

Promoting Trust and Transparency in the UK Investment Industry

Initiated by



Contents

Page	
1	**Executive Summary**
3	**Statistical Evidence**
5	**UK Investment Industry Levels of Transparency in a Global Context**
7	**Economies of Scale**
8	**Lack of Transparency and Associated Financial Frauds**
9	**Examples of recent financial scandals in the UK investment industry**
13	**Findings from New Research Commissioned by SCM**
15	**True and Fair Campaign -** Background - The Proposed Solution
16	**True and Fair Campaign -** Mission Statement - The True and Fair code Schedule of Fees and Holdings
17	**Financial Advisers and the Retail Distribution Review (RDR) – Consumers Beware**
19	**Schedule of Fees and Holdings**
21	**Sample Label**
22	**Label Example 1 -** A £1 Billion+ UK Income Mutual Fund
23	**Label Example 2 -** A £1 Billion+ UK Absolute Return Mutual Fund
24	**Label Example 3 -** A £1 Billion+ UK Equity Index Mutual Fund
25	**Label Example 4 -** A £1 Billion+ Mixed Investment 40 - 85% Shares fund of funds style Mutual Fund
26	**Label Example 5 -** A £1 Billion+ Global Investment Trust
27	**Label Example 6 -** A £1 Billion+ European Equities Exchange Traded Fund (ETF)
28	**Further Explanatory Notes**
29	**Conclusion - A Way Forward**
30	**Appendix - Academic Research**

Report Authors: SCM Private LLP
Contact: Gina Miller
SCM Private LLP
2 Eaton Gate
London SW1W 9BJ
Tel 020 7838 8650
www.scmprivate.com

www.trueandfaircampaign.com

Initiated by SCM PRIVATE The Investment Family

February 2012

Executive Summary

Since establishing SCM Private in 2009, the authors of this report have been publicly calling for greater transparency in the UK investment management industry.

SCM Private (SCM) now launches a landmark report explaining how British consumers - investors and pensioners alike - have, over many years, been comprehensively misled by the investment management industry in relation to transparency of charges and investments.

Key issues are the multiplicity of hidden fees, lack of product transparency and the convoluted language which the investment management industry uses. The odds are stacked against consumers being able to make informed and competitive investment decisions.

The investment management industry has been given no regulatory or behavioural incentive to enhance industry transparency or improve consumers' ability to effectively judge provider or product performance.

The following Report sets out a code and labelling scheme called **'True and Fair'** designed to:

- Enable consumers to compare products and providers on a like-for-like basis without hidden costs or fees
- Make companies accountable by forcing full disclosure of all holdings within any investment fund, online, on at least a quarterly basis
- Help consumers make better informed investment decisions
- Create a truly competitive investment management market
- Reduce future mis-selling or financial scandals through greater transparency of fees and investments
- Generate a new gold standard for best practice
- Restore confidence to this important part of financial services
- Provide a roadmap to regulatory reform to improve outcomes for consumers
- Detail a model to deliver fundamental change in the investment management industry

The Report also contains the findings of a specially commissioned ICM Research poll, with a large UK-wide sample which shows that:

- **84% of people surveyed agree that fund managers should be required to disclose the full breakdown of all fees incurred whilst investing someone's money**
- **Of those who save or invest, 70% want to be able to find out exactly where their money is being invested**
- **63% say they are more likely to invest if investment products had clearer labelling like food products so they could see exactly what they were buying and how much it costs**

The UK trade association, the Investment Management Association (IMA), is leading the investment industry in the wrong direction - reducing industry transparency, rather than improving it. For example, from June 2012 fund managers will no longer have to report the rate at which they trade client funds. This has rightly been described as: *"a step backwards in transparency"*[1] as it makes it much harder for investors to calculate their managers' hidden dealing costs.

The authors of this report do not believe the financial crisis is the root cause of mistrust of the City. The crisis has merely fuelled concerns which have long existed about questionable practices in the industry which have, in turn, accentuated mistrust among consumers who suffer poor investment returns.

The issues of hidden fees, lack of transparency and convoluted language have dogged the investment industry for the last decade. Nothing has changed.

Since the original executive summary of this report, released on the 31st January 2012, there has been a healthy debate over the transparency of fees, culminating in even the Chief Executive of the Investment Management Association (IMA) belatedly admitting in an interview, that some of the hidden dealing costs:
"are in the report and accounts which is a document which I completely agree that most investors would never see. They probably don't even know it exists. I think there is a good case for making those much more, much more prominently available to investors."[2]

The fundamental problem is that it has paid investment management companies to be confusing and opaque but…

The time for change has come.
The time for action is now.

[1] We Will Miss Portfolio Turnover Rates - Christopher J. Traulsen Morningstar, 5th September 2011

[2] Radio 4 Moneybox interview with Mr. Richard Saunders of the IMA and Mrs. Gina Miller originally broadcast on 4th February 2012

Statistical Evidence

- There is little evidence of price competition in the UK with Lipper research finding that among funds that had changed their fees (up or down) 80% had raised them between 2001 and 2011.[3] SCM found that 68% of money invested in active funds within the UK largest retail fund sector had an identical Annual Management Fee.[4]
- A 2007 study found the UK had the 4th highest total charges out of 19 countries ranked by country of domicile.[5] Weighted by assets, a 2009 study found that UK funds charged 79% more than US funds, being 1.63% pa in the UK versus 0.91% pa in the US.[6]
- According to the IMF the 2010 UK level of gross national savings relative to GDP at 12.4%, substantially less than the European average of 19.3% in Europe or 23% worldwide.[7]
- **A recent study has shown 49% of the UK workforce is not saving enough for retirement and that there is 'widespread and ingrained inertia'.**[8]
- **More than one fifth of Britons do not have any savings and 35% have less than £500 set aside according to another study.**[9]
- Many investment funds only advertise their annual management fee to the public, thereby excluding significant costs.[10] A 2006 US study found that due to hidden transaction costs, 43% of fund expenses were omitted from published measures of costs. An earlier 2000 FSA research paper similarly found that in the UK only half the overall fees and costs were disclosed to investors.[11]
- SCM has calculated that one of the largest hidden elements - dealing costs - is currently running at £2.7 billion pa in UK retail funds alone. Using the same assumptions, these costs would be £18.5 billion pa in the whole UK savings and investment industry.[12]

[3] Time May Change Me – Mutual Funds' Management Fee Changes by Lipper, October 2011

