

The asset management industry had become distant from the consumers of its products, even before the GFC. **CLAIRE KEATING** reports on a new study that looks at driving positive change.

**A**s the Cooper Review works through submissions on Phase One – Governance, it is timely to consider whether the proposals could have some relevance for driving positive change in the Australian context.

The “*Ideal Fund – Reengineering the fund value proposition, June 2009*” is research from PricewaterhouseCoopers Luxembourg and Caceis Investor Services. It is based on the UCITS framework (Undertakings for Collective Investments in Transferrable Securities) which covers mutual funds in the EU and is designed to stimulate debate and serve as a catalyst to drive positive change in the long-term investment industry in the EU.

The premise for this paper is the relative underperformance of the European market during 2008 which saw net redemptions of 300 billion euros in comparison to 98 billion euros of net outflow in the US market (which is twice as large) and the Asian market which saw positive net inflows of 75 billion euros over the same period.

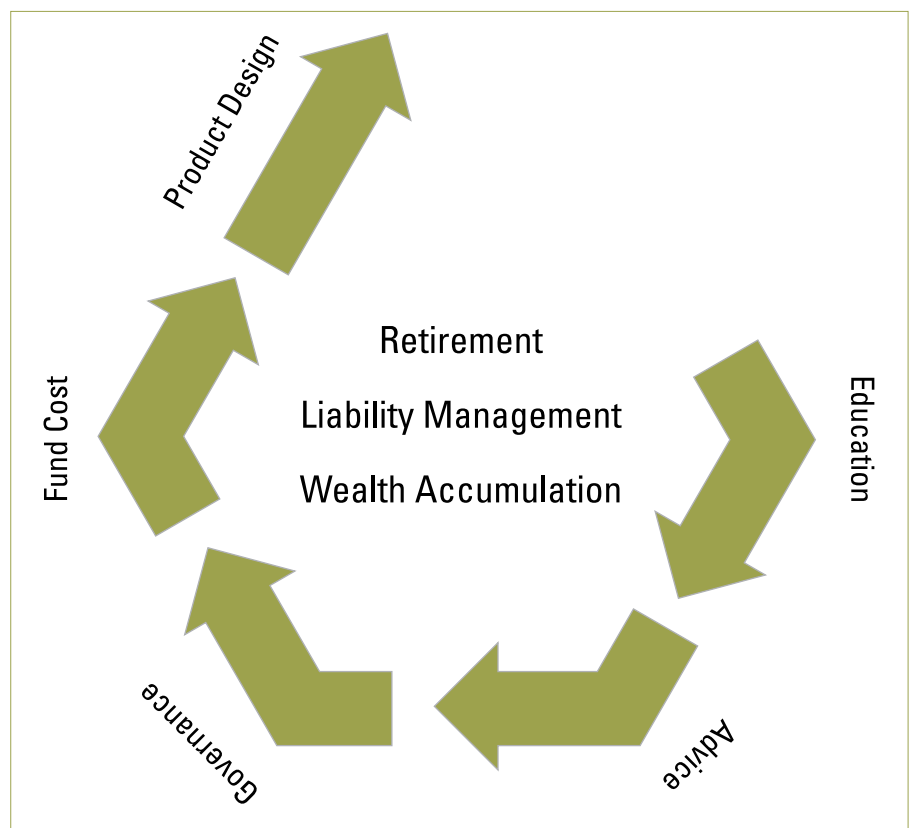
Surveys among investors have shown that the asset management industry has become increasingly distant from the consumers of its products over the past few years.

Even before the current crisis, a number of shortcomings had driven this gap between supply and demand expectations, and the financial crisis and recent fraud cases have only served to further damage investor confidence in the industry.

In order to ensure the sustainability of the industry’s value proposition, we need well-educated investors who receive appropriate advice, with access to an industry with a sound governance framework and which provides them the right product at the right price and with the right level of transparency.

