**Response by The True and Fair Campaign – 4th May 2015 to DP15/2:**

**Transaction Costs Disclosure: Improving Transparency in Workplace Pensions**

**Call for Evidence**

The True and Fair Campaign was initiated by the founders of SCM Private, Alan and Gina Miller, in 2012 to raise awareness of the lack of transparency within the UK investment management industry. It has been calling on UK and European politicians, regulators and fund providers to give consumers 100% transparency on all transaction costs, management fees and intermediary fees via a labelling system; as well as full disclosure on where funds are invested**.**

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**Question 1: Should the requirements for standardised, comparable disclosure of transaction costs apply only to those schemes that will be subject to the new governance and charges measures from April 2015?**

*No.*

*This should apply to all schemes, old and new. Some of the worst examples of excessive charging and over-trading have been uncovered within older schemes by the recent OFT report [1]and these members need to be protected just as much as more recent scheme members through the provision of comparable and understandable transaction cost disclosure.*

*There are significant conflicts of evidence that are apparent within many IGCs and consultants that may prevent them from properly evaluating the transaction costs on behalf of members. There is overwhelming evidence of complete apathy on the subject by many of these so called experts which therefore necessitates that the information must be passed on to the end members rather than be left solely in the hands of these 'experts'.*

*There needs to be a simple, common analysis of transaction costs and other costs presented in a mandated uniformed format to enable easily comprehension by scheme members. This does not prevent further detail and analysis being conducted by IGCs and others but ensures that there will be pressure on the IGCs to carry out their responsibilities by members.*

**If not, are there differences that should be taken into account when considering transparency in other schemes?**

*Not relevant since the disclosure format should be a common standard to all schemes.*

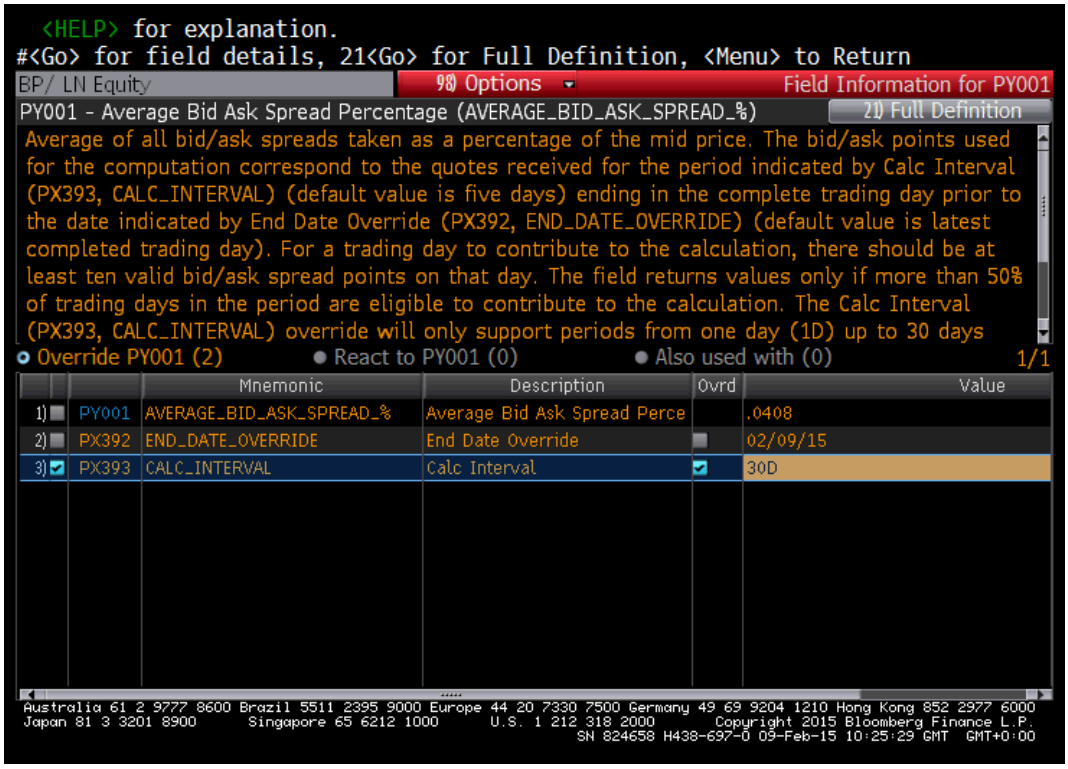
**Question 2: What are the advantages and disadvantages of capturing and reporting bid-ask spreads?**