[4] SCM Private Analysis of 233 active funds within the IMA All Companies Sector with total assets under management of £63.4 Billion utilising latest Morningstar data available as at 23rd January 2012

[5] Mutual Fund Fees Around the World by Ajay Khorana, Henri Servaes and Peter Tufano, May 2007

[6] Fund Expenses: A Transatlantic Study by Lipper, December 2009

[7] IMF April 2011 World Economic Outlook

[8] The seventh annual Scottish Widows UK Pension Report, June 2011

[9] More than a fifth of Britons have no savings, Daily Telegraph, 1st April 2010

[10] The Costs of Using a Broker to Select Mutual Funds by O'Neal and Bullard, November 2006

[11] The Price of Retail Investing in the UK by Kevin James, February 2000 FSA Occasional Paper

[12] SCM Private Analysis of 2,162 UK unit trusts with total assets under management of £591 Billion, utilising latest Morningstar data available as at 23rd January 2012. The average fund turnover was found to be 65% pa (dividing the reported UCITS headline turnover by 2). Based on the overall asset allocation of these funds and the cost of dealing in the various assets shown elsewhere in this report, the weighted average dealing cost was estimated at 73 bp. According to the IMA, the total UK retail industry is worth £560.3 Billion and the total UK investment industry £3.9 trillion as at November 2011

- Lack of transparency in investments has been prevalent in many of the UK's financial scandals e.g. the miss-selling of over £1 billion of AIG bonds or the £400m+ losses from Cru investment products.

- The US regulator, the Stock Exchange Commission (SEC) takes these issues very seriously and following proposals in July 2010 to provide transparency for investors and potentially reduce costs, the Commissioner recently said "fees need to be set in a manner that's fair," and that "it's very difficult for investors to understand what they're paying and when".[13]

- The SEC already places great emphasis on transparency of investments. In fact, as long ago as 2004 it insisted on 'Enhanced Mutual Fund Expense and Portfolio Disclosure' whereby funds must file their complete portfolio holdings schedule with the Commission on a quarterly basis which ensures they are publicly available via the internet.[14]

[13] SEC to Consider Caps on Mutual-Fund Fees Wall Street Journal, April 30th 2011

[14] SEC Adopts Enhanced Mutual Fund Expense and Portfolio Disclosure; Proposes Improved Disclosure of Board Approval of Investment Advisory Contracts and Prohibition on the Use of Brokerage Commissions to Finance Distribution, *Washington, D.C. Feb. 11, 2004*

UK Investment Industry Levels of Transparency in a Global Context

The US regulator, the Stock Exchange Commission (SEC) takes transparency very seriously and recently stated:
"fees need to be set in a manner that's fair," and that "it's very difficult for investors to understand what they're paying and when".[15] The SEC has gone as far as hosting a link to a 'mutual fund calculator' on its website[16] enabling US investors to easily calculate and compare different funds charges in $ according to the consumer's choice of amount to be invested, estimated underlying return and investment time horizon. No such facility, in any form, is currently offered by either the FSA or the IMA.

Correspondingly in 2011 the Chairman of the European regulator (ESMA) said: ***"Given the lack of sufficient and credible steps made by market led initiatives of a self regulatory nature, transparency is an area where regulators had and have to intervene in the general public interest".***[17]

Academic research on transparency in the US has shown that increased holdings disclosure is associated with less fraud, finding that *'funds with semi-annual disclosure have a higher likelihood of committing fraud than funds with quarterly disclosure'.*[18] They also found that funds with higher turnover, and higher expense ratios tended to disclose their holdings less frequently.

Not only are the levels of transparency of holdings for UK investors far behind those in the US, transparency in respect of securities lending or stock lending are completely opaque in the UK. A SCM Private research report[19] published in 2011 highlighted that within the UK, the FSA allows up to 100% of clients' funds to be lent out without any requirement to publish daily individual exposures, borrowers' names or the precise makeup of the collateral backing these loans. The report pointed out that controls and standards fell far short of many other regions, notably the US and Ireland.

The European regulator (ESMA) has demonstrated a different attitude to the UK regulator and recently put forward proposals [20] for much greater disclosures to investors regarding such activities, in particular details of the underlying exposure, the identity of the counterparties and the type and amount of collateral received. Investors in many FSA regulated UK funds which participate in securities lending, cannot currently find **anywhere** which precise assets are being held as security against such loans. The terrible truth is that UK investors have little up to date transparency of what it is they exactly own in many funds, and normally even less transparency when the same fund then lends out these assets to third parties.

[15] SEC to Consider Caps on Mutual-Fund Fees Wall Street Journal, April 30th 2011

[16] http://apps.finra.org/fundanalyzer/1/fa.aspx

[17] Market Transparency - Does it prevent crisis? Steven Maijoor ESMA Chair, FMA Supervision Conference, Vienna, 29 September 2011

[18] The Frequency of Mutual Fund Portfolio Disclosure, Weili Ge and Lu Zheng, March 2006

[19] SCM Private research paper published 1st September 2011 'reveals UK retail fund managers controlling over £241 billion, can lend out up to 100% of funds yet investors are kept in the dark'

[20] ESMA's guidelines on ETFs and other UCITS issues published 1st February 2012

As far back as 2004, the US regulator (SEC) insisted on all funds filing their **complete** portfolio holdings on a quarterly basis; available publically via the Internet.[21] In respect of transparency of holding there has not been significant debate within the UK. A recent article entitled *'Fund managers reject calls for full portfolio disclosure'*[22] quoted two very substantial US fund managers with UK retail funds. The article stated that Fidelity had *'not added its voice to calls for full fund portfolios to be published'* and that Blackrock said *'full portfolios were already disclosed in annual reports and accounts and more regular reporting could cause portfolios and investors to suffer'.*

Many of the largest fund management companies seemingly operate with different levels of portfolio disclosure according to the particular region in which they operate rather than apply the same standards worldwide.

