent that a trend is underway toward assets being held in clean share classes, the trend is less advanced than in the United States. As the trend progresses in the United Kingdom, the share of assets in "clean" share classes will no doubt rise, and, over time, investors will likely incur even lower charges overall through funds. But some assets could remain in pre-RDR share classes for various reasons.

[22] Office for National Statistics.

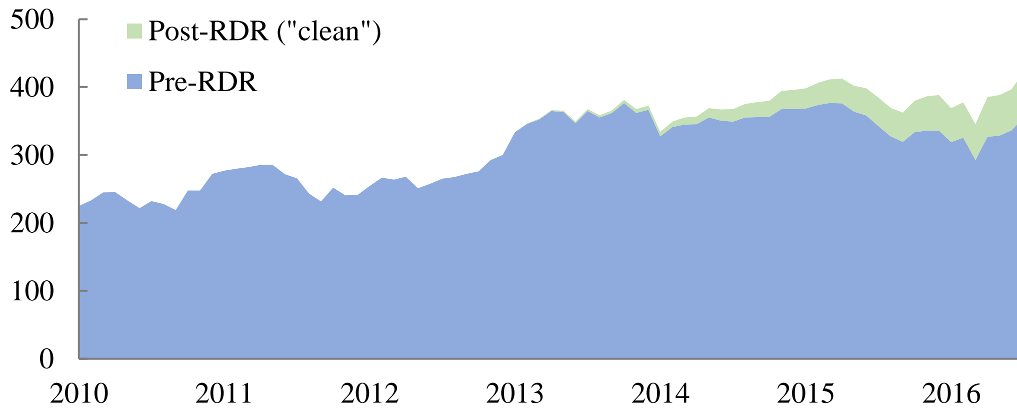
[23] Figure 10 on page 13-14 of Annex 7 in the Report.

Figure A.10: Assets Have Shifted Over Time toward "Clean" Share Classes of Funds

Panel A: US-authorised equity funds, trillions of US dollars; year-end, 2008–2015



Panel B: UK-available equity UCITS with a sterling-denominated share class, billions of pounds sterling; month-end, January 2010–July 2016



[1]Pure no-load ("clean") share classes of mutual funds are those with no front-end or back-end load and no 12b-1 fees.
Note: Data exclude funds of funds and ETFs.
Source: Investment Company Institute tabulations of Morningstar Direct data

4. Investors Can and Do "Switch" Out of Funds

The Report argues that "For competition to work effectively, investors need to be able to assess whether their products have delivered value for money and switch if alternative products are likely to better meet their needs."[24]

[24] Report at 62.

We agree and believe that the evidence supports these propositions. The Report, for instance, indicates that investors respond to returns.[25] It follows that investors should also respond to ongoing charges.

Evidence indicates that UK investors do respond to ongoing charges. The Report, for instance, states that nearly three-fourths (72 percent) of survey respondents indicated that they looked at funds' ongoing charges when making an investment.[26]

Since what consumers say and do sometimes differ, it is worth considering direct evidence of whether investors respond to ongoing charges. Direct evidence indicates that UK investors tend to favor funds with lower ongoing charges. Figure A.11 looks at net flows to funds available for sale in the United Kingdom. As seen in Panel A, in 2015, funds with below average ongoing charges (those in either the lowest or second quintile) experienced inflows. Funds with ongoing charges at the upper end (fourth and highest quintiles) experienced net outflows. As the middle and bottom panels of the figure show, these same patterns hold up when one conducts the analysis using funds domiciled in the United Kingdom (i.e., UK-authorised funds) or only the sterling-denominated share classes of all funds available for sale in the United Kingdom.

Although our analysis here is limited to a single year, 2015, it indicates that in practice investors likely do respond to fund charges.[27] We encourage the FCA to supplement its survey data on the issue of whether fund investors respond to fund charges with this kind of analysis.

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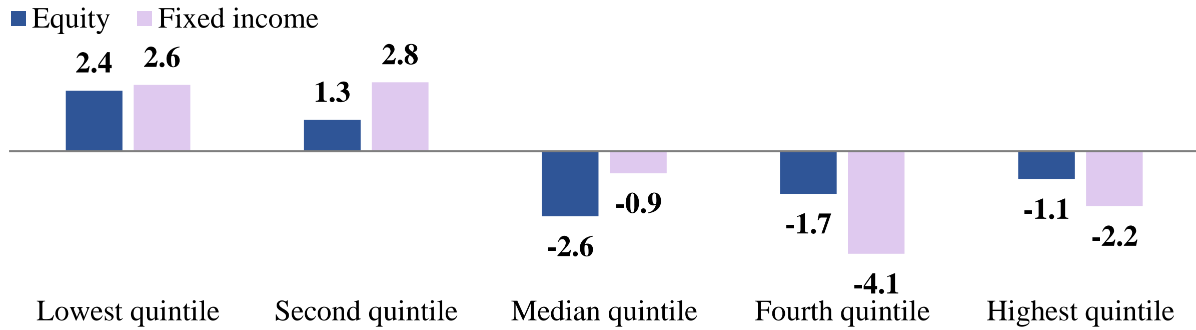
[25] Report at page 26 of Annex 3, indicating that among the "most mentioned drivers of value for money" by respondents were returns and charges.

[26] *See* Figure 17 on page 41 of Annex 3 in the Report.

[27] Much of the report seems to conflate "funds", "the industry" and "retail." Whilst clearly funds are the predominant vehicle of choice for retail customers, funds are also used by institutions. As a rough estimate, perhaps 50 percent of the global asset management marketplace is institutional in nature. Industry participants indicate that institutional investors demonstrate strong price sensitivity, which in turn influences price structures and levels in the institutional market, whether through separate accounts or funds.

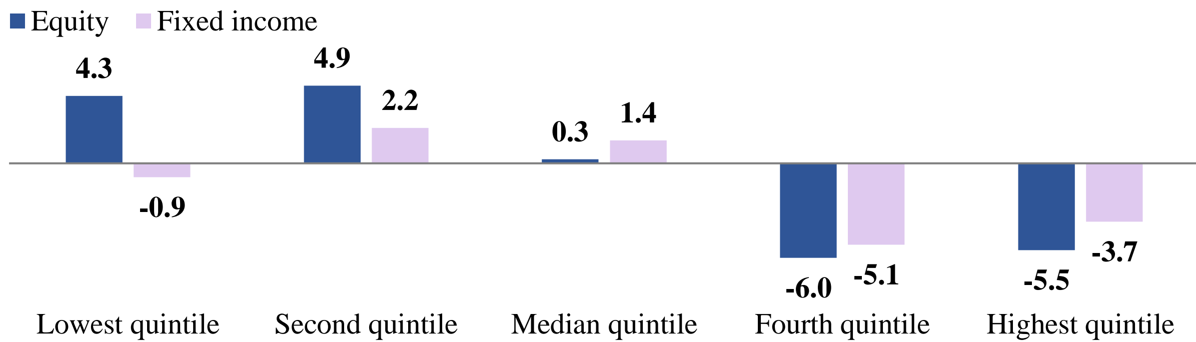
Figure A.11: Estimated Flows to UCITS Available for Sale in the United Kingdom by Ongoing Charges
Percentage of fund category total net assets, 2015

