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SCM Direct Comments on the UK's Investment Association's (IA) Latest Cost Disclosure Proposal, and MiFID II

Introduction

In the most recent paper from the IA entitled, '*Meaningful Cost and Charges Disclosure – a Discussion Document'* they admit that for over 20 years people have been charged hidden fees, and that no-one understands what they are paying.

As in any other sector or industry, consumers have the basic right to know what they are paying for a given product or service. They should be treated fairly and honestly, and allowed to make fully informed investment decisions; as well as make comparisons on a like for like basis. This is more important than even in a low return environment, and where an increasing number of people are seeking to manage their money themselves. It is widely accepted by academics and industry professionals that costs and fees are the largest eroder of returns. Behaviorists have also found that fees are one of the most important buying triggers. We firmly believe investors must have access to a reasoned estimate of the likely total cost of any potential investments before they purchase, presented in an understand format.

It is no defence to say that simply because a cost changes from year to year, it should continue to be hidden. Good consumer outcomes are best served by showing all costs with 95% accuracy, rather than 50% of costs with 100% accuracy. **We completely agree with ESMA that '*These volatile costs should be estimated on a best effort basis*' rather than artificially ignored completely.**

Any concerted effort to improve public understanding and awareness of fund fees is to be welcomed, but it should be driven by regulators and consumer groups, not by fund managers and their obviously conflicted trade body, intent on keeping fees hidden and confusing for as long as possible. It is clearly absurd that this self-interested body should be leading this debate or proposing the solution.

MiFID II

In March of 2014, text pertaining to the disclosure of costs was include in MiFID II which is clear and unambiguous:

*'The information about **all costs and charges**, including costs and charges in connection with the investment service and the financial instrument, which are not caused by the occurrence of underlying market risk, **shall be aggregated** to allow the client to understand the overall cost as well as the **cumulative effect on return of the investment**, and where the client so requests, an itemised breakdown'.*

The suggested disclosure included in the IA discussion paper does not comply with this text. It is baffling that they even acknowledge this publicly:

Godfrey acknowledges that while the IA's work doesn't tally with the MiFID II proposals in their current form, the work they have done should represent a valuable building block for firms to work towards a methodology to calculating total costs and charges. He said: 'I think there is a chance of a contradiction but I don't think it is inevitable. Citywire, 12 Feb 2015

The MiFID II proposals come into force in January 2017, but we believe the IA's proposals clash with these and are consistent with the direction of travel in Europe, towards greater transparency.

SCM Direct's View – The Reporting of Costs and Fees Should Meet These Key Objectives:

1. **The fewer numbers shown the better. Individual investors are unlikely to ever understand countless different numbers in differing formats.** The IA's proposal includes many different types of fee, artificially separated with some shown per fund unit and some per transaction. This fragrantly breaches the overriding MiFID II aim to "aggregate" all costs or to display costs in a 'comprehensible' manner. Furthermore, the fund management related costs are just one part of the total annual costs facing consumers anyway. Platform charges, advice charges, wrapper charges are often more substantial than the fund management related charges alone. ALL these costs and fees charges need to be added together to enable consumers to judge the total cost they face and the merits of buying the same product through different channels.

2. **The costs shown prior to purchase (ex-ante) should aim to closely represent the same costs when calculated by investment firms after purchase (ex-post).** It is clearly highly misleading to exclude some costs prior to purchase and then show the same costs to consumers after purchase, by which time the investment decision has been made, buyer inertia sets in and investors are unlikely to change or switch.

   The argument that some costs should be excluded from the ex-ante cost as they may be volatile is entirely spurious. This can be simply overcome by 'smoothing' such items of costs over the previous three years. This would allow consumers to have a guide to future transaction costs or performance fees based on recent history, rather than these significant costs being ignored completely.

   There cannot be an arbitrary debate as to which costs should be shown to consumers in this 'Ex-ante' number, it must be all the costs. The argument that some costs can deliver a higher return and therefore should be excluded is entirely bogus. Even if this was true (and the academic evidence[1] says otherwise), the returns are already being shown to investors anyway.

   Investors need to know the full costs of deriving those returns to allow them to decide whether it is worthwhile investing or not.

[1] "Shedding Light on 'Invisible' Costs: Trading Costs and Mutual Fund Performance", by Roger Edelen, Richard Evans and Gregory Kadlec, Financial Analysts Journal, Volume 69, Number 1

3. **IA Contradicts Itself**

It is interesting that the three year smoothing principle, was a key part of the Investment Associations Enhanced Fund Disclosure code[2] in which it was recommended that '*three-year average figures for any brokers commissions and any transfer taxes'* be taken.