For example, the popular Fidelity (US) $13 billion Magellan Fund publishes monthly 100% of its holdings on-line; the latest date being 31st December 2011.[23] However, investors in the UK Fidelity's £2.2 billion UK Special Situations fund can currently see just 44% of their portfolios on-line, via the latest monthly factsheet.[24] The latest full portfolio for this UK fund is revealed in its annual report and accounts, dated 28 February 2011.[25]

Similarly, the popular Blackrock (US) $19.2 billion equity dividend fund provides 100% of its portfolio on-line quarterly, the latest date being 31st October 2011.[26] Meanwhile, in the UK, the popular Blackrock UK Special Situations Fund reveals its full portfolio annually via its report and accounts, the latest date being 20 April 2011. Its latest monthly factsheet reveals just its top 10 holdings accounting for 42% of the fund.[27]

[21] SEC Adopts Enhanced Mutual Fund Expense and Portfolio Disclosure; Proposes Improved Disclosure of Board Approval of Investment Advisory Contracts and Prohibition on the Use of Brokerage Commissions to Finance Distribution, Washington, D.C. Feb. 11, 2004

[22] Fund managers reject calls for full portfolio disclosure, FTadviser, 9th February 2012

[23] Fidelity US website via prospectus & reports link http://fundresearch.fidelity.com/mutual-funds/composition/316184100

[24] Fidelity UK website http://www.fundslibrary.co.uk/FundsLibrary.DataRetrieval/Documents.aspx?type=packet_fund_class_doc_factsheet_private&id=3219f765-6bbd-4e99-9cf9-70a31e559e16&user=fidelitydocumentreport

[25] Fidelity UK website https://www.fidelity.co.uk/static/pdf/common/statutory-documents/ro_ann_I.pdf

[26] http://quicktake.morningstar.com/FundNet/SecFiling.aspx?symbol=MRDVX&country=USA

[27] http://www.blackrock.co.uk/literature/fact-sheet/blackrock-uk-special-situations-fund-d-gbp-factsheet.pdf

Economies of Scale

It should also be noted that in the US, unlike the UK these mutual funds operate with independent directors. According to the Supreme Court, these independent directors have "the primary responsibility" for looking after the interests of the fund's shareholders and serve as "independent watchdogs" who "furnish an independent check" upon the management of the fund.

It is commonplace in the US for substantial funds to reduce their management fees as they grow larger, thereby passing on some of their economies of scale back to investors. This partly explains why weighted by assets, a 2009 study found that UK funds charged 79% more than US funds, being 1.63% pa in the UK versus 0.91% pa in the US.[28]

[28] Fund Expenses: A Transatlantic Study by Lipper, December 2009

Lack of Transparency and Associated Financial Frauds

There has been a high incidence of mis-selling and other financial frauds in the UK. Many of these have taken place since 2007 and yet there is no evidence of the FSA either calling for or actioning greater transparency. In our view many of these recent scandals could have been significantly reduced had there been proper transparency of fees and investments in place.

It could be argued that giving important powers of fund labeling and classification to a self-interested trade body is not serving either the regulators key responsibilities or investors' key interests. The mislabeling of recent Arch Cru retail funds may have acted against the public interest and contributed to the £400m+ financial scandal. In this example the industry body, the IMA, chose to classify a fund investing in unquoted African and Greek investments as being 'Cautious Balanced'. This no doubt gave many of the elderly investors who chose to invest their life savings in these funds a completely illusory sense of security.

This is not the only time that the IMA designed and endorsed fund labels have been criticised for being misleading. For example, £21 billion of Absolute Return funds are currently being sold to the public with an IMA objective setting out to achieve absolute returns over a 12 month period *'in **any** market conditions'*. The leading rating agency, Fitch warning in July 2011 of an increased mis-selling risk for these funds, stating that it *'views favourably efforts to refine the categorisation of absolute return funds, based on achievable, specific and timely risk and return objectives'*. [29]

Despite repeated adverse press and industry comments associated with this promise of the impossible, changes to these funds objective through the current IMA sector review are scheduled to take 18 months to complete. [30]

There is a real possibility that the mislabeling by the IMA could result in a new mis-selling scandal of the £21 billion Absolute Return Sector. This needs to be reviewed immediately.

[29] Fitch Ratings July 2011, European Absolute Return Funds: A Snapshot

[30] IMA Absolute Return Sector review will take another six months, Portfolio Adviser, 2nd February 2012

Below are examples of recent financial scandals in the UK investment industry and our views as to how increased transparency could have negated their effects:

NHFA-owned by HSBC (July 2005- July 2010)

HSBC-owned NHFA, formally the UK's leading adviser on long-term care funding, was ordered to pay £29.3million in compensation to thousands of customers mis-sold investment bonds between July 2005 and July 2010. The victims were elderly, with an average age of 83, and were either about to enter, or already in, long-term care. NHFA salesmen were found to have not taken due consideration of elderly people's life-expectancy when selling them investment bonds. Typically, these bonds invested in the stock market and required that investors commit their money for a minimum five years. However, in a number of cases investors had a life-expectancy shorter than the period of the bond. This caused many bond-holders to redeem their investments before the bond matured, triggering capital shortfalls and penalty charges.

Our View:

These bonds may have come out poorly in terms of the 'true' total costs including adviser charges which might have put off many of the people from investing. HSBC said that it was typical for NHFA advisers to be paid 5% of the investment amount up front and then a further 1% each year thereafter.

Bank of Scotland (July 2007- October 2009)

Between July 2007 and October 2009, the Bank of Scotland (BOS) received over 2,500 complaints about its sales of the Collective Investment Plan, Personal Investment Plan, Guaranteed Growth Bond, ISA investor and Guaranteed Investment plan. The FSA awarded £17m compensation for BOS customers who complained about being mis-sold these investment plans. The advice failings centred on a risk profiling tool used by the bank which classified these clients as having a cautious approach to risk.

Our View:

Complaints included cases *'where savers were sold inappropriate products, as well as instances where exit penalty fees had not been adequately explained'*.[31] If these funds had been forced to disclose an easy to understand 'true' total cost, which included the exit fees, investors may have been dissuaded from investing. This clearly shows once again that the current system is not working whereby many investors are simply unaware of either the total cost or the precise nature of their investments.

[31] *Bank of Scotland £17m mis-selling payout,* Daily Mail, 25th May 2011

Keydata (2005 – June 2009)

The Serious Fraud Office began probing Keydata Investment Services in July 2009, a few weeks after the firm went into administration. Keydata specialised in complex high-income investment bonds that were sold via a network of independent financial advisers from 2005 onwards and managed by SLS Capital. Some of the bonds promised a high 7.5% return with low risk, with the money put into US investments known as "life settlements" - similar to second-hand endowment policies. The Financial Services Authority, which regulated Keydata, applied for the company to be put into administration because it had been selling products it claimed qualified for ISA status when they did not.