Panel A: Funds available for sale in the United Kingdom



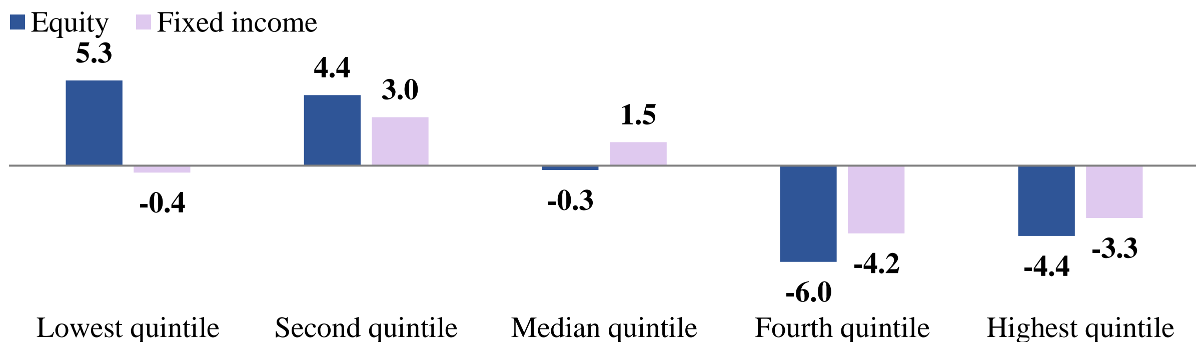
Quintiles for ongoing charges figures by fund category

Panel B: Funds authorised in the United Kingdom



Quintiles for ongoing charges figures by fund category

Panel C: Fund share classes that are sterling-denominated



Quintiles for ongoing charges figures by fund category

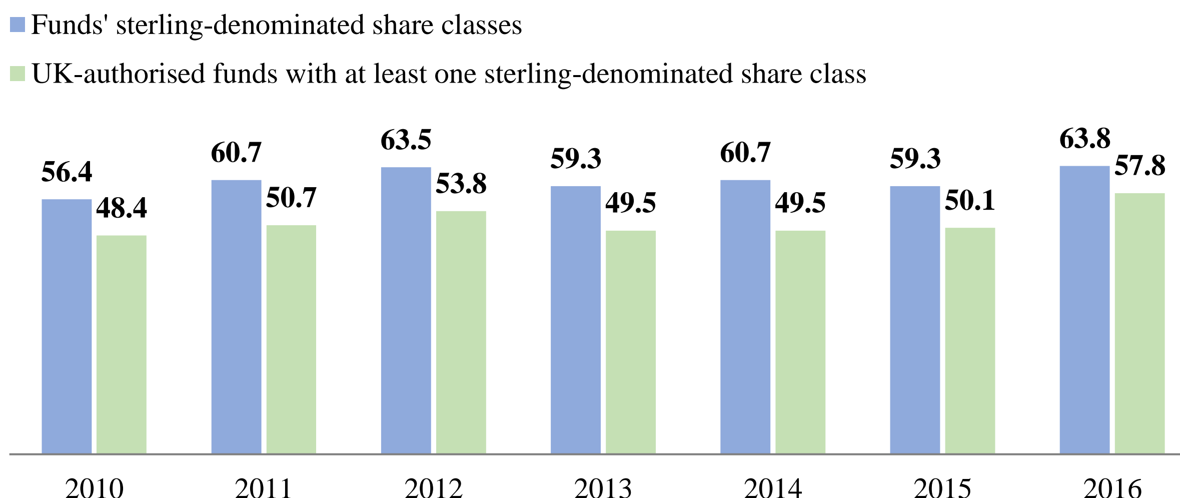
Note: Data include both active and index tracker funds. Data exclude funds of funds and ETFs.
Source: Investment Company Institute tabulations of Morningstar Direct data

Based on its survey of 2,500 investors, the Report states that in certain cases, investors may not switch between funds, either because they did not know that was possible, could not find reasonable alternatives, or simply had not considered doing so.

These cases, however, must be limited.[28] Figure A.12 shows that each year from 2010 to 2016 at least half of all funds available for sale in the United Kingdom experienced net outflows. For example, in 2016, 57.8 percent of UK-authorised funds that had at least one sterling-denominated share class experienced net outflows. The percentage is even higher (63.8 percent) among share classes most likely to be held by UK residents (i.e., counting only the flows to sterling-denominated share classes of funds available for sale in the United Kingdom).

In short, direct evidence (as opposed to survey responses) indicates that investors can and do "switch" and are able to discern value for money. The ability of investors to switch puts tremendous competitive pressure on fund providers to deliver value for money.

Figure A.12: Each Year, About Half of All UK-Authorised Funds Experience Net Outflows
*Percentage of total number of funds; 2010–2016**



*Data through end of July 2016.
Note: Data exclude funds of funds and ETFs.
Source: Investment Company Institute tabulations of Morningstar Direct data

5. <u>Economies of Scale</u>

The Report also voices concerns that "fund level economies of scale do not get passed on in lower charges to investors."[29] The Report's logic seems to be that: (a) funds are subject to substantial economies of scale; (b) industry assets are growing; and therefore (c) fund charges should be falling.

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[28] The Report's conclusions are based on a survey of 2,500 direct fund investors. It is unclear whether and how a focus on direct fund investors could influence the survey's results.

[29] Report at 114.

The role of economies of scale in fund charges is in fact much more nuanced. In particular, economies of scale occur at various levels in the fund industry for very different reasons.

