FTfm Investing in funds

Unforgiving light on fees and charges alarms asset managers

Critics say regulator's disclosures on performance and costs don't go far enough

3 HOURS AGO Chris Flood

Policymakers worldwide are desperate for workers to save more for their pensions and to invest more to support economic growth instead of leaving money to stagnate in bank accounts that pay minimal or no interest.

But growing awareness among savers of the negative impact of fees on long-term investment returns has led to widespread mistrust of the promises made by financial professionals.

In a drive to make investing more attractive, European regulators have decided to examine fees and charges for mutual funds, personal pensions, insurance-based investment schemes and structured products to ensure that consumers receive a fairer deal from the finance industry.

In October, the European Commission, the EU's executive arm, directed Europe's pan-regional regulators to publish performance and cost reports. This set off alarm bells for investment product providers.

The European Securities and Markets Authority, the EU financial regulator, shone a deeply unflattering spotlight on the impact of fees and charges on returns to investors in a study of more than 40,000 mutual funds sold in Europe, published last month.

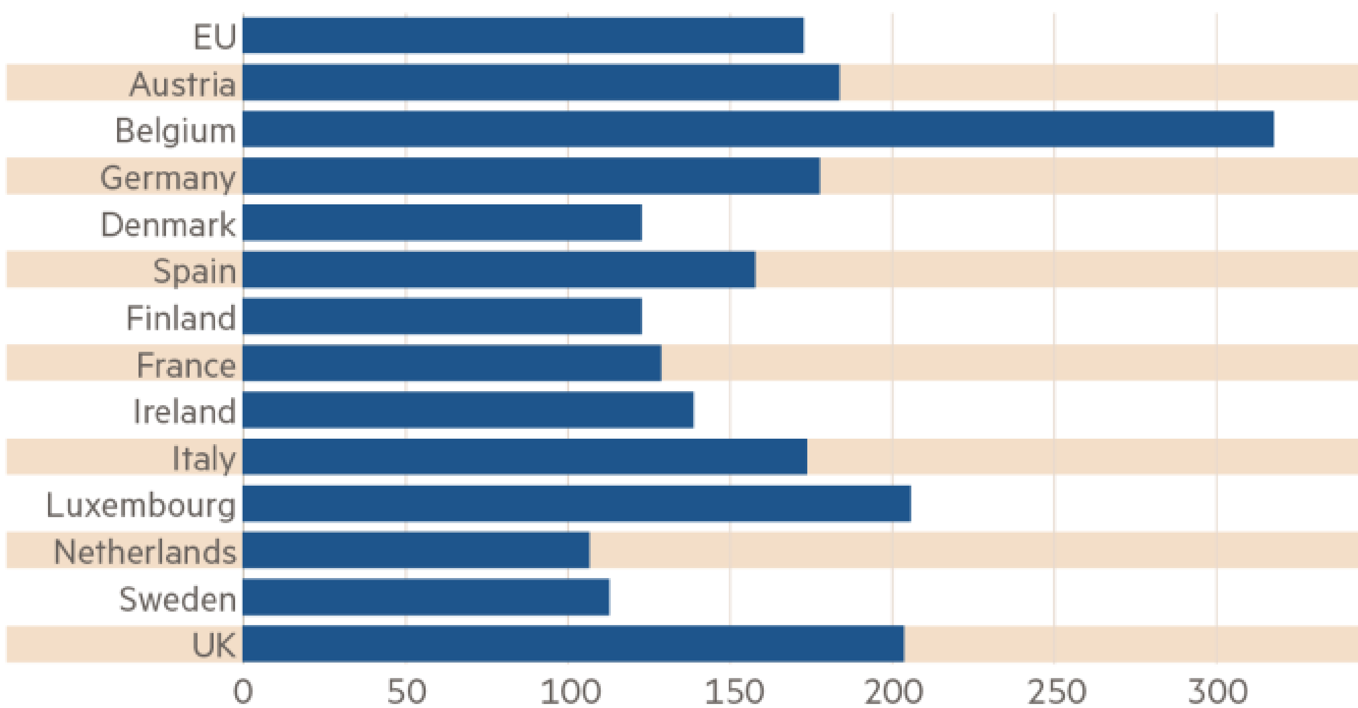
Steven Maijoor, Esma's chairman, reiterated that transparency of costs and performance was key to "increasing the attractiveness of long-term savings products for retail investors" in a speech in Brussels last week.