At first, concern around the firm centred on an unpaid tax bill, but then administrators discovered a black hole in its books - over £100 million of investors' money had been stolen from a Luxembourg-based fund in which Keydata invested. The Financial Services Compensation Scheme (FSCA) declared Keydata in default, and indicated that 21,000 investors would be able to seek financial redress. The FSCS has had to pay out more than £300 million in compensation.

Our View:

These bonds would have come out poorly in terms of the 'true' costs including adviser charges, which may have dissuaded many people from investing. The high charges within these products allowed it to pay IFAs a 3% initial commission and a 0.5% trail.[32] In fact it was reported after the collapse *"that it is glaring now is that investors have no idea what this fund costs. Operating costs... suggests a fund with annual expenses approaching 4%. Pricey and when more legitimately set against the present £350m fund value… well, ruinous… Would a UK investor know this?' No. Expense ratios routinely available on vanilla collective funds - unit trusts, OEICs etc - go undisclosed when they come wrapped up in the mystique packaging of a 'structured product".*[33]

[32] *Keydata and offshore firm drained £80m from Lifemark,* MoneyMarketing, 11 June 2010

[33] *Its Lifemark…But Not as Expected, Mackrill.com,* March 18th 2010

2009: Arch Cru (2006 - March 2009)

Arch Cru was set up in 2006 to provide a range of low-risk cautiously managed funds sold through independent advisers. One fund, the Arch Cru Investment Portfolio, was placed in the "cautious managed" category of the UK Investment Management Association's (IMA) classification system, although the IMA apparently later told Citywire, a news service, that the word "cautious" should "not be taken literally".[34]

The funds were regulated by the FSA and given respectability by the fact that leading financial brands lent their names to the funds. The Arch Cru funds raised over £400 million from 20,000 private investors prior to their funds being suspended in 2009. The money was then invested in a series of 24 "cells" listed on the Channel Islands Stock Exchange, designed to invest in asset classes such as private equity, private finance, real estate and "sustainable" opportunities. It invested a quarter of the Cru funds into seven ships owned by the same Greek shipping company, and put investors' money into Cru Investment Management. Many elderly investors are likely to end up losing between 30 and 40% of their original investment.

Our View:

Much of the losses would have been avoided since the 'true' cost of investing would have been a very high number with advisors often being paid very high commissions, typically a 1% per annum renewal commission as well as a 4% initial fee. Also, the transparency of full underlying investments would have revealed that 25% of the funds were invested in an unquoted Greek shipping company which, in our view, would have put off many investors and produced significant adverse publicity which would have acted as a warning to other investors.

[34] *Investors' losses reveal darker tone of Arch Cru affair,* Financial Times, January 15, 2012

Barclays (July 2007 – November 2008)

Between July 2007 and November 2008, 12,331 Barclay's customers invested £692 million, an average of £56,000 each into the Aviva Global Balanced Income fund and the Aviva Global Cautious Income fund. Despite their names, both funds were taking plenty of risk and held investments in emerging markets. *'In fact, the balanced fund, despite its name, was rated as high risk by independent analysts. Some 60 per cent of the fund was invested in risky shares which plunged 45 per cent during the financial crisis. The 'cautious' fund nosedived 22 per cent.'*[35] The Cautious Income fund was categorised by independent analyst Morningstar as being 'aggressive balanced'.

Our View:

If these funds had disclosed 100% of their investments on-line and more frequently, it might have been revealed earlier that the investments were not cautious and the ensuing adverse publicity would have made it harder to sell such investments to the general public. If a professional and independent organisation rather than an industry trade body was given the key role of fund classifications, it is much less likely that investors would have been misled by the fund being classified as 'cautious'. It is surprising given repeated mis-selling scandals involving mis-leading fund classifications, that the FSA does not appear to question their decision to delegate these important powers to a self-interested trade body.

Coutts (December 2003 – September 2008)

Coutts & Company has been fined £6.3 million by the Financial Services Authority (FSA) for mis-selling an investment fund to customers. Numerous failings were uncovered in the way the private bank sold the AIG enhanced variable rate fund to its clients. Various banks sold these AIG bonds to customers with the total amount invested being over £1.4 billion. The regulator said the 427 high net worth customers who were sold the fund between 3 December 2003 and 15 September 2008 had been exposed to an 'unacceptable risk of an unsuitable sale'.

The FSA sharply rebuked the bank over a string of failings related to the way the investment was sold. It said customers were offered the fund as an alternative to a bank or building society account, which meant they may not have realised the risks involved. In reality, however, a significant proportion of the fund's assets did not meet this description, and instead sought to deliver an enhanced return by investing in riskier asset backed securities and floating rate notes. These included residential and commercial mortgage bonds and other assets with 3 to 5 year maturity dates.

Our View:

It is clear that 100% transparency of investments would have revealed the nature of many of the underlying investments which were neither short term nor low risk in nature as would be appropriate for a fund marketed as an alternative to cash. Many investors and their advisers would have avoided these funds as a result.

[35] *Humbling of a banking giant: Victory for Mail as Barclays pays out £60m to customers it conned,* Daily Mail, 19th January 2011

Findings from New Research Commissioned by SCM

An independent ICM Research poll of 2,029 adults across the UK in December 2011 revealed overwhelming support for the principles of increased fee and investment transparency. Crucially there was an overwhelming willingness to save more should these principles be adhered to by the investment industry.

How confident are you in the way your savings & investments are being looked after?

- 44% of respondents were confident



Which of the options below would encourage you to invest your money in investment products?

- 44% paying fewer charges and receiving a higher return
- 31% being able to see fully how and where their money is invested
- 27% better understanding of the products
- 12% an industry kite mark or consumer confidence mark



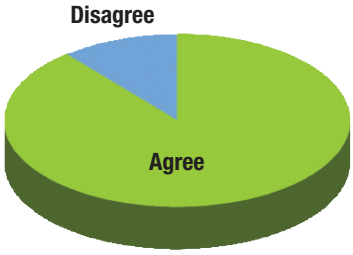
In terms of fees and charges on your investment products, do you know what you are being charged for and why?