*It is hugely advantageous to capture and report the bid-ask spread at the time of the trade. In fact it is highly unlikely that any organisation that is responsible for the execution of trades does not capture such information anyway as compliance requires them to collect this information to meet various Best Execution responsibilities.*

**Do you have any views on the ease of identifying bid-ask spreads, or modelling them?**

*There is more misleading views written on this subject by companies and investment trade bodies than almost any other. It is actually surprisingly easy to capture the bid-ask spreads, particularly within the equities market. Here is a simple tool available on Bloomberg that captures the average bid/ask % spread for most securities over customisable periods of time (this screenshot below shows that over the last 30 days the average bid-ask spread in BP shares has been 0.04%):*

[1] http://webarchive.nationalarchives.gov.uk/20140402142426/http://www.oft.gov.uk/shared_oft/market-studies/oft1505




*Therefore it is easy to adjust the interval to whatever level is prescribed e.g. if its decided to say use the 90 day level used within the Dutch model rather than the 30 day level which we would recommend as a fair way of smoothing daily changes of the spread.*

**What practical challenges are there in calculating bid-ask spreads?**

*There is sometimes a challenge in calculating bid-ask spreads in bonds - however, again, any major financial organisation with a dealing desk will have intimate knowledge of such spreads in the bonds in which they trade. Again, it is impossible to perform the duty of best execution to clients without knowledge of the relevant market price at the time of the trade. The data for such trades could therefore be cheaply collected by any fund management organisation without significant expense.*

*In fact, such spreads must be possible to be calculated relatively easily when the Investment Association itself included in its 2012 Enhanced Disclosure provision for the bid/offer spread of transactions to be shown and their 2014 Statement of Recommended Practice (SORP) recommended that the spread on the portfolio at the end of the financial year to be disclosed in the notes to the accounts. Neither of these Investment Association recommendations ever suggested that bond funds should be excluded. In fact many large groups[2] have shown the spreads for all their funds, including their bond funds, and no group has decided to specifically exclude these funds from their Enhanced Disclosures.*

**Do you have any views on estimation models of bid-ask spreads?**

*It is preferable to have actual data relevant to the particular securities in which the fund/portfolio is investing rather than simply applying a model which may produce misleading results.*

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2 https://www20.landg.com/DocumentLibraryWeb/Document?lgrouter=CommApp&targetApp=MANAGEYOURACCOUNT_DOCUMENTLIBRARY_ENTRY&reference=additionalfund.pdf

*However, there may be instances when an organisation is dealing in some rarely traded security or because they are a very small fund management organisation without a dedicated dealing desk, when it may be easier to simply take the estimates of bid-ask spreads from a model. However, they should still be required to question the relevance and accuracy of the assumption to their own investments and adjust accordingly when necessary.*

**Question 3: What are the advantages and disadvantages of capturing and reporting market impact?**

*The main advantage of capturing and reporting market impact is as a management/information tool to judge the ability of the fund manager dealers to execute large trades efficiently. Such information is not actually required for the purpose of calculating transaction costs since the spreads within such costs should be the normal spreads with which the fund management organisation regularly deals and which therefore already implicitly incorporate market impact related costs.*

**Do you have any views on the ease of identifying market identifying market impact costs?**

*There are many firms and organisations supplying such services but in terms of any cost/benefit analysis, it is unlikely that the quantifiable extra benefits would outweigh the costs of producing such analysis in all but the largest (over £billion) funds.*

**What practical challenges are there in calculating market impact costs?**

*We are not experts in calculating market impact costs but have seen analysis from third parties.*

**Do you have any views on the possible estimation models of market impact?**

*No.*

**Do you have any views on the availability of these models, their consistency, and the costs providers charge to access them?**