Between 2013 and 2015, investors across Europe saw annual fund returns reduced by 173 basis points, or 19.8 per cent, on average as a result of fees and one-off charges, according Esma.

Losses due to fees and charges ranged from a low of 107bp (9.2 per cent) in the Netherlands to as much as 318bp (31 per cent) for Belgium.

Leakage due to fees and costs is significant in all countries

Basis points



Source: Esma
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Alan Miller, co-founder of SCM Direct, the investment boutique that has long campaigned against hidden charges, says Esma has "significantly understated" costs borne by investors.

"Esma's measures exclude brokerage costs, account costs, charges by financial advisers and transaction costs levied by brokers and dealers," says Mr Miller.

A spokesman for Esma in Paris, says data on fees and charges levied by brokers and financial advisers are not currently available on a consistent basis. However, the regulator intends to offer investors a more complete picture in the future.

Esma is planning to perform further analysis on fund costs, as more information will become available from 2018 following the implementation of new European rules known as Mifid II and Priips, or packaged retail insurance-based investment products.

Mick McAteer, co-founder of the Financial Inclusion Centre, a non-profit investor campaign group, and a former board member of the Financial Conduct Authority, the UK regulator, says Esma’s figures are “shocking”, and driving costs down must become a priority for regulators.

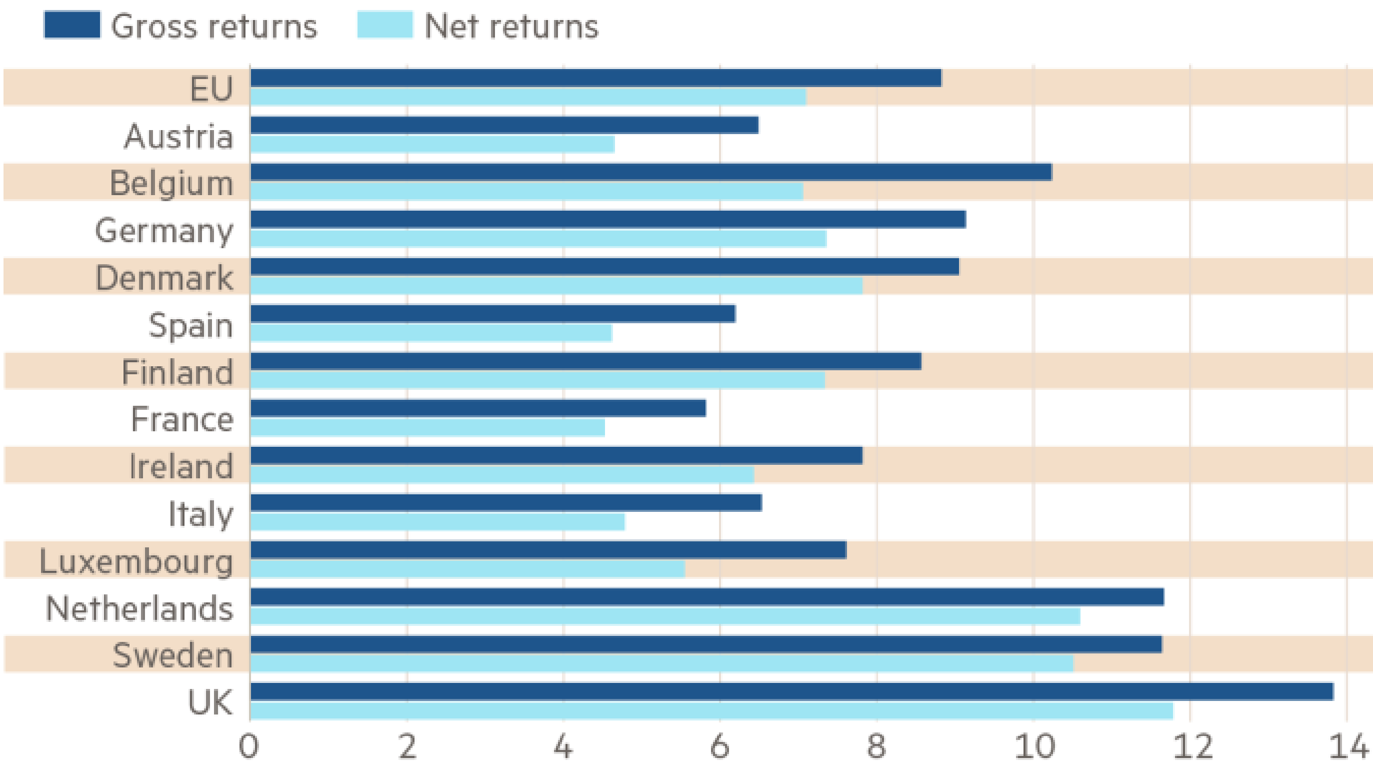
Some of the variations in the losses due to fees and charges are due to differences in the ratio of equity, bond and mixed-asset funds sold in different European countries.