The IA now claim in their latest paper that '*Implicit costs, however, cover a variety of impacts not all of which are measurable with any high level of certainty'*…. '*it is much harder to measure spread for bond transactions.* This contradicts their *own* 2012 Enhanced Disclosure that provided for the bid/offer spread of transactions to be shown and its 2014 Statement of Recommended Practice (SORP) that also required the spread on the portfolio at the end of the financial year to be disclosed in the notes to the accounts.

Neither of these ever suggested that bond funds should be excluded. In fact many large groups[3] 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.

In our view it is practically impossible for funds to reliably capture the impact costs associated with dealing in larger size, and therefore only the typical spreads of the investments held should be shown. In order to give a better indication of spreads, we recommend taking an average of the 30 day average spread as at the beginning, middle and end of the relevant investment period – this field is available for many securities via independent data providers e.g. Bloomberg.

4. **In accordance with MiFID II the impact of costs and charges should be shown over the course of the investment.** Few investors are aware of the importance of compounding where paying high costs, year after year, can decimate long-term returns. The only way to illustrate the impact of such costs is to produce a table showing the total of ALL charges for a typical investment size, over various periods of time.

   This would not only serve to show consumers the costs over their likely investment period, but enable the costs to be shown in monetary amounts. Our research has found that as many as 89% of investors want to see their charges in percentages, as well as actual amounts.

5. **The important headline cost numbers and the table illustrating the total charged over the course of the investment should be shown clearly at the point of sale.** Many consumers will not look at the KIID document so regulators should strongly encourage such information to be prominently displayed at other key places e.g. the relevant summary page on platform websites and the relevant factsheet. Many more consumers look at the factsheet rather than the KIID document prior to purchase.

ESMA recently stated that '*The aggregated costs and charges should be totaled and expressed both as a cash amount and as a percentage*.' And that '*Information about costs provided on a regular basis during the life of the investment should be based on costs incurred and should be provided on a*

[2] IMA Enhanced disclosure of fund charges and costs (September 2012)

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

***personalised basis*.'** It is imperative that whoever the last in the chain is, provides the full total of the various layers and shows this to customers individually.

In our view, the easiest way to achieve this is via on-line calculators populated with the various underlying cost and charges data, allowing every investor a 'personalised illustration'. Once an investor enters the amount to be invested, the product, the length of time anticipated and the assumed investment return, a monetarised cost and return illustration is produced.

Unlike the IA which cheery picks which costs and charges should be shown, ESMA has produced comprehensive tables of the various costs to be included which requires no changes in our view.

Portfolio Turnover

It can be argued that there may be duplication of costs since some of the transaction costs may be already reflected in initial charges to reflect the cost of investing/disinvesting. However, the pricing of funds is incredibly complicated with funds priced on a Cancellation Price, Creation Price, Bid Price or Offer Price to name a few.

It would therefore seem sensible to follow the **US definition of Portfolio Turnover Rate (PTR**) and take the lesser of purchases or sales and then apply the full transaction costs on these transactions encapsulating all taxes, commissions and spread related costs. This would effectively reduce the level of reported transaction costs and allow for the fact that some (though often not all) investors may be paying an extra creation or cancellation levy that serves to reduce the impact of transaction costs on the fund.

However, 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 leading FTSE 100 mutual index funds in calendar 2014. We found that the actual performance differed from the index return, less the reported KIID ongoing charge by an average 0.28%. We concluded this must be a result of the extra costs associated with investors buying or selling units not incorporated in any unit pricing related charges; thereby impacting overall returns.

Equally, just showing the formula by which a performance fee is calculated or showing a level of portfolio turnover, as low, medium or high, is completely different from showing actual performance fees or actual transaction costs. A system of showing levels of portfolio turnover alone as an indication of costs will be highly misleading as the transaction costs differ for different assets, and therefore the overall impact would vary enormously.

Suggested Table Showing All Costs and Fees - Example:

Fund A, invested via a tax-efficient wrapper bought through an investment adviser holding the fund on a platform. The headline aggregated charge (2.70% pa in this example) should be displayed in the KIID document, factsheet and other key marketing materials, with a full breakdown available.

Total Costs and Fees – 2.70% pa 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 • 0.2% pa custody and administration charge • 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

Charges Table (either personalised to the individual or by a typical investor)

Term of Investment - Years	**Investment to Date**	**Aggregated costs and charges – in £, and as a % over investment period**
1	**£ 15,000**	**£810 5.4%**
3	**£ 15,000**	**£1,530 10.2%**
5	**£ 15,000**	**£2,250 15.0%**
10	**£ 15,000**	**£4,050 27.0%**

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