*No.*

**Question 4: Do you believe that missed trade "opportunity costs" and "delay costs" are transaction costs?**

*No.*

*In our view this is where academic theory does not meet rational practicality. How can anyone ever properly calculate the opportunity cost of any delay in a transaction since the reference point will always be artificial and what should you do when there is an opportunity gain? For example if the security being bought is being financed by a sale of another, the delay in the purchase could well be accompanied by an event causing the security being sold to increase in price significantly. Thus one could argue there had been an opportunity gain from the delay in selling the other security.*

**Do you believe that there is merit in reporting them as part of the disclosure regime and in governance bodies reviewing them?**

*It may be worthwhile for larger funds (over £billion) but certainly should not be mandated for all funds.*

**Do you believe that the practical issues, for example around the subjective nature of some of the inputs needed to calculate them could be addressed?**

*Yes.*

*It could be addressed with a lot of hard work but this does not seem a high priority when looking at the bigger picture of communicating information that would enhance consumer protection, in our view.*

**Question 5: Do you have any further thoughts on the analysis of transaction costs outlined in this chapter?**

*It is imperative to convert transaction costs into an understandable format which means incorporating the three key elements of transaction costs – broker commissions, taxes and spreads - into one comprehensive number that is then multiplied by the average portfolio turnover rate in order to give the actual impact of transaction costs as a percentage of the fund/portfolio each year.*

*The Investment Association CEO's Mr. Godfrey, has stated that the investment industry has mislead the public over the last 20 years regarding charges 'with disclosure that nobody understands at best and which can be misleading at worst'.*[3] *Unless these transaction costs are presented in a comprehensive and understandable fashion, nothing substantive will have been achieved.*

**Are there any alternative approaches to identifying transaction costs, or other considerations to take into account?**

*The easiest and most straight forward way to calculate the transaction costs is as follows:*

- *i) Calculate the commission rate paid on the purchase and sale of the security/ies*
- *ii) Calculate the taxes paid on the purchase and sale of the security/ies*
- *iii) Calculate the average spread (last 30 days) of the security/ies*
- *iv) Calculate the average Portfolio Turnover Rate (PTR) over the last 3 years calculated in accordance with the US, SEC definition of annual Portfolio Turnover (this is a measure of the fund's trading activity, which is computed by taking the lesser of purchases or sales and dividing by average monthly net assets). This smoothing effect of averaging portfolio turnover over 3 years smooth's out the effects of years in which the turnover may be anomalously low or high.*
- *v) Multiply the sum of i) +ii) +iii) by the average PTR within iv) to give the overall impact of transaction costs as a %age of the fund/portfolio.*

**Question 6: Do you have any comments about the different frameworks within which information might be reported and their respective strengths and weaknesses?**

*No.*

**Question 7: How should transaction costs incurred at product level be captured and reported?**

*This is an important area to consider.*

*It should be noted that a significant amount of transaction costs within a fund that arise from investors joining or leaving a fund are effectively being partly borne by the fund and the remaining investors. This can be proved by an analysis by SCM of 10 FTSE 100 mutual funds of their returns after all charges during calendar 2014 – the difference between their actual performance and their expected performance (the index return less their stated KIID ongoing charge) was 0.28% - this must be a result*

[3] http://www.theinvestmentassociation.org/media-centre/chief-executives-blog/2015/2015-02-10.html

*of the extra costs associated with investors buying or selling units not incorporated in any unit pricing related charges thereby impacting overall returns.*

**Would there be merit in splitting out costs incurred for different reasons?**

*No.*

*The costs associated with buying and selling units of the fund which are not passed on to new investors or investors leaving the fund should be incorporated within the overall level of reported transaction costs.*

*It may be that these costs are already captured by the transaction costs reported elsewhere and to add to these costs would cause such costs to be erroneously duplicated within the overall transaction costs. A more detailed breakdown can be provided to IGCs on request.*

**How could this be achieved in practice?**

*Any costs associated with the fund whether in relation to investment, transaction costs, administration costs or any other costs should be shown and totalled within one overall number.*

**Are there any other costs incurred at a product level that are not administration charges, and that could potentially be considered transaction costs?**