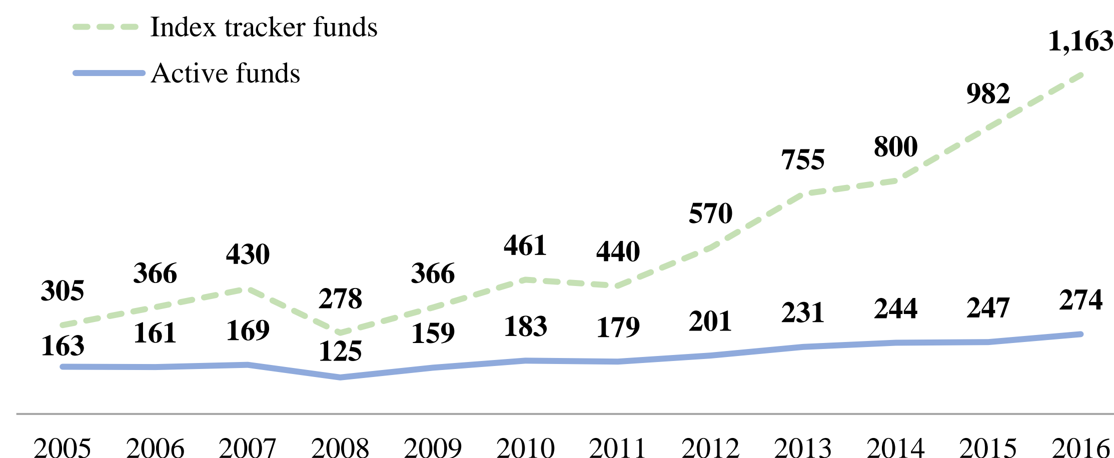
First, economies of scale can arise at the industry level. If fund industry assets rise, the supply of, and competition among, third-party service providers may rise, helping reduce operating costs across the entire industry. But this is not the only route to economies of scale, nor necessarily the most important one.

Economies of scale also may occur at an individual fund. For instance, in theory, a single portfolio manager might be able to manage a portfolio of £100 million just as ably as a portfolio of £10 million. Thus, fund charges would decline as a percent of assets as a fund grows. As the fund grows from £10 million to £100 million, it contributes an additional £90 million to industry assets. An outside observer would see fund industry assets growing and asset-weighted fund charges falling.

Suppose, however, that the fund industry grows because the number of £10 million funds, all offered by different providers, rises from 1 to 10. Industry assets still grow by £90 million. But the industry must hire 9 additional portfolio managers. Consequently, the growth in industry assets is unlikely to help reduce fund charges. This means average fund size is important.

This fact may help explain some of the cost advantage of index tracker funds in the United Kingdom. The average size of index tracker funds is larger than that of active funds (Figure A.13). Moreover, the difference is widening. For instance, in 2005, among UK-authorised funds, the average index tracker fund was roughly twice as big as the average active fund. The average size of index tracker funds grew from £305 million in 2005 to £1,163 million in 2016. In comparison, the average active fund grew from £163 million to £274 million. Thus, by 2016, the average index tracker fund was over 4 times larger than the average active fund.

Figure A.13: UK-Authorised Index Tracker Funds Are Much Larger Than Active Funds
Average fund size in millions of pounds sterling, 2005–2016



Source: ICI compilation of Investment Association data

Economies of scale can also occur at the level of investors' account balances. Suppose that a fund's assets grow from £10 million to £100 million because a single investor adds £90 million. The single additional shareholder may add only modestly to back-office burdens. In contrast, if the fund grows from £10 million to £100 million because the fund takes on 90,000 new investors each with an account balance of £1,000, this will place a large additional burden on the fund's back office operations, limiting any potential economies of scale from the fund's growth in assets.

It is self-evident that funds pass along economies of scale arising from average account size. Funds available for sale in the United Kingdom routinely offer one or more share classes that charge lower OCFs for higher minimum account balances. Whilst these share classes frequently are labelled, or thought of by providers, as "institutional," they are typically available to retail clients investing through fund platforms. These platforms pool investments of retail clients in omnibus accounts to take advantage of funds' price breaks.[30]

The Report asks whether additional pooling of assets might add to economies of scale. We agree the FCA should study this issue. One significant difference between UK and US available funds is that US funds gain considerably greater economies of scale from defined contribution plans. In 2015, 401(k) plans had assets of $4.7 trillion, of which $2.8 trillion was invested in US mutual funds. Another $3.5 trillion in mutual fund assets were in IRAs, much of which represents from "roll-overs" from 401(k) plans when employees change jobs. US investors may hold assets in these accounts for decades. Thus, the retirement market provides a large pool of highly stable assets, creating significant pooling benefits to US mutual funds and their investors.

Fund providers also may "pass along" economies of scale even before the fund has realised them. New funds, being new, are typically small and thus do not benefit much from economies of scale. In theory, the OCF of a new fund could be so high that the fund is unable to attract any investor demand. To compensate, a fund provider may subsidise the new fund's operations, initially setting the OCF below the level that the fund's small size might dictate. The fund provider assumes the risk that over time the fund will grow to become self-sustaining and profitable. Early fund investors benefit from approach because they are able to invest in reasonable cost in a fund that may, for instance, offer a new, innovative strategy. Later fund investors (and indeed all market participants) benefit because the fund ultimately may grow to a sustainable size, expanding the array and number of funds in the market, in turn bolstering competition across the market.

Finally, economies of scale may diminish at some point, especially for actively managed funds. The Report presents evidence that OCFs for UK active funds are about the same for funds with assets of £500 million to about £1,800. One reason could be the potential for diseconomies of scale if an active fund grows too large. If an active fund is able to generate significant alpha, it may well attract substantial new inflows. But as the active fund grows larger, especially if it is a

[30] Indeed, in the post-RDR world, it is more the rule than exception that a fund provider's lowest cost share class will be that available on a particular fund platform.

fund focusing on a more specialised niche or less liquid market sector, the portfolio manager may find it increasingly difficult to generate alpha. The academic literature has found evidence of just these kinds of diseconomies of scale.[31] Not surprisingly, fund providers sometimes close such funds to new investors so that *diseconomies* of scale "do not get passed on" to existing fund shareholders.

We recommend the FCA consider and discuss such nuances and whether and how they are likely to impact the Report's findings.

6. Profitability of Fund Providers:

The Report voices concerns that asset managers appear to have "high" profit margins, concluding that competition may not be working "as effectively as it could."[32]

In almost any market, changes can be envisioned that might improve competition (e.g., by enhancing information available to consumers). But it is unclear whether the Report's profitability analysis provides evidence that competition among UK fund providers is lacking.

If correct, the regulatory objective would be to determine whether there is an impediment that prevents other fund providers from entering the market and competing away above-average profits. The Report seems to adopt the view that investors do not "switch" funds, making it difficult for other fund providers to gain market share. Earlier, however, we provided evidence that fund investors can and do switch funds, ruling that out as an impediment.

Another possibility is that some barrier (e.g., regulation) prevents firms from entering the UK market. As we argued earlier, that also does not appear to be the case in the UK market: new firms have entered the market in recent years and new products are coming on line, both of which add to competitive pressures.

Alternatively, an industry, though highly competitive, might have higher-than-average profit margins to compensate for risk. As noted earlier, creating and managing funds is a risky proposition. The fund provider must set up the fund, create or provide the supporting infrastructure, perhaps invest seed capital, advertise the fund, perhaps subsidise the fund in its early years, but above all seek out and maintain investors. There is no guarantee investors will come. Even if investors do come and the fund grows, given that investors can redeem on a daily basis, the fund provider faces the risk that the investors could leave at any stage.