Although the UCITS Directive already provides a sound regime for the regulation and transparency of funds, there is a need

## FIVE DIMENSIONS AROUND LONG-TERM INVESTMENT OBJECTIVES



for labelling and defining the characteristics of long-term investment products, as well as creating a level playing field for all products designed to cater for the long-term investment needs of the investor.

The *Ideal Fund* paper takes an investor-centric approach to examine the mutual fund value proposition and outlines recommendations for governments and the industry to promote sustainable solutions that will serve investors.

The focus is on the long-term investment goals of European retail investors.

Five primary dimensions have been identified around which the fund value proposition could be enhanced from an investor-centric perspective (see Figure 1 above).

- Education
- Advice
- Governance
- Fund costs
- Product design

The paper reviews each of these dimensions and proposes key recommendations specific to long-term products aimed at satisfying the retirement



# Creating the ideal fund

needs of the individual, taking into account the fact that this is targeted to the mass-market rather than just the mass-affluent and above.

## EDUCATION

Basic education about investing and retirement planning is critical to the social well-being of Europe and should be compulsory and state provided – that is, integrated into the school system.

Further education for more advanced investing (liability management and wealth accumulation for the long term) is also important but within the balance of priorities, state support needs to focus on ensuring a basic knowledge is provided (and not just made available) to all. This is recognised as a very long-term goal and that, in the meantime, state-led campaigns may assist in raising the awareness of the mass-market.

## ADVICE

Similarly to education, it is contended that the long-term goal should be that basic advice around retirement planning is

made available to the mass-market on an independent basis.

Within this context, the model used for basic healthcare within member states could be looked at to determine whether a similar model on a more limited basis could be applied for the mass-market.

Advice could be limited to key inflexion points within an individual's life-span (change of career, pre-retirement, change of family status etc), but should be available to ensure proper advice is made available to maximise the likelihood of full provision on a personal level. Such advice should take a holistic view of the investor's "financial health".

## GOVERNANCE

Even within the UCITS regime, governance models vary and are arguably more or less effective. Outside UCITS, effective governance becomes increasingly difficult to establish.

As part of long-term savings vehicles, there should be a basic governance model which is established and consistently applied across all member states. The

components of such a model require two basic features:

- The product provider needs to assume legally an institutional responsibility for the proper operation of the vehicle within the best interests of the long-term investor in accordance with the vehicle's objectives;
- A clear framework outlining proper conduct of business rules and inherent conflicts of interest which exist should be created and parties independent of the promoter should be legally tasked with monitoring adherence to such a framework.

Responsibility for such monitoring may fall to parties such as the depositary, independent directors or even the auditor. However, the framework should be clear enough to ensure that the inherent conflict which exists in appointment of the independent party minimises the risk of "oversight arbitrage" which may arise.

For products eligible as retirement vehicles, one could also consider the appointment of an "investor representative" which would likely be a state-registered

individual with specific additional scope for protecting the long-term retirement interests of investors and thus managing the State's "systemic" interest in the vehicles operation.

#### FUND COSTS

The amount, breakdown, and ambiguity of fees are a major source of discontent among investors and regulators alike.

No single definition of Total Expense Ratio (TER) – the annual cost effectively paid by the investor – exists in Europe. In addition, most of the TER that is communicated by funds does not include transaction costs, which may have a significant impact on the overall cost to the investor.

This additional cost is especially applicable to long-term investors in funds with high portfolio turnover rates.

This failing harmonisation and transparency makes it difficult to identify the nature of underlying fees or the actual costs for the investor and makes fee comparison between funds highly challenging.

A major portion of fees paid by the investor is neither for the performance nor the operation of the fund, but for fund distribution.

There are "sales commissions" that are paid to distributors for selling or "advising" the funds. In fact, distribution fees account for an average of 64 per cent of the TER in Europe. (Source: CRA Analysis for the European Commission).

Another significant portion of fund fees is used for the active portfolio management of the fund. However, there is no clear relationship between management fees and risk-adjusted returns.