*The cost of buying or selling units within a fund as per above.*

**Question 8: Do you have any views on whether pension schemes should be required to look through to the transaction costs of all listed, exchange-traded investment schemes?**

*Yes.*

*The overall goal must be to show all the costs associated with investment. It is therefore highly misleading <u>not</u> to 'look through' any investments within the funds in calculating the overall level of transaction costs.*

**Do you have any particular comments on how the transaction costs incurred by property, (and other real asset investments), private equity and hedge funds should be identified and disclosed?**

*These costs can be closely estimated e.g. the costs of buying and selling physical properties can be significant in terms of taxes and agents' commissions. Equally, the performance fees associated with private equity and hedge funds can be significant. All these costs are capable of measurement from year to year – where the costs can be extremely volatile as in the case of yearly performance fees, they should be smoothed over the last 3 year period, in order to give a better guide to future costs.*

**Is separate guidance needed on how to disclose transaction costs in these areas, or can the principles used in securities markets be applied?**

*No - the same general principles outlined above should be applied to all fields of investment. It is vital that information is presented in a uniformed comparable format for all products.*

**Question 9: Do you have any comments on the treatment of derivatives?**

*Derivatives often include significant hidden costs in addition to the headline costs. Any costs of such investments that detracts from the underlying investment return before costs should be recorded as a cost. For example it is common for some structured products to keep the underlying income from the*

*securities in addition to the headline annual cost, in such circumstances the loss of income is clearly a 'cost' that should be added to the other costs.*

**Should the costs of derivatives be disclosed separately somewhere within the disclosure reports?**

For simplicity and comprehension these should not be artificially separated, except when requested within more advanced reports suitable for IGCs.

**Do you have any comment about the transaction costs associated with structured products?**

*These will vary from structured product to structured product, but it is common for these costs to be borne by the investment provider rather than the investor and in such circumstances should not be recorded as they are not effecting the overall investment return.*

**Question 10: Do have any views on the different approaches to calculating transaction costs?**

*We believe in keeping things simple which means recording the overall transaction costs impact on returns as a cost based on typical spreads, taxes and commissions rather than artificial impact or opportunity related costs. Simplicity also makes it more difficult to 'fudge' the calculations.*

**Do you agree that a principles-based approach is appropriate to set how transaction costs should be reported for each type of asset?**

*We believe that the best form of transparency is one that aims to capture as much as possible of the costs as measured by the difference between the underlying investment return before costs, and the actual return received by investors, in one comprehensive and comparable number.*

**Do you have any comments on the reporting of negative transaction costs?**

*This has arisen in the past mainly due to the implementation of the highly misleading Investment Association Portfolio Turnover Rate definition that adjusted for purchases and sales of units within the fund. It is of course complete nonsense to report a negative transaction cost and in such circumstances a zero should be recorded instead.*

**Question 11: Should portfolio turnover rates be reported alongside transaction costs? If so, do you have any comments on the best methodology to use to ensure comparability of portfolio turnover and transaction costs?**

*Yes.*

*Of course but most importantly the transaction costs per amount bought/sold needs to be multiplied by the level of portfolio turnover to quantify the actual transaction cost incurred as a percentage of the fund. We would recommend using the methodology explained above.*

**Question 12: Do governance bodies need risk and return information to be reported alongside transaction costs, or is it sufficiently readily available to them from other sources, considering the balance of costs and benefits that such new requirements may impose? If you think risk information should be reported, do you have any feedback on the best risk measures to use when considering transaction costs?**