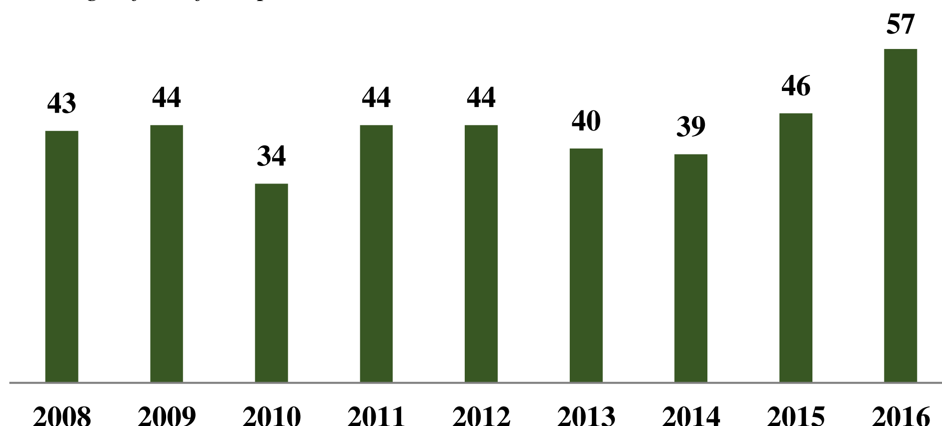
Not infrequently, fund providers experience very sizable outflows owing to underperforming funds, loss of a prominent portfolio manager, a fund mix that goes out of style, changes in platform offerings or approved lists, and other idiosyncratic factors. As Figure A.14 shows, in every year during the period 2008 to 2016, at least one-third of the fund providers

[31] Joseph Chen, Harrison Hong, Ming Huang, and Jeffrey D. Kubik (2004), "Does Fund Size Erode Mutual Fund Performance? The Role of Liquidity and Organization," *American Economic Review*, 94(5), 1276-1302.

[32] Report at 119.

operating in the United Kingdom experienced aggregate outflows from their UK-authorised funds. In 2016, nearly 60 percent of UK fund providers experienced net outflows from their UK-authorised funds. This highlights the business risks fund providers face.

Figure A.14: Fund Providers with Net Cash Outflows from Their UK-Authorised Funds
Percentage of UK fund providers, 2008–2016



Note: Data are based on the Assets Flows tab in Morningstar Direct for UK-domiciled open-end funds. It excludes assets in funds of funds and ETFs. As such, it is not survivor-bias free.
Source: Investment Company Institute tabulations of Morningstar Direct data

In addition, because (as the Report indicates) fund charges are "ad valorem," the provider's revenue stream depends on market conditions. When stock and bond markets decline, so too will the fund provider's revenue stream. Given market volatility, profit margins may vary substantially over market cycles. A higher-than-average profit margin may help compensate a fund provider for the considerable uncertainty that market volatility imparts to its revenues.

Finally, we have concerns about the data the Report uses to assess the profitability of asset managers. For example, the Report assesses profit margins over 2010–2015. This may give a distorted view of profitability because it focuses on a period immediately following the financial crisis. At that point, profit margins likely were compressed. The sample ends before 2016 when, because of Brexit, markets were down and asset manager profits also may have been depressed.

In addition, the Report's analysis is based on a limited sample, just 16 asset managers out of a total of the roughly 100 operating in the United Kingdom. It is very difficult to tell from the Report what types of asset managers it ultimately included in its profitability analysis. Our own experience, both with UK and US fund providers, is that it can be extremely challenging to attempt any kind of meaningful analysis of profitability. For example, many asset managers operating in the United Kingdom operate globally and may be subsidiaries of large global banks, insurance companies, or other firms. Our impression is that seeking to parse out the profits that such a company may earn on a given line of business in a particular country may be at best be an exercise in transfer pricing and/or cost allocation.

The Report's profitability analysis also may be subject to the "survivor-bias" criticism. In Chapter 4, the report notes that the average performance of funds can be biased upward if one fails to account for funds that underperformed and were subsequently closed or liquidated but that do not appear in one's dataset. In its profitability analysis, however, the Report does not discuss whether particular fund providers, perhaps because of low profitability, have merged with other asset managers, left the market, or simply gone bankrupt. These providers would likely have been unprofitable and, were they included in the sample, could lower the average profit margins.

The Report acknowledges many of these concerns in passing but largely dismisses them. As just one example, the Report states that "Some firms have suggested that their business is cyclical …Whilst this may be true for certain specialist asset managers, invested in one set of markets, it seems less likely to be the case for firms that are diversified globally across many markets."[33] We wonder if this view is consistent with the experiences of global asset managers during the financial crisis of 2007–2009. Although the crisis started in the United States, it ultimately affected most financial markets around the world and hence, we suspect, most global asset managers. Indeed, firms whose investor base was primarily in a particular country (e.g., Canada) may have been more insulated than global asset managers.

We encourage the FCA to consider these issues in future rounds of research. In particular, we encourage the FCA to focus on whether there are legal, regulatory, or capital markets impediments that prevent competition from functioning as fully as the FCA might hope.

7. Fund Providers Compete on a Range of Other Characteristics In Addition to Price

Although funds compete on price, they also must compete along a number of other dimensions such as risk and return, product mix and design, investment objective, nature and quality of the services offered (e.g., fund websites, automated voice-response systems, opening hours of telephone call centres), minimum initial investments, charges assessed outside the fund's OCF (e.g., entry or exit charges), firm reputation, convenience, and brand.

Funds must do this because, as the Report acknowledges, fund investors are diverse.[34] They differ in terms of age, risk-aversion, current and expected future income, goals, family characteristics, knowledge, and investable assets. Consequently, fund providers also must compete on the basis of fund variety.

The UK fund market is populated by a large number of funds that offer investors tremendous variety. Figure A.15 shows the number of funds available for sale in the top 20 categories (in terms of assets under management). In most active categories, there are dozens to hundreds of active funds. In most categories, active funds compete with index trackers for investors' assets, but especially in the categories with the greatest assets. For instance, the top

[33] Report at Annex 8, page 11.

[34] *See* Report at Annex 3, page 6, stating that "Investors can differ substantially in terms of knowledge, preferences, experience and behavior."

category in terms of assets is UK Equity Large Cap. In this category, by our calculation, there are 411 active funds and 55 index trackers that are available for sale in the United Kingdom and that have a least one sterling-denominated share class. In short, not only do fund providers compete on the basis of price, but also fund variety.