“Esma is planning a deeper analysis and to disentangle the asset mix of funds sold in each country to ensure that we are not comparing apples and oranges when discussing fund costs across EU member states,” says the regulator.

Differences in the mixture of funds sold in European countries also partly account for the striking variations in gross returns (before fees and charges are taken into account) reported by Esma, ranging from a high of 13.8 per cent in the UK to just 5.83 per cent for France.

Fund returns vary widely across Europe

Annual % return 2013-2015



Source: Esma

Many retail investors also exhibit a distinct home bias when buying stocks and bonds, so differences in the performance of domestic equity and bond markets contribute to variations in gross returns.

Rodolfo Crespo, senior analyst at Platforum, the consultancy, says Esma's study shows investors receive poorer returns in countries where sales are heavily influenced by commission payments made by asset managers to fund distributors, such as Italy and Spain.

Banks are traditionally the biggest distributors of asset managers' funds across most of mainland Europe. The commission payments, also known as retrocessions, can account for up to 65 per cent of the management fee of a fund.

Improvements in fee disclosures are planned under Mifid II, the sweeping package of rules that is due to come into force in January. But Mr Crespo notes that distributors such as banks will still be able to receive rebates from fund managers if they provide execution-only services or if they offer access to third-party (competitor) products while also providing a high level of service, such as ongoing financial advice.