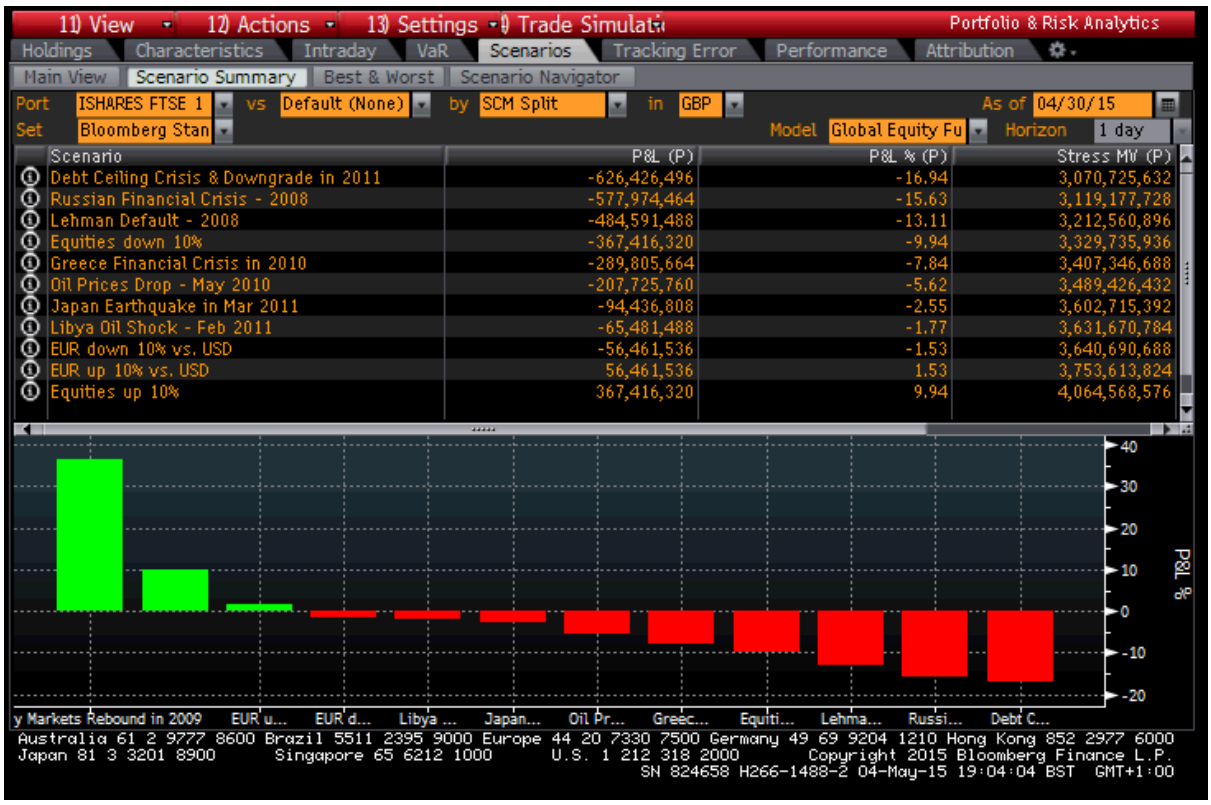
*Yes.*

*Any investor in any fund needs to have an overall sense of perspective by looking at and balancing Cost, Risk and Return together as the contextual relationship may be rather different from knowing*

*each in isolation. It may for example be worthwhile taking on more risk with more cost but in exchange for more return.*

*The simplest measure of risk is volatility of returns as shown by monthly, three year standard deviation of returns but other measures should be looked at including the liquidity of the underlying investments and the impact of various standard stress scenarios on the likely returns.*

*As an example here is a standard Bloomberg stress test:*




**Question 13: Do you have any views on the value and/or costs of benchmarking? Are there any other issues to be taken into account when exploring benchmarking?**

*Benchmarks need to be agreed that are appropriate for the fund and its investment parameters and which represent a fair target of returns, whether this benchmark be made of a composite of indexes or competitors returns.*

*Investment managers need to have a system by which their returns after costs are judged. This should be balanced against the risks and costs involved in making these returns and these other measures should also be compared against the relevant indexes and/or peer groups.*

**Question 14: Do you have any feedback on the reporting of the costs of securities lending, foreign exchange and related activities, and on how these should be reported? Are there any other areas or practices that you would highlight where providers are imposing additional costs or generating "hidden" revenues?**

*The same test should be applied to these costs as any other costs in that the overall costs that represent part of the gap between the gross return earned by the underlying investments and the actual returns received should be clearly identified and shown to all investors.*

*In securities lending the payment made by the fund for such activities should be shown – the benefit in terms of revenues will be already recorded within the overall fund returns.*

*In the case of foreign exchange, the turns taken by banks/other intermediaries from the actual spot rate should be shown in terms of the bottom line impact on the returns of the fund.*