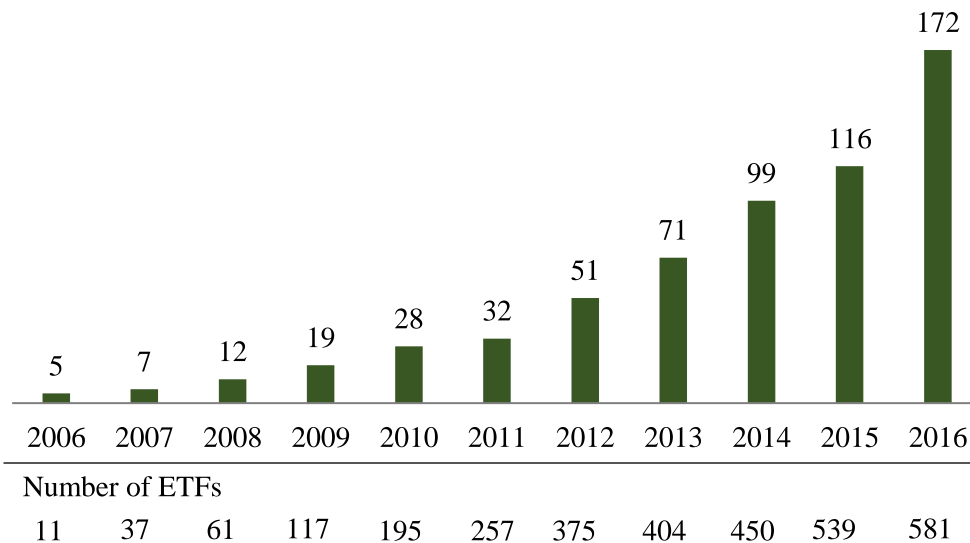
Figure A.15: UK Fund Providers Compete by Offering a Wide Variety of Funds
Number of UK-available UCITS with at least one sterling-denominated share class, year-end 2015

	Category	Actively managed	Index tracker
1	UK Equity Large Cap	411	55
2	Global Fixed Income	215	10
3	Global Equity Large Cap	345	13
4	Europe Equity Large Cap	201	15
5	Other Fixed Income	151	5
6	High Yield Fixed Income	130	0
7	Moderate Allocation	133	0
8	Emerging Markets Equity	209	11
9	Sterling Fixed Income	199	16
10	UK Equity Mid/Small Cap	221	2
11	Multialternative	79	0
12	Asia ex-Japan Equity	142	8
13	Other Alternative	115	1
14	Japan Equity	105	12
15	Cautious Allocation	68	0
16	Emerging Markets Fixed Income	60	1
17	Aggressive Allocation	136	1
18	Long/Short Equity	93	0
19	Euro Fixed Income	28	1
20	Other	773	25
	Total	**3,814**	**176**

Note: Fund categories represent data aggregated from Morningstar's "global category" and therefore might aggregate certain classes of funds seen in other sources. Data exclude funds of funds, ETFs, and money market funds.
Source: Investment Company Institute tabulations of Morningstar Direct data

Choice and variety of funds also has expanded in the United Kingdom in recent years through growth of the ETF market. As Figure A.16 shows, in 2016, there were nearly 600 ETFs listed for sale on the London Stock Exchange, up from 11 in 2006. Assets in these ETFs have expanded rapidly, from just £5 billion in 2006 to £172 in 2016. Active and tracker funds must compete not only with and among each other, but also with ETFs.

Figure A.16: The ETF Market is Growing in the United Kingdom
Assets in billions of pounds sterling; year-end, 2006–2016



Source: Investment Company Institute tabulations of Morningstar Direct data

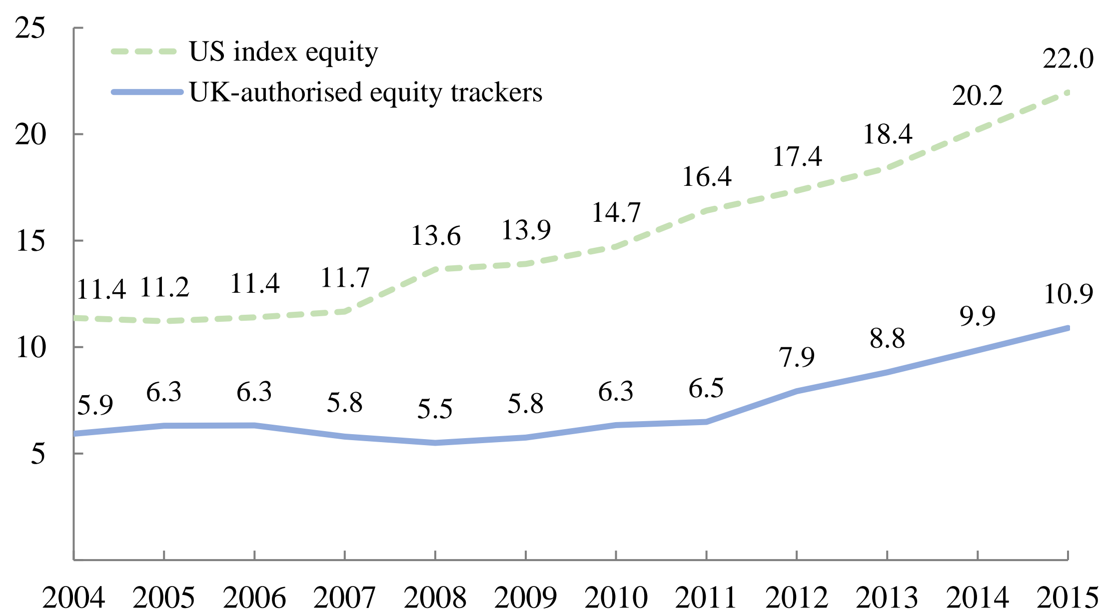
We encourage the FCA to consider in its analysis that fund providers compete not just through price, but also along a number of dimensions, such as variety of funds offered.

8. Competition Between and Among Active and Passive Funds

Perhaps one of the most significant developments in the fund industry this century is the rising market share of passively managed funds. This phenomenon, though somewhat more advanced in the United States, is also evident in the United Kingdom.

For example, Figure A.17 compares the share of equity fund assets accounted for by tracker funds in the United Kingdom to that in the United States. In both countries, the share has risen significantly in the past decade, but especially since the end of the financial crisis.

Figure A.17: Index Funds' Share of Retail Fund Markets: UK and US Compared
Equity index tracker fund share of equity fund assets, percentage; year-end 2004–2015



Note: Data exclude assets in ETFs.
Sources: Investment Company Institute and Investment Association

This shift is creating tremendous competitive pressure as industry participants seek to adapt. Active funds compete not just with other active funds but head-on with index tracker funds and ETFs.[35] The Report seems to acknowledge this, stating that "Our evidence also suggests that competitive pressures are building in some parts of the market and stakeholders and commentators suggest this is likely to continue."[36]

Most investors, whether retail or institutional, seek investment strategies that deliver favorable returns while meeting their financial objectives. Among other things, this involves weighing an investor's risk tolerances, preferences and other individual circumstances (e.g., age) against expected returns and risks. Inevitably this involves some level of active management.