- 19% of savers and investors were fully aware of what they are being charged for



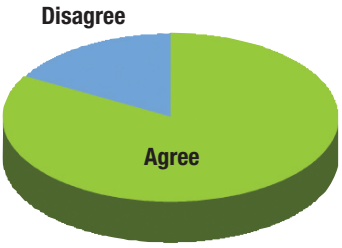
Would you agree or dis-agree that fund managers should be required to disclose the full breakdown of all fees incurred?

- 89% agree



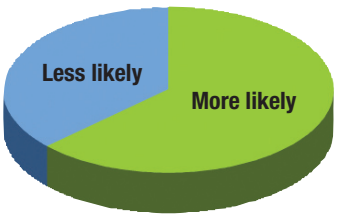
As an investor or saver, would you like to be able to find out exactly where your money was being invested?

- 83% agree



If investment products had clearer labelling like food products so you could see exactly what you were buying and how much it costs, would that encourage you to invest more?

- 63% more likely to invest or invest more



© True and Fair Campaign

Background

Accountancy standards and company reporting have been based around the "true and fair view" since 1948. The clear objective being that all accounts fairly reflect the true "substance" of a business and the results of its operation.

To support the application of the "true and fair view", accounting has adopted certain concepts and conventions to ensure that accounting information is presented accurately and consistently.

SCM believes the same principles can practically be applied to the investment indus try, to the greater benefit of consumers and the industry as a whole.

The Proposed Solution

A self-regulatory, industry-wide best practise - the 'True and Fair Code'

Signatories would commit to providing consumers with a product label that amounts to a Full Schedule of Fees and Holdings. This would include exactly where consumers' money is invested, both in terms of assets held directly as well as indirectly (e.g. individual assets held as collateral against securities lent out), in a timely manner, together with 100% transparency as to the full underlying costs of investment.

SCM is hopeful that the Code would attract industry and consumer 'champions'. These champions would adopt the code creating a momentum that would persuade investment managers and consumers alike to prioritise full investment and cost transparency, better product description and accuracy, and an industry consistent format.

For the first time different investment products could then be compared irrespective of if they are an ISA, pension, unit trust, exchange traded fund, hedge fund, investment trust, or any other investment product.

This can plainly be demonstrated in Appendix 2, which shows simply and clearly the costs of different investment products on an all-in basis – including distributor costs, performance fees, dealing costs, purchase costs and various other charges.

Full transparency should ultimately lead to a more competitive investment management industry as companies are forced to focus on reducing the total cost of investing in order to remain competitive.

Mission Statement

The authors are calling on the Government, Parliament and regulators to require that the UK investment management industry now provide every prospective customer with:

a) A guarantee of 100% transparency to consumers in respect of where their money is invested
b) A guarantee of 100% transparency as to the full underlying costs of investments
c) A gold standard industry template providing consumers with product information in a consistent, unified and understandable format

This should restore trust in the investment management industry and encourage more consumers to save for their futures.

The True and Fair Code

Company XYZ commits to providing clients with a full breakdown of all fees incurred during the investment of their money, including management fees and all underlying costs or charges.

Company XYZ commits to providing clients with a full online breakdown of all holdings held directly, as well as indirectly (e.g. individual assets held as collateral against securities lent out), together with a full percentage breakdown, online, on at least a quarterly basis.

Schedule of Fees and Holdings – Template Label and What It Means

This is purely an example - the final layout and precise detail should be signed off by a professional organisation or independent consumer body.

In our view, a workable format is akin to the company accounts format. Whilst some people will look at the detail within the accounts, most will simply focus on the key figure of how much profit the company made. Similarly, whilst consumers may want to look at the full breakdown of the various costs, most will simply want to know what the total cost figure, either in terms of the fund - shown as the Total Provider Cost, the TPC; or more importantly through their chosen sales channel - shown as the Total Cost of Investment, the TCI. The over-riding objective will be to fairly reflect the full underlying costs of the investment from top to bottom.

Since fund management companies will often sell their products through various distribution channels, they can only be expected to publish their Total Provider Cost (TPC). Any sales channel would then be required to calculate and add their own extra costs to the 'label' so consumers / investors can see the Total Costs of Investment (TCI).

Financial Advisers and the Retail Distribution Review (RDR) – Consumers Beware

It is accepted that the majority of investment and savings products are sold through advisers, but the sad truth is that these advisers have been giving expert advice to clients when they themselves have found it almost impossible to access or understand 100% of fund providers' charges.

Anecdotal evidence gathered by the authors of this report found that even the heads of research within some of the largest advisory firms did not know that the TER does not include dealing costs.

The proposed solution in this report will not only enable advisers to give truer investment costs to clients; it will also allow clients to see one all in cost, including the adviser fee which will have to be declare post the Retail Distribution Review (RDR) that comes into effect in January 2013.

A recent survey by YouGov on behalf of global management consultants AT Kearney, found that since 2008, when the global financial crisis began, there has been a 50% drop in the number of individuals opting to work through an independent financial adviser.[36]

"The survey's authors noted that the shift towards greater use of direct channels of asset management occurred at the same time people were becoming more wary, in response to the economic downturn. The trend towards more DIY wealth management was also found not to be limited to those at the higher end of the income scale.

The research revealed, for example, that there has been a 20% increase in the use of direct channels for personal wealth management among those earning between £60,000 and £99,999.

What is more, nearly 70% respondents earning less than £60,000 per annum said they were using direct channels to track their finances in the wake of the downturn."

It is thought that RDR will improve the service ordinary investors receive from financial advisers by banning commissions but recent research conducted by the accounting and consulting network, BDO, claims that advisers would simply be charging "commission by another name". They state *"Investors remain at risk of being sold products they do not need – in spite of an upcoming ban on advisers receiving commission, which is designed to prevent mis-selling"*.[37] The research also found that:

"More than two-thirds of financial advisers questioned in the new research said they planned to continue taking payments from product providers next year, rather than charging upfront fees to clients."

[36] Article: "50% drop in use of IFAs by those earning more than 100K: survey", Helen Burggraf, International Adviser, 8 February, 2012

[37] Article: "Fears of back-door commission", Elaine Moore, Financial Times, 10 February 2012

The entire savings and investment management industry, including advisers, has to look at its moral compass as technology and the internet along with a lack of trust will empower individuals to self invest to the detriment of the industry.