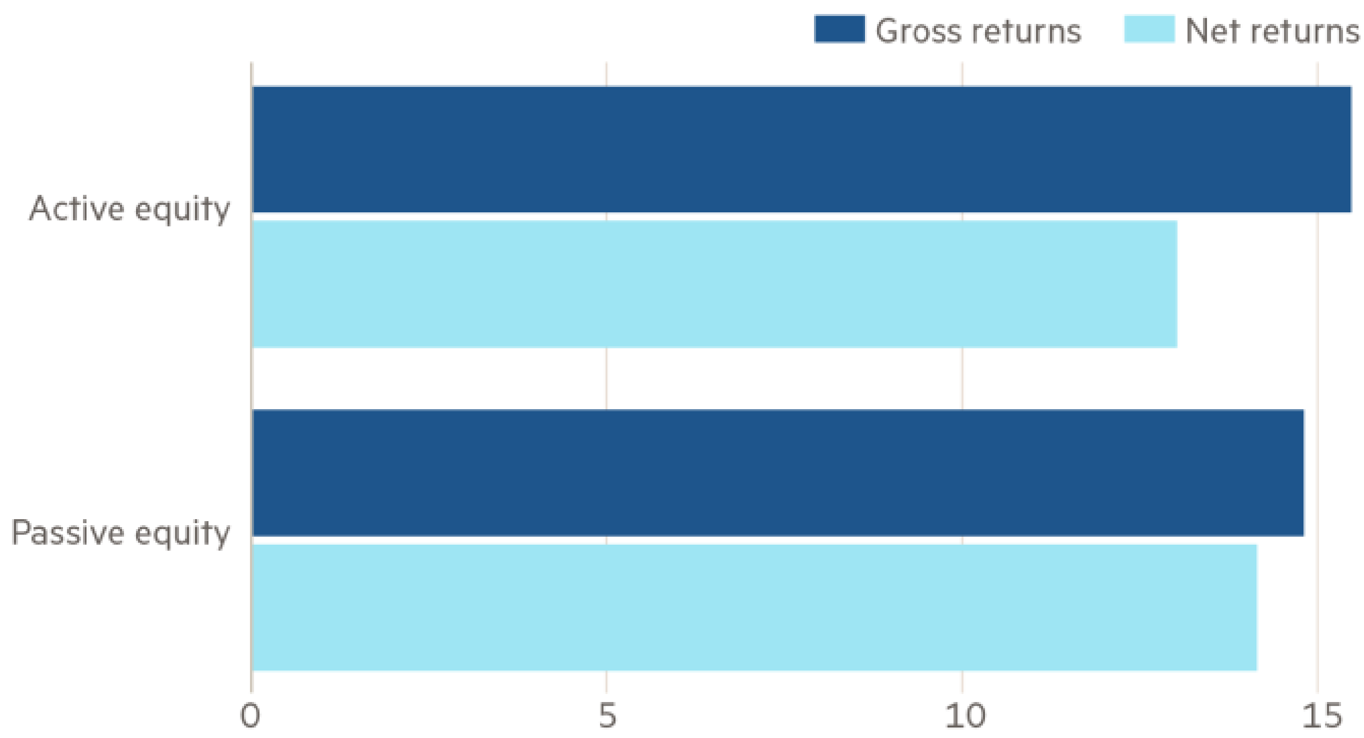
"Esma will realise that it cannot simply blame the asset managers, because fund fees incorporate payments [rebates] for distribution in continental Europe. Most asset managers have no choice if they want to attract investor inflows," says Mr Crespo.

Esma also examined how fees and one-off charges affected the returns delivered by actively and passively managed equity funds.

Active equity funds generated higher gross returns of just under 15.5 per cent that fell, on average, by 245bp to 13 per cent.

Fees and costs almost 4x higher for active funds versus passive

Per cent



Source: Esma
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Passive equity funds produced lower gross returns of 14.8 per cent, but losses due to fees and charges were smaller at 66bp. As a result, the average net return of passive equity funds at 14.1 per cent was better than that produced by the average active equity fund.

"Esma and national regulators across Europe have to tackle the behaviour of advisers and intermediaries who keep recommending high-cost, value-destroying funds," says Mr McAteer.

Esma is also concerned that retail investors in general appear to take little account of the impact of fees and charges before buying funds. This problem becomes particularly acute with low-yielding bond and money market funds, where the impact of fees and charges on final returns is magnified.

Households in Europe, on average, invest only 7 per cent of their financial savings into funds.

“Most long-term financial savings are held via more ‘packaged’ products, such as unit-linked life insurance investments and personal pensions, that add another layer of fees to those uncovered in the Esma study,” says Guillaume Prache, managing director of Better Finance, a Brussels-based investor rights group.