This is not altered by the fact that passively managed products (index tracker funds and ETFs) are gaining market share. Instead, it simply shifts active management from the "inside' of actively managed funds to the "outside" of passively managed products.[37]

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[35] Academic research indicates that the presence and growth of index funds in a country promotes increased competition that benefits investors in active funds. See, for example, Martijn Cremers, Miguel A. Ferreira, Pedro Matos, and Laura Starks (2016), "Indexing and Active Fund Management: International Evidence," *Journal of Financial Economics*, 120, 539-560 stating that "Markets with more competition from explicitly indexed funds display active funds that pursue more differentiated product strategies … to deliver alpha to investors and charge lower fees for active management."

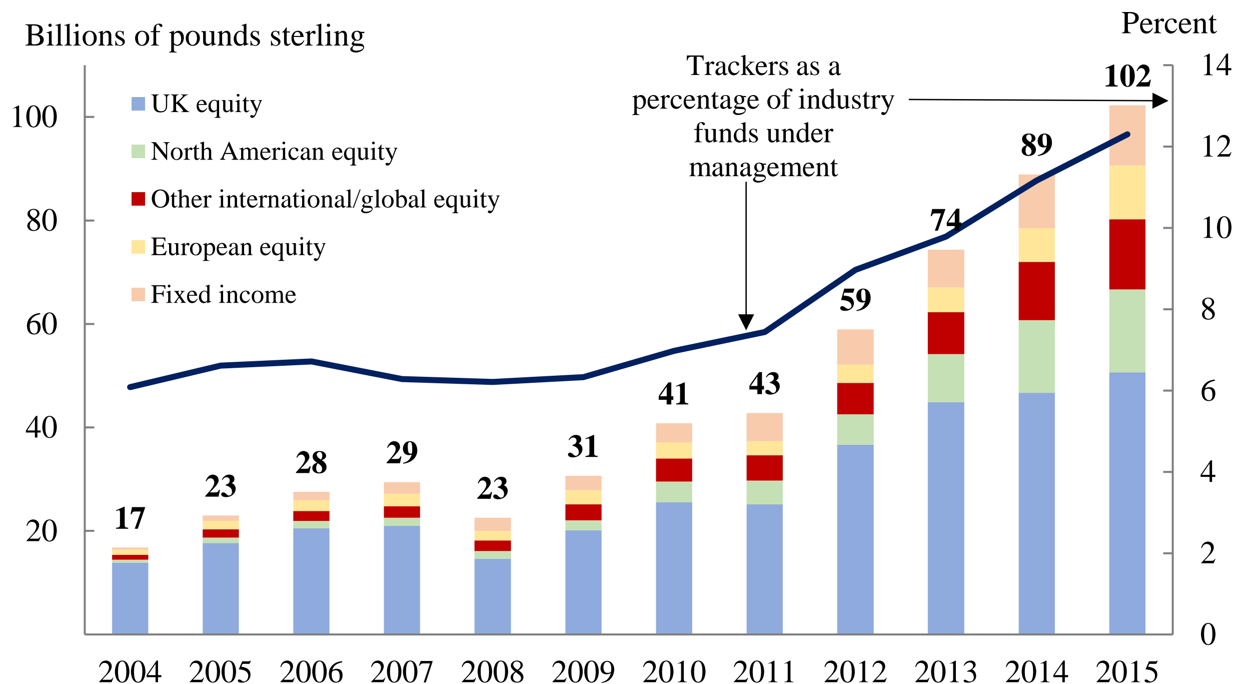
[36] Report at 20.

[37] For example, an investor who puts all of his or her pot in a FTSE All Shares index tracker fund has actively chosen to focus only on UK equities.

For example, platforms and financial advisers offer portfolios of tracker funds that are bundled and perhaps actively managed (such as through periodic rebalancing) to maintain a given asset allocation or focus. In such cases, the investor will incur charges on the underlying funds, and also may pay an asset-based fee to the platform or financial adviser. Alternatively, an investor might choose an actively managed fund that performs essentially the same functions. For example, asset allocation funds, target date funds, and target risk funds all provide varying degrees of active management on behalf of fund investors. Or, a financial adviser might propose an asset allocation strategy based on a core of index tracker funds that target the UK equity market and a "satellite" of actively managed funds to ensure exposure to other market segments. Each of these strategies provides active management that helps the investor meet his or her goals, but they achieve it through varying mixes of active and passive products.

One reason an investor might choose the "core and satellite" approach to building a portfolio is that index tracker funds have tended to be more predominant in certain market segments, especially large-cap equity. For example, of the £102 billion held in UK tracker funds in 2015, about half was invested in tracker funds targeting UK equities (Figure A.18). Actively managed funds may be a natural choice for investors seeking exposure to sectors that are less well populated by index tracker funds, especially particular segments of the fixed income market (e.g., high yield and emerging markets debt).

Figure A.18: Share of Index Tracker Funds in Various Investment Categories
Year-end, 2004–2015



Note: Excludes assets in ETFs.
Sources: Investment Company Institute and Investment Association

Smart beta funds, absolute return funds and volatility-managed funds are by definition actively managed. Smart beta and absolute return funds have been in high demand by UK investors in the past few years, in no small part because (as the Report recognises), "Not all investors are seeking to outperform a given market … Investors are increasingly seeking absolute returns, rather than returns relative to a benchmark."[38]

In short, both active and index funds can help investors meet their goals. For this reason, investors tend to rely on a mix of both active and index tracker funds. This is exactly what the Report finds: in its online survey of 2,500 investors, 40 percent reported investing in a mix of active and passive funds.[39] Most respondents (71 percent) stated that there were "very familiar" or "quite familiar" with the terms "active" and "passive."[40]

Moreover, it is crucial to bear in mind that an investor typically considers a fund as a piece of an overall portfolio. A given investor might, therefore, hold a particular fund even if it has "underperformed." For example, suppose an investor holds 50 percent of his or her pot in an equity fund and the other 50 percent in a fixed income fund. If stock prices fall while bond prices rise, a reasoned asset allocation strategy might call for the investor to *add* to his or her holdings of the equity fund. This helps bring the portfolio back into balance. As another example, suppose an investor holds an active equity fund that overweights small cap stocks relative to other funds in the same investment category. The investor might be willing to accept shorter-term losses on the plausible assumption that small cap stocks will in the longer-term outperform large cap stocks. An investor might value a fund that underperforms an index if the fund provides a hedge against short- to medium-term variation in the index, a feature the Report seems to acknowledge.[41] Many types of funds, such as "go anywhere" or absolute returns funds, have the explicit goal of trying to earn favorable returns, not to beat a benchmark. Other funds may have the goal of minimising risk or dampening the volatility of returns.