**Question 15: Do you have any comments on the practical issues with presenting costs and charges information? Do you have any comments on the degree of standardisation that will both enable governance bodies to take decisions on their scheme and achieve comparability across the market? Are there any other factors in the presentation of transaction costs in a report that would enable governance bodies to make better decisions?**

*We would suggest the format below, which is simple, understandable and comprehensive and which would allow all users whether individual members or IGC's to understand the impact and amount of various costs, including transaction charges.*

*These costs are the costs to be included as per the latest ESMA MifidII paper http://www.esma.europa.eu/system/files/2014-1569_final_report_-_esmas_technical_advice_to_the_commission_on_mifid_ii_and_mifir.pdf.*

*In order to annualise the various costs of which some may be initial costs and some ongoing costs, these should generally be annualised over 10 years. It may be more appropriate for a pension for it to be annualised over a longer period, say 25 years. Many schemes involve significant initial or exit charges e.g. the NEST 1.8% charge for initial contributions. By showing the overall costs over a typical investment period and over different investment periods, members are able to see the impact of such costs.*

*Additionally, many members/savers find percentages baffling. We therefore suggest that the total cost one number, should also be shown in £ and p, as this would significantly increase understanding of the impact of costs.*

| *Cost items to be disclosed* | | *Examples:* |
|---|---|---|
| *One-off charges* | *All costs and charges paid at the beginning or at the end of the investment.* | *Deposit fees, termination fees and switching costs, Front-loaded management fee, structuring fee, distribution fee.* |
| *On-going costs and charges* | *All on-going costs and charges paid by the client.* | *Management fees, advisory fees, custodian fees, service costs, swap fees, securities lending costs and taxes, financing costs, broker commissions, entry and exit charges paid to the fund manager, platform fees, mark ups (embedded in the transaction price), stamp duty, transactions tax and foreign exchange costs, research costs, performance fees.* |

*Suggested Layout: Example for Fund A:*

| *Total Costs and Fees – 2.42% Annualised over 10 years* | |
|---|---|
| *Fund Manager Related Costs and Charges* | |
| *One-off charges: All costs and charges paid at the beginning or at the end of the investment. A 10 year investment period assumed.* | • *1% initial fund charge* |
| *On-going costs and charges: All on-going costs and charges paid by the client.* | • *0.75% pa annual fund management charge*<br>• *0.2% pa custody and administration charge*<br>• *0.4% pa transaction related costs* |
| *Platform/Stockbroker Related Costs and Charges* | |
| *One-off charges: All costs and charges paid at the beginning or at the end of the investment. A 10 year investment period assumed.* | • *0.3% pa platform related charges* |
| *On-going costs and charges - All on-going costs and charges paid by the client.* | |
| *Product Related Costs and Charges* | |
| *One-off charges: All costs and charges paid at the beginning or at the end of the investment. A 10 year investment period assumed.* | |
| *On-going costs and charges: All on-going costs and charges paid by the client.* | • *0.25% pa annual product wrapper related charge* |
| *Adviser Related Costs and Charges* | |
| *One-off charges: All costs and charges paid at the beginning or at the end of the investment. A 10 year investment period assumed.* | • *2% initial adviser charge* |
| *On-going costs and charges: All on-going costs and charges paid by the client.* | • *0.5% annual adviser charge* |

*Illustrative Effect of Charges Table (using example above)*

| ***Term of Investment*** | ***Assumed Investment to Date*** | ***Aggregated costs and charges over investment assuming no underlying investment returns (the impact will be greater if there are positive returns)*** |
|---|---|---|
| *1* | *£ 15,000* | *£ 810 (5.40% pa)* |
| *3* | *£ 15,000* | *£ 1,530 (3.29% pa)* |
| *5* | *£ 15,000* | *£ 2,250 (2.83% pa)* |
| *10* | *£ 15,000* | *£ 4,050 (2.42% pa)* |

**Question 16: Do you agree with the use of portfolio turnover rates and unit transaction costs to enable better prediction of likely transaction costs? Should providers be required to provide reasons if turnover rates are likely to be different in the forthcoming period? Is there any other information that would enable the governance body or scheme members to understand potential future transaction costs?**