If this industry is to have any long term future it needs to examine:

- **What is it that we do?**
- **What can we do better?**
- **Are we good enough at communicating that?**
- **And most importantly, are we rigorous enough in terms of transparency? And are we helping people make better informed decisions about their investments?**

Schedule of Fees and Holdings

True and Fair System vs The Current System

Current Misleading Fee System	Proposed True and Fair Code and Label Scheme
Annual Management Charge (AMC) What many investors think they are paying	Full and transparent fund management and ALL related costs and fees
Some of the extra costs eg. custody charges, administration costs, other fund costs etc. are added to produce	**Total Provider Cost (TPC)**
Total Expense Ratio (TER) but often not featured in fund manager advertisements	End distributor and ALL related charges added
Still significant hidden costs eg. performance fees, dealing costs*, platform charges, initial charges, exit charges etc.	**Total Cost of Investment (TCI)**
IMPOSSIBLE FOR CONSUMERS TO KNOW THE REAL TOTAL COSTS OF THEIR INVESTMENT	**INVESTORS SEE THE REAL TOTAL COST AND CAN COMPARE VIA DIFFERENT SALES CHANNELS**

* Whilst performance fees are officially included in the FSA definition of the TER, they are often excluded in reported TERs

Examples of the True and Fair Label

In order to test the robustness of this code we have demonstrated its application on six substantial funds with an average fund size of £2.4 billion. We analysed four mutual funds, one investment trust and one exchange traded fund available to the consumer through various sales channels.

The data for these calculations all comes from publicly available sources and is mostly derived from latest available Morningstar data, individual company websites and fund documents.

These are mere examples and are not in any way a criticism of any of these funds or a suggestion that any particular fund is somehow better than another - these are six very different substantial funds investing in different asset categories or different markets and with different strategies. **These examples are purely for illustration purposes.**

Similarly the various sales channels shown may provide different qualities of service and different levels of investment advice. It should be entirely the consumer's choice as to which sales channel or level of service they wish to engage. The sales channels detailed in the example labels are purely for demonstration purposes and illustrate the flexibility and universal application of the True and Fair label.

Sample Label

The final format would be assigned to an independent organisation

	%pa	Notes (All calculations based on minimum required investment or typical size if no minimum)
% Annual Management Charge (AMC)		
% Custody & admin costs etc		
% Performance fee		Based on 12 months disclosed performance fee or average of up to three years if data available.
% Dealing costs		Based on latest 12 months or average of up to three years if data available. Dealing costs = Portfolio Turnover Rate X estimated full cost buying/selling underlying assets. Most funds will simply use a common agreed schedule of costs.
% Any other costs		E.g. extra costs of underlying funds when investing in a "fund of fund" structure if not already included above.
Less any other recurring revenues		E.g. net securities lending revenues or other recurring income received based on last 12 months or average of up to last three years if data available.
Total Provider Cost (TPC)		**This is the figure that should be advertised by fund managers.**
Platform fees via Sales Channel A		Where not already included in above figures.
Entry / Exit costs via Sales Channel A		Any charges should be amortised over five years as the assumed length of investment unless stated otherwise e.g. for pensions.
Advisor fees / rebates not included above via Sales Channel A		Amortised over five years unless clearly stated as per above.
Total Cost of Investment (TCI) via Sales Channel A		**This is the figure that should be advertised by the sales channel**.

Example 1 : A £1 Billion+ UK Income Mutual Fund

	%pa
% Annual Management Charge (AMC)	1.50% pa
% Custody & admin costs etc	0.04
% Performance fee	0
% Dealing costs *(Derived from average of 2 years reported turnover and est. UK equity cost)*	0.31
% Any other costs	0
Less any other recurring revenues	0
Total Provider Cost (TPC)	**1.85% pa**
Platform fees via Sales Channel A	0
Entry / Exit costs via Sales Channel A	0
Advisor fees / rebates not included above via Sales Channel A *(Rebate on Annual Management Charge)*	-0.125
Total Cost of Investment (TCI) via Sales Channel A	**1.73% pa**
Platform fees via Sales Channel B	0
Entry / Exit costs via Sales Channel B *(2.25% over 5 year assumed investment)*	0.45
Advisor fees / rebates not included above via Sales Channel B	0
Total Cost of Investment (TCI) via Sales Channel B	**2.30% pa**
Platform fees via an advisor C	0
Entry / Exit costs via an advisor C *(5.25% over 5 year assumed investment)*	1.05
Advisor fees / rebates not included above via via an advisor C	
Total Cost of Investment (TCI) via an advisor C	**2.90% pa**

Example 2: A £1 Billion+ UK Absolute Return Mutual Fund

	%pa
% Annual Management Charge (AMC)	1.50% pa
% Custody & admin costs etc	0.18
% Performance fee *(Derived from average of last 2 years reported performance fees as a percentage of the year end value)*	0.49
% Dealing costs *(Derived from average of 2 years reported turnover and estimated weighted average cost of various assets invested)*	0.32
% Any other costs	0
Less any other recurring revenues	0
Total Provider Cost (TPC)	**2.49% pa**
Platform fees via Sales Channel A	0
Entry / Exit costs via Sales Channel A	0
Advisor fees / rebates not included above via Sales Channel A *(Rebate on Annual Management Charge)*	-0.1
Total Cost of Investment (TCI) via Sales Channel A	**2.39% pa**
Platform fees via Sales Channel B	0
Entry / Exit costs via Sales Channel B *(0.5% over 5 year assumed investment)*	0.1
Advisor fees / rebates not included above via Sales Channel B	0
Total Cost of Investment (TCI) via Sales Channel B	**2.59% pa**
Platform fees via an advisor C	0
Entry / Exit costs via an advisor C *(5.0% over 5 year assumed investment)*	1.0
Advisor fees / rebates not included above via via an advisor C	0
Total Cost of Investment (TCI) via an advisor C	**3.49% pa**

Example 3: A £1 Billion+ UK Equity Index Mutual Fund

	%pa
% Annual Management Charge (AMC)	1.0% pa
% Custody & admin costs etc	0
% Performance fee	0
% Dealing costs *(Derived from average of 2 years reported turnover and est. UK equity cost)*	0.06
% Any other costs	0
Less any other recurring revenues	0
Total Provider Cost (TPC)	**1.06% pa**
Platform fees via Sales Channel A *(£2 per month on a minimum investment of £1,000)*	2.4
Entry / Exit costs via Sales Channel A	0
Advisor fees / rebates not included above via Sales Channel A	0
Total Cost of Investment (TCI) via Sales Channel A	**3.46% pa**
Platform fees via Sales Channel B	0
Entry / Exit costs via Sales Channel B	0
Advisor fees / rebates not included above via Sales Channel B	0
Total Cost of Investment (TCI) via Sales Channel B	**1.06% pa**