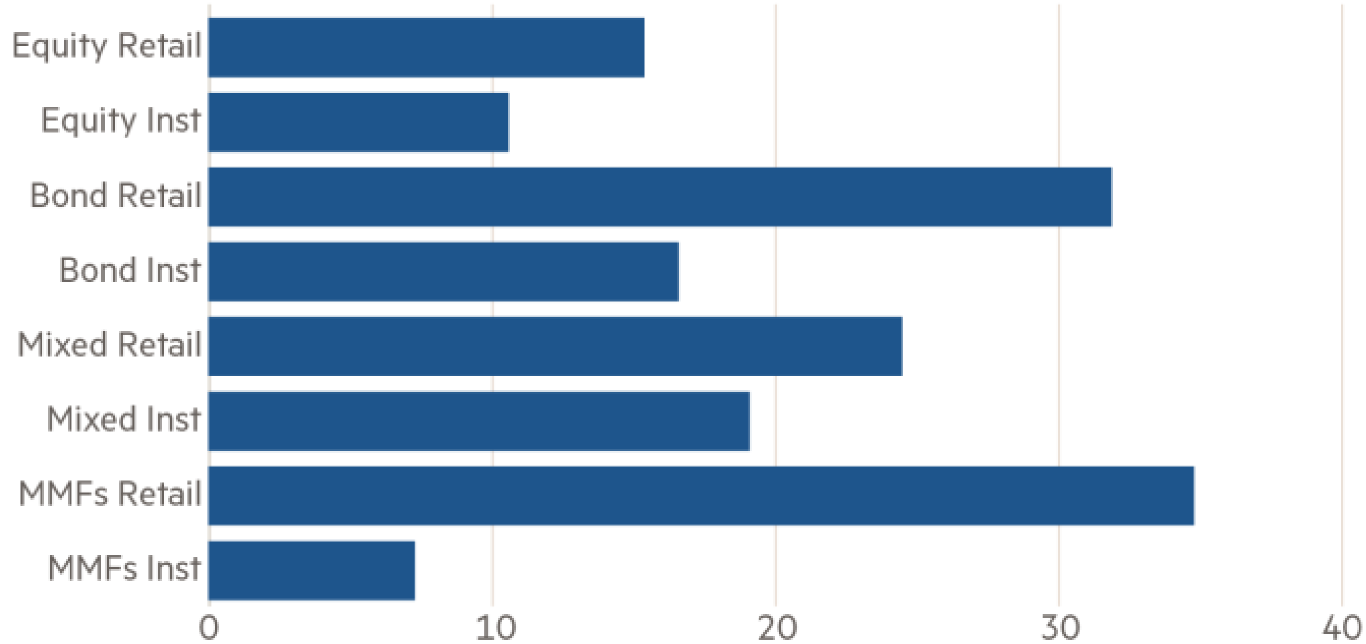
Better Finance is concerned that historic performance data are to be eliminated from mutual funds’ key investor information documents (Kiids) in favour of future performance scenarios that will show a range of possible returns under different market conditions. Ongoing fund charges will no longer be included in Kiids for new funds from January 2018 and for existing funds from 2019.

“Future performance scenarios could be highly misleading and will make comparisons between funds much more complex [and] far more difficult for investors to understand.

“It will fail to enhance the transparency of fees and performance of long-term investment products,” says Mr Prache.

Fees have a bigger impact on low-yielding bond and money market funds for retail investors

% reduction in returns due to fees and charges



Source: Esma
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Mr Miller says it is “a scandal” that regulators have not mandated a common template so that every manager can calculate and show costs on exactly the same basis.

SCM suggests that UK asset managers could be in breach of EU competition laws, since there cannot be genuine price competition if consumers cannot see the full price of an investment fund and costs are not displayed in a comparable format.

Mr Miller believes the asset management industry is running the risk of a class-action lawsuit, as the true cost of fund fees has been under-reported to UK clients for decades.

“The liabilities associated with 20 years of hiding nearly two-thirds of their charges from clients will make the payment protection insurance miss-selling scandal look like a rounding error,” he warns.