*Yes.*

*The best guide to the future level of transaction costs is the past level of transaction costs.*

*We would strongly recommend smoothing the portfolio turnover rate over a three year period in order to provide a better estimate that will take out years where the PTR was abnormally low or high. There is no harm providers commenting if such recent average turnover was likely to be higher or lower than future turnover with a clear rational reasoning outlined for such a difference.*

*Similarly it may be that future transaction costs may be different in the future for example to reflect a change of asset allocation by the fund into securities with a higher/lower attendant transaction cost. For example an increase in the exposure to physical property assets or private equity may well significantly increase the overall transaction costs.*

**Question 17: Do you have any comments on whether a transaction cost disclosure regime will have any other consequences for the way that pension schemes and their agents transact?**

*Yes.*

*It is our view that it will significantly change behaviour which is clearly dysfunctional at present. At the moment it is completely ignored by managers and various agents along the investment chain as the costs may be small individually but significant when added to other layers of costs.*

*Providing such overall costs are considered not just on their own but in context of the likely risks and returns, should lead to better investment decisions being taken overall.*

**Question 18: Should regulations and rules on transaction cost disclosure only directly apply to pension providers and trustees? If not, on whom would additional disclosure requirements be necessary to ensure that transaction costs are reported accurately to relevant people?**

*This should apply to all investors rather than just pension providers and trustees, many of whom are operating with clear conflicts of interest which prevent them having any genuine interest in the overall costs faced by a fund or the overall impact of such costs on investor returns.*

*It would be completely artificial to provide genuine transparency to so called professional investors only, who often demonstrate lower knowledge and interest than many retail investors.*

*The funds should be run for the benefit of the end members, not the various intermediaries involved.*

**Question 19: What information on transaction costs would be useful to employers and members?**

*See above suggested layout.*

**How and when should this be reported to them?**

At least annually, or on request.

**Question 20: What information on costs and charges should be made publicly available? When and how should this be information be provided?**

*All the information detailed above, together with any extra information supplied to IGCs should be made publicly available via the internet, updated at least once a year.*

*The industry and the regulators need to restore trust in individuals pensions and this can only be achieved if these individuals can easily see for themselves all the costs and other relevant information pertaining to their pensions.*

*Members should not be treated as second class citizens by not being given the same information as the IGC's purporting to act on their behalf.*

**Question 21: Are there any areas that you would highlight where firms, trustees or asset managers may not comply with the disclosure regime in the way intended? If you are concerned that this may be the case, are there steps that could be taken to reduce the incentive to get around reporting transaction costs? Would third-party oversight of reports enhance their value and usefulness?**

*There will always be various organisations and trade bodies who attempt to 'game' or manipulate the regulation to their own advantage at the expense of the investors.*

*This has been allowed to take place for more than 20 years. Ending this anti-consumer behaviour requires legislation that is clear, simple and comprehensive. The providers should be forced by the regulator to 'sign-off' that the disclosure of costs has met the spirit rather than just the rules, and all significant costs should be reported, aggregated and the impact shown in £ as well as a percentage. Any providers / individuals found to be intentionally misleading investors, by partially or falsely declaring costs should be banned from the industry.*

**Question 22: Do you have any comment on the likely costs involved in implementing transaction cost disclosure along the lines described in this call for evidence?**

*The costs involved in following the approach outlined above would be very low indeed as virtually every piece of underlying data is captured at present.*

*The only piece of data that is not captured at present is spreads which can be cheaply obtained via existing tools e.g. Bloomberg for all equities and for bonds can be estimated by the fund management dealing desk at the time of transaction.*

*There would be some extra costs involved in building a formal process to ensure consistency of data but again this would be insignificant for most firms. As a small firm we have demonstrated that such data can be easily captured, updated monthly and exhibited in a comprehensive, understandable format. We have built a calculator showing all the costs and the impact on returns over different periods and for different amounts via an online simulator - http://scmdirect.com/simulator.*

*In our view, these costs would pale into insignificance when compared to the consumer knowledge, protection, and trust it would build. The more onerous costs would be one-off build costs as once the reporting formats are in place, it would simply require a small team to maintain and update the data.*