The Report nevertheless judges that some funds—both active[42] and passive[43]—may not be offering "value for money." This judgement appears based at least in part on the presumption that the primary goal of most investors is to "beat a benchmark" at the least possible cost.

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[38] Report at 109-110.

[39] Report at Annex 3, page 33.

[40] Report at Annex 3, page 32.

[41] Report at 109-110 stating that "Not all investors are seeking to outperform a given market. Some are looking for active asset management to manage the downside risk of their investment. For example, they may be prepared to accept market returns or even below market returns when markets are rising, in the hope that when markets fall, their fund manager is able to limit the downside risk. This could be, for example, by moving investments out of a falling market."

[42] Report at 99 arguing that "Expensive 'partly active' funds are unlikely to deliver value for money."

[43] Report at 108 stating that "the lower the tracking difference [i.e., tracking error], the closer to the market benchmark the passive fund will be. However, we have found that there is a substantial amount of AUM invested in passive funds that are priced highly and therefore are unlikely to be delivering value for money" and Report at 91 stating that "around £6bn is invested in passive funds which are significantly more expensive than average."

This has the unfortunate outcome of leading the Report to try to address the question of which funds outperform benchmarks. Comparisons of this kind face difficult methodological hurdles. For examples, many funds compare themselves to multiple benchmarks. Other funds may not report a benchmark. Results can vary markedly depending on the time period analysed. Newly created funds may have too little history to be included. Funds that were merged or closed may be excluded.

Whilst the Report acknowledges some of these concerns, it largely ignores them, making the strong conclusion that actively managed funds underperformed their benchmarks from 2003 to 2015. "Overall, our evidence suggests that actively managed investments do not outperform their benchmarks after costs. Funds which are available to retail investors underperform their benchmarks after costs."[44] This result, which has been widely noted in the media,[45] is a key element of the FCA's contention that some funds do not offer "value for money."

In fact, the evidence in the Report is inconclusive. The key evidence is Figure 6.1, reproduced below as Figure A.19. The figure presents results on fund returns relative to funds' benchmarks (apparently as reported in Morningstar) for sterling-denominated share classes of funds available for sale in the United Kingdom. Results are reported for: (1) active and passive funds; (2) as simple and asset-weighted averages; (3) and by whether share classes had distribution charges bundled in their OCFs or not. Summary figures are reported for equity, fixed income ("FI"), asset allocation ("Allocation"), and alternative strategies funds all combined, and for equity funds by themselves.

[44] Report at 15.

[45] *See*, for instance, Caroline Binham, Chris Newlands, and Madison Marriage, "UK Regulator Plans Shake-up of Fund Sector," *Financial Times*, 18 November 2016.

Figure A.19: Monthly Net Returns over the Benchmark in Morningstar Direct (percentage points)
As presented in the FCA Asset Management Market Study Figure 6.1

			Clean and bundled (2003–2015)	**Bundled share classes (2003–2015)**	**Bundled share classes pre-RDR (2003–2012)**	**Bundled share classes, and clean share classes post-RDR with representative platform charge (2003–2015)**
Equity, FI, Allocation, Alternative	Active	Simple average	-0.08	-0.09	-0.08	-0.09
		Weighted average	-0.04	-0.07	-0.07	-0.05
	Passive	Simple average	-0.08	-0.08	-0.08	-0.10
		Weighted average	-0.05	-0.06	-0.06	-0.07
Equity	Active	Simple average	-0.01	-0.02	-0.02	-0.01
		Weighted average	0.04	0.01	-0.02	0.03
	Passive	Simple average	-0.07	-0.08	-0.07	-0.09
		Weighted average	-0.05	-0.06	-0.06	-0.06

Source: FCA, *Asset Management Market Study,* Figure 6.1: "Monthly net returns and benchmark returns data from Morningstar Direct, for open-ended funds with GDP denominated share classes available for sale in the [United Kingdom]."

As noted, the Report states that "active funds underperformed their benchmarks after charges."[46] But what the Figure shows, as the Report indicates a few paragraphs later, is something quite different. According to the figure, in most cases both active and passive funds underperformed their benchmarks. In some cases, active funds underperformed by less and, in other cases, passive funds underperformed by less.

There is a very important exception, however. As the Report notes, "The exception to this is when we consider equity share classes only and use a money-weighted average: in three specifications the excess net performance for active funds is positive"[47] (highlighted in yellow in Figure A.19). In other words, on a money-weighted basis, actively managed equity funds *outperformed* their benchmarks. That is a very significant exception, given that in 2015, nearly half of the assets in UK-authorised funds were in actively managed equity funds. In short, the evidence in this table presents a mixed and inconclusive picture about underperformance by various types of funds.

[46] Report at 96, paragraph 6.23.

[47] Report at 96.

9. Conclusions

To conclude, the evidence the Report provides is not compelling that a lack of competition among fund providers is a problem in the United Kingdom. In fact, there appears to be strong competition among fund providers for investors' business. Meanwhile, investors can and do migrate between funds and fund providers. Competition for investors' pots between and among active and passive funds promotes a more efficient fund market across the board.

Reflecting this, charges for funds available for sale in the United Kingdom are only modestly higher than comparable funds in the United States, which is generally deemed the world's most competitive fund market. Moreover, our findings indicate that the charges UK investors incur through funds have declined over time, whether funds are bundled with distribution charges or not, and whether those funds are active or passive.

Both active and passive funds can help investors meet their financial goals. Investors, perhaps with the assistance of a financial advisor, are best placed to determine how to manage their assets, whether through active funds, passive funds, target date funds, smart beta funds, ETFs, direct investment in stocks and bonds, or any mix.

Well-designed disclosure can help foster investor awareness and good decision-making. But regulators should be careful about not leaving the impression that investors should tip their portfolios toward any particular goal, investment strategy, fund provider, or fund type. Those decisions are best left to investors.

Indeed, so long as there is strong competition among fund providers, as the evidence indicates there is, regulators should be very cautious about whether and how they interject themselves into these dynamics. Doing so risks reducing investor choice, degrading competition, and eroding price discovery in capital markets. This consideration is especially important given the uncertainty surrounding what Brexit may mean for UK investors and the asset management industry.

Annex 2: Fund Governance[1]

The Report lists various ways to improve competition by strengthening the duty of asset managers to act in the best interests of investors, including by reforming governance standards. The Report indicates that authorised fund manager ("AFM") boards have a duty to act independently and in the best interests of investors, but that there is no "explicit and well defined obligation to seek value for money." Proposed reform options in the Report include (1) clarifying AFM board duties, (2) extending the Senior Managers and Certification Regime to AFM board members, along with requiring consideration of value for money, (3) implementing changes for more independence, such as a new governance body modelled after DC pension fund governance or the US-style fund governance regime, or (4) enhancing the duties of trustees and depositaries to assess value for money.