Example 4: A £1 Billion+ Mixed Investment 40 - 85% Shares fund of funds style Mutual Fund

	%pa
% Annual Management Charge (AMC)	1.50% pa
% Custody & admin costs etc *(Includes the annual management charges and custody/admin costs of the underlying funds invested)*	0.91
% Performance fee	0
% Dealing costs *(Calculated by looking at the weighted average dealing costs of the underlying funds)*	0.16
% Any other costs	0
Less any other recurring revenues	0
Total Provider Cost (TPC)	**2.57% pa**
Platform fees via Sales Channel A	0
Entry / Exit costs via Sales Channel A *(0.25% over 5 year assumed investment)*	0.05
Advisor fees / rebates not included above via Sales Channel A	-0.2
Total Cost of Investment (TCI) via Sales Channel A	**2.42% pa**
Platform fees via Sales Channel B	0
Entry / Exit costs via Sales Channel B *(2.25% over 5 year assumed investment)*	0.45
Advisor fees / rebates not included above via Sales Channel B	0
Total Cost of Investment (TCI) via Sales Channel B	**3.02% pa**
Platform fees via an advisor C	0
Entry / Exit costs via an advisor C *(5.25% over 5 year assumed investment)*	1.05
Advisor fees / rebates not included above via via an advisor C	0
Total Cost of Investment (TCI) via an advisor C	**3.62% pa**

Example 5: A £1 Billion+ Global Investment Trust

	%pa
% Annual Management Charge (AMC)	NA
% Custody & admin costs etc *(This investment trust reports just its Total Expense Ratio i.e. the AMC + various other custody & administration charges)*	0.63
% Performance fee	0
% Dealing costs *(Derived from average of 2 years reported turnover and estimated weighted average cost of dealing in various asset categories)*	0.23
% Any other costs	0
Less any other recurring revenues	0
Total Provider Cost (TPC)	**0.86% pa**
Platform fees via Broker A	0
Entry / Exit costs via Broker A *(Based on £10 dealing cost to buy or sell a share and a £1,000 investment)*	0.4
Advisor fees / rebates not included above via Broker A	0
Total Cost of Investment (TCI) via Broker A	**1.26% pa**

Example 6: A £1 Billion+ European Equities Exchange Traded Fund (ETF)

	%pa
% Annual Management Charge (AMC)	NA
% Custody & admin costs etc *(This exchange traded fund (ETF) reports just its Total Expense Ratio i.e. the AMC + various other custody & administration charges)*	0.35
% Performance fee	0
% Dealing costs *(Derived from average of 3 years reported turnover and estimated dealing cost of European equities)*	0.05
% Any other costs	0
Less any other recurring revenues *(Latest estimate by provider of contribution of securities lending income to the fund return)*	-0.18
Total Provider Cost (TPC)	**0.22% pa**
Platform fees via Broker A	0
Entry / Exit costs via Broker A *(Based on £10 dealing cost to buy or sell a share and a £1,000 investment)*	0.4
Advisor fees / rebates not included above via Broker A	0
Total Cost of Investment (TCI) via Broker A	**0.62% pa**

Further Explanatory Notes

The minimum investment should be used, wherever available, to calculate such figures in order to encourage companies to look at the true costs for their ordinary/smaller customers.

All charges should include VAT where payable by most investors.

All precise assumptions for above calculations should be available to investors online in order to generate trust that the rules are being strictly and fairly adhered to.

For UCITS funds, the standard measure of turnover needs to be halved as the UCITS definition adds purchases to sales, thereby double counting turnover. The standard UCITS formula also includes the value of cash flows into and out of the fund, thereby creating negative turnover ratios from time to time.

In order to prevent the distortions of recording negative values, any such values should be recorded as 0 rather than calculate a misleading negative dealing cost.

The following costs of dealing in terms of purchase + sales costs to include commissions, taxes and market maker spreads has been estimated as follows:

- UK equities 97bp - based on 85% FTSE 100/15% FTSE 250 split
- Developed world Ex UK equities 37bp
- European equities 42bp
- Asia ex Japan equities 67bp
- US equities 25bp
- Japan equities 65bp
- Emerging market equities 137bp
- Government/Corporate bond mix 42bp

These initial estimates of dealing costs within various assets were calculated through combining the Investment Technology Group Inc. (ITG) Q1 2011 commission rates and the November 2011 iShares Reported Exchange Activity document showing the underlying costs of buying various index baskets. The commission rates from ITG were combined with the spreads, impact costs and taxes to estimate the overall dealing costs (being purchase + sales costs).

There is little research on bond dealing costs so the average London Stock Exchange spread of the iShares Barclays Capital Euro Aggregate Bond ETF, which invests in a mix of government and corporate bonds, has been used as a proxy.

For many Funds of Funds investing through mutual funds, it may be more representative of the underlying dealing cost to calculate the individual underlying fund dealing costs and then calculate the weighted average cost, grossed up to 100 if a full breakdown or full underlying data is unavailable. Where the fund of funds is investing via stock exchange listed funds directly, it may be more representative to take the typical weighted average cost of the market maker spreads and commissions of the listed funds multiplied by the overall portfolio turnover rate.

A Way Forward

As this report has detailed, the UK investment management industry has been deceiving consumers for far too long and this has resulted in fewer people saving and investing adequately for their future.

SCM believes the best way forward would be the introduction of an industry-wide Best Practice, a "True and Fair Code", which would ensure that the industry guarantees 100% transparency to consumers about where their money is exactly invested, together with 100% transparency as to the full underlying costs of investment.

SCM would ideally like to see this approach agreed voluntarily throughout the industry. This would result in the introduction of a self-regulatory industry code, which enshrines the principles of True and Fair. A sensible discussion amongst the investment management industry about how to improve standards of transparency is long overdue. But if there is resistance from the industry, these issues may require action from politicians and regulators and, if necessary, new statutory controls to protect the interests of consumers.

The net result of our research illustrates that those that are careful, prudent and planning for their and their family's futures are the ones being betrayed. Investors and savers deserve to have their hard earned money looked after in a respectful and honest manner.

In addition, the authors propose there is an urgent review of the product labeling powers that have been delegated by the FSA to the Investment Management Association. Due to their mislabeling of Absolute Return funds there is yet another financial scandal on the horizon.