First, as described in Annex 1, we question the basis – weak competition – upon which the Report premises the need for its proposed governance remedies. Second, while we recognise that a robust governance structure can help promote competition, it is primarily a tool to address and mitigate conflicts of interest. We recommend that any governance reforms be assessed primarily from that perspective so that reforms can be calibrated to address identified problems. This is particularly important, as IOSCO has recognised, because there are a number of entities and factors (*e.g.*, investor rights, transparency, depositary) that affect fund governance and the management of conflicts. We describe below the fundamental aspects of the US fund governance regime.

When the ICA was enacted, it included a provision requiring that at least forty percent of a fund's directors not be affiliated with the fund's adviser (manager) or principal underwriter.[2] Notably, in contrast to the laws applicable to pooled funds in the United Kingdom, the ICA presumes a corporate style fund structure and a contract or agreement with an investment manager as a separate entity. The ICA provision regarding directors was specifically put into place to address the potential for conflicts of interest and self-dealing – concerns which were prevalent at the time of enactment. As a result, US fund boards are primarily tasked with serving as "watchdogs" for protecting investor interests and providing an independent check on the fund's investment adviser.[3]

This oversight responsibility of the fund's board has formed the backdrop for the role of independent directors in the United States. In general, the role of the board is to oversee the management and operations of the fund on behalf of the fund's shareholders. Directors also have significant and specific responsibilities under US law. Among other things, directors annually approve the fund's management agreement and fees paid to the investment adviser for its services, oversee the performance of the fund, and oversee the fund's compliance program. As part of the board's annual review and approval of a fund's investment advisory contract, the board must request and evaluate, and the adviser must furnish, such information as may reasonably be necessary for the board to evaluate the terms of the advisory contract.[4] Recognising that the ICA is relying on fund boards to oversee conflicts of interest, including conflicts with respect to fees to be received by a fund's

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[1] For questions on US regulated fund governance, please contact Amy Lancellotta, IDC Managing Director, at amy@ici.org or +1-202-326-5824.

[2] 15 U.S. Code §10(a).

[3] Burks v. Lasker, 441 U.S. 471, 484 (1979).

[4] S*ee* 15 U.S. Code §15(c).

investment adviser, the US Securities and Exchange Commission ("SEC") requires that funds disclose the material factors that formed the basis of the board's approval of the fund's investment advisory contract.[5]

To that end, fund boards consider a number of factors when reviewing a fund's investment advisory contract. The factors, which, for many years, have been referred to as the "Gartenberg factors" after the court decision that first articulated them, have been incorporated into the SEC disclosure rule requiring funds to discuss the basis for the board's approval of the fund's advisory contract.[6] Further, directors have a fiduciary duty to represent the interests of the fund's shareholders. When facing claims regarding a breach of fiduciary duty, directors often rely on the US "business judgment rule." This long-standing legal doctrine provides considerable deference by courts to decisions of directors that have acted on an informed basis, in good faith, and in the honest belief that their decisions were made in the best interests of the fund and its shareholders. In addition, in US litigation challenging the payment of advisory fees by funds, US law holds that a breach of the fund adviser's fiduciary duty exists only when the adviser charges a fee that is so disproportionately large that it bears no reasonable relationship to the services rendered and could not have been the product of arms-length bargaining.[7]

The US independent board framework has been effective in addressing concerns of conflicts of interest and self-dealing. Nevertheless, it is noteworthy that, in its 2007 Final Report on the Examination of Governance for Collective Investment Schemes, IOSCO recognised that a number of entities and factors (*e.g.*, investor rights, transparency, role of depository) have a role in fund governance and the management and mitigation of conflicts of interest and refrained from deeming a particular model superior to others.[8]

Ultimately, the establishment of a strong governance system for a given jurisdiction necessitates balancing various concerns and taking into consideration the existing framework and supporting infrastructure. As explained above, considerations unique to the United States were instrumental to the adoption of the existing framework. US fund governance operates within the full framework of the ICA. The ICA presumes a corporate fund structure and imposes specific responsibilities on the fund's board of directors. The ICA also includes other provisions to mitigate conflicts of interest, such as restrictions on affiliated transactions. The laws of the United Kingdom impacting funds have differences with the United States. For example, as recognised in the Report, pooled funds in the United Kingdom can be set up using a variety of forms, including as companies, trusts and partnerships, and managed within a number of regulatory structures such as UCITS or under the Alternative Investment Fund Manager Directive.[9] UK regulated collective investment schemes have a depositary with

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[5] *See* Disclosure Regarding Approval of Investment Advisory Contracts by Directors of Investment Companies, Sec. Act Rel. No 33-8433 (June 23, 2004), available at https://www.sec.gov/rules/final/33-8433.htm.

[6] *See* Gartenberg v. Merrill Lynch Asset Management, Inc., 694 F.2d 923 (2d Cir. 1982).

[7] Id. at 928.

[8] *See* IOSCO, Examination of Governance for Collective Investment Schemes, Final Report, Part I, Report of the Technical Committee of IOSCO (June 2006), available at http://www.iosco.org/library/pubdocs/pdf/IOSCOPD219.pdf. *See also* IOSCO, Examination of Governance for Collective Investment Schemes, Final Report, Part II, Independence Criteria, Empowerment Conditions and Functions to be performed by the 'Independent Oversight Entities,' Report of the Technical Committee of IOSCO (February 2007), available at http://www.iosco.org/library/pubdocs/pdf/IOSCOPD237.pdf.

[9] Report at 36.

oversight duties over the AFM.[10] The laws of a fund's domicile also impact a fund such as when a UK authorised UCITS is organised in another Member State. Other recent laws which will impact, or are impacting, the asset management industry and funds, include the Senior Managers and Certification Regime,[11] and the UK's implementation of the product governance framework under MiFID II.[12] These differences with the United States (and other jurisdictions) must inform the evaluation and tailoring of any fund governance reforms for the United Kingdom.

As thoroughly examined by IOSCO on a global basis, there are a range of approaches and entities that can contribute to more effective independent oversight including:

- Depositary
- Trustee
- Enhanced role of fund auditor
- Independent Review Committee
- Independent Compliance Committee
- Independent directors on fund manager's board
- Supervisory board of the fund manager

The FCA must consider, in light of the UK's own local laws and circumstances, whether and how various entities and other features may mitigate conflicts of interest to the benefit of UK regulated fund investors.

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[10] Report at 37.

[11] The Senior Managers and Certification Regime, which is expected to come into force for all financial services firms in 2018, will enhance individual accountability, impose new conduct rules, and require additional training and record-keeping. More generally, under the FCA's Principles for Businesses, a firm must pay due regard to the interests of its customers and treat them fairly.

[12] The MiFID II product governance requirements impose significant responsibilities on product manufacturers and distributors, including obligations to consider charging structures, the target markets for products and the management of conflicts. Firms also must undertake periodic reviews of the target market and the performance of products.