The financial services sector is a core part of the UK's economic system. It's reputation matters to us all – even if you don't work within the financial sector.

The time to act is now.

Appendix

Academic Research

There has been much academic research into the various hidden costs of investing in mutual funds both in the US and the UK. Some research has focused on the hidden costs of front end loads and others relate to the hidden costs of dealing expenses born by fund managers which are not revealed in headline charges but are partly revealed within annual fund statements.

- As far back as November 1999, John Chalmers, Roger Edelen and Gregory Kadlec wrote about **Mutual Fund Trading Costs.** They found that *"Trading costs are negatively related to fund returns. In fact, the explanatory power of trading costs is as strong as that of the expense ratio. If we limit our analysis to funds with at least 90% equity in their portfolio, a sample of 88 funds; the average direct estimate of annual trading cost is 0.92% of fund assets while the average implicit estimate is 1.03% of fund assets."*

- It was not long after this that the FSA itself commissioned a research paper entitled, **The Price of Retail Investing in the UK** by Kevin James in February 2000. This research paper highlighted that retail investors were unaware of their full charges, stating that *'surveys of investor knowledge in both the UK and the US consistently find that retail investors do not understand how disclosed charges affect performance, let alone the pound and pence cost of that performance impact. Furthermore, disclosed charges alone provide a misleading picture of the price of investing, as they do not include dealing costs (the costs of trading assets in a fund's portfolio)… implicit costs account for about half of the total cost of portfolio management.'*

They found that the round trip cost of a trade i.e. buying and selling amounted to 180 bp on an average fund turnover of 70% to 90% implies an implicit cost of 1.05% to 1.6% pa…Retail investors cannot easily measure the price of investing through the investment funds they must choose between, in part because a significant element of this price is mostly not disclosed at all. *"..If retail investors had the knowledge and the information needed to assess which funds provided value for money portfolio management and risk management services, then they would be able to exercise more effective investment decisions."*

- In 2002, Schwartz and Steil reported in **Controlling Institutional Trading Costs** that investors are mainly worried about management fees. A finding based on an expansive survey of chief investment officers and head equity traders at 72 asset management firms, spanning North America, Europe and Australia. *'This fixation on ex ante costs allows fund managers to have considerable freedom in commissions - bundled commissions in particular - that allow them to "hide" the costs of these ancillary services in returns rather than declaring them as expenses.'*

- A 2004 study by Jason Karceksi, Miles Livingston and Edward S. O'Neal, entitled **Portfolio Transactions Costs at U.S. Equity Mutual Funds** looked at the trading costs for a large sample of equity mutual funds. *'Using the actual brokerage commissions paid in 2002 and estimating the implicit trading costs, we find that fund investors bear substantial portfolio trading costs. Equity funds incur an average*

annual explicit brokerage commission of 38 basis points and an average annual implicit trading cost of 58 basis points… We suspect that many mutual fund investors are completely unaware of these trading costs and simply assume that the reported expense ratio includes them. Our findings suggest that greater attention to trading costs might help investors make more informed mutual fund investment decisions and that greater disclosure of trading costs might benefit investors.'

- In terms of transparency of holdings rather than just transparency of fees, a 2004 University of Chicago paper titled, **Copycat funds: information disclosure regulation and the returns to active management in the mutual fund industry,** found that *'more frequent disclosure would facilitate investors' monitoring of the securities held in various funds and thereby improve the asset allocation and diversification choices for their overall portfolio. Second, more frequent disclosure would enhance shareholders' detection of changes in fund investment strategy. Finally, more frequent disclosure would make it more costly for fund managers to pursue trading strategies, sometimes labelled "window dressing," that generate differences between the portfolio held on the reporting date and the portfolio held at other times.'*

- A 2007 study entitled, **Mutual Fund Fees around the World** by Ajay Khorana, Henri Servaes and Peter Tufano highlighted that the most common measure of costs - the TER - excluded certain distribution fees, such as front-end or back-end loads, as well as annual fees charged by distributors that are separate from the fund charges. They produced a 'measure of total shareholder charges' (TSC), which included the expense ratio plus annualised loads. *"Because loads are paid when entering or exiting the fund, it is necessary to divide these loads over the investor's holding period. We assume a five-year holding period in our analysis."* In fact, on this measure the UK was found to rank 4th out of 19 countries by amount charged (excluding dealing costs) with an average total cost of 2.18% pa vs. 1.25% mean worldwide.

- A March 2009 paper by Mark Abrahamson and Tim Jenkinson, entitled **'Does transparency overcome conflicts of interest?'** reported the outcome of a landmark ruling under the UK Freedom of Information Act, which allowed them to obtain, from UK pension funds, information on commissions, trading activity, payments for research and other variables. They found that following recent regulatory changes in the UK to increase transparency, average commission rates have fallen. However, trading has increased significantly, resulting in total commission payments to brokers more than doubling between 2003 and 2007.

- A June 2010 US paper probably represents the best summary of the transparency issues and how they should be viewed. In **Creating Mutual Fund Transparency: The Elimination of Deceptive Communication** by Brian D. Fitzpatrick there is an excellent summary, stating *"The main question is how much are you really paying for your mutual fund? A sad commentary is that even if you try to find out, you simply cannot do it. We know that high expenses will drag down your investment return. Professor Edward O'Neal from Wake Forest University states that "on average, fund managers cannot recoup these expenses in the form of better performance." He concludes by saying "rampant price-gouging by mutual fund advisors costs shareholders $9 billion a year." Jane Bryant Quinn (2007) Professor O'Neal from Wake Forrest University and law professor Mercer Bullard from Ole Miss reviews a*

discussion on fees which the mutual fund shareholder cannot determine. They review various arrangements: the cost of buying and selling stocks; the cost of the spread; soft dollars revenue sharing; and lack of communication. Funds pay commissions to large institutional brokers and the more a fund trades, the more brokers earn...

The lack of transparency phenomenon should never fall on the investor if we are to promulgate an ethical and clear investment standard within the mutual fund industry. Implementing absolute guidelines is the only way to protect the consumer; we need to offer complete transparency. Rational human behaviour works well in describing economic models, but unfortunately reality paints a picture of selfish self-centred behaviour. Research continues to show that expense ratios do not always adequately tell the consumer how much they are really paying for the manager to invest his/her money."