#### Proposed solutions

- An industry-wide aligned definition and investor-friendly reporting of total fees (including costs endured through transaction fees) paid by the investor would foster transparency and confidence.
- In addition to covering the providers' operational and opportunity costs, fees for retirement products should be linked to the risk-return objectives within the investors' timeframe ("objective fees") in order to align the investors' and asset managers' goals. Such "objective fees" would differ from performance fees which target outperforming a certain level of return, in that they would be determined in line with final

and intermediate risk-return objectives.

#### PRODUCT DESIGN AND TRANSPARENCY

Education, advice and governance mechanisms only work to the point the available products are suitable to investor needs.

There are more than 50,000 mutual funds in Europe. New fund launches are supported by high marketing spends and lucrative incentives for distributors during the launch phase in comparison to existing funds.

Managers are paid to maximise assets within the funds and have little direct incentive for accomplishing investors' goals.

#### ONE-SIZE-FITS-ALL APPROACH

Investment funds were originally designed to target long-term investors but along with the increasing sophistication of the market, various investment fund strategies

The crisis has also demonstrated that funds are restricted by their investment strategies.

have evolved that pursue not only long term but short-term trading strategies.

Nevertheless most funds are still communicated and labeled as being suitable for all investors, ranging from the man in the street to high net worth or to institutional.

During the recent crisis short-term liquidity needs of certain investors conflicted with the long-term investment horizon of others resulting in some significant issues for certain funds.

The crisis has also demonstrated that funds that are restricted by their investment strategies to have a minimum or maximum allocation within an asset class are robbed of the ability to act more flexibly, especially in times of crisis when rigid strategies can be disadvantageous for the investor. The fund's goal should be to manage an objective, not a strategy.

#### MISMATCH OF LIQUIDITY NEEDS TO PORTFOLIO STRATEGY

By its very design, UCITS must provide ongoing liquidity for investors who want to redeem. However, investors with different time horizons have varying liquidity needs, and the mutual fund's provision for this liquidity comes at a cost.

Long-term investors with a much lower

need for ongoing liquidity have to bear the cost of the fund's non invested capital, as well as trading costs and other dilutive effects and eventually face lower returns.

#### Proposed solutions

- For vehicles categorised as long term, the need for daily liquidity, as provided for within the major UCITS, is not required and represents a significant additional cost – and arguably a risk – for investors holding for the long term. Vehicles designed for the long term should not only be permitted, but should be required to offer liquidity designed with the long-term investor in mind. This could be accomplished through various measures such as managed redemption programs, swing price mechanisms or limitation of redemption possibilities over certain time periods. The current blurring within the UCITS world of vehicles

accommodating short and long-term needs should be eliminated or at least managed for the benefit of the long-term investor.

- Vehicles designed to incorporate a one-stop solution as an objective (such as target date funds) should retain flexibility and, arguably, be required to incorporate mechanisms which protect the investor in times of crisis such as counter-cyclical hedges or triggers for safe-harbour investment.
- Transparency within the UCITS world remains extremely high in comparison with other vehicles on offer. Vehicles classed as long term should all have the equivalent levels of disclosure which are designed for the long-term investor. For example, daily price publication or monthly fact sheets with benchmark performance indicators are arguably less relevant for products with a specific end objective than periodic (say quarterly) reporting on the performance versus objective, together with any changes in the underlying risk features of the product.
- Long-term vehicles should be developed to meet the investor's financial objectives rather than to adhere to a fixed strategy such as a fund limited

to a country or industry. The fund industry, when servicing long-term financial needs especially in the space of retirement planning, should shift focus from benchmarks to investors' time and risk objectives in constructing retirement eligible products. Such vehicles could be used either as building blocks or have built-in solutions for investors looking to plan for their old-age financial security.

#### AUSTRALIAN CONTEXT EDUCATION

The low level of financial literacy identified in Europe is equally applicable to Australia and the Financial Literacy foundation was established in 2005 to start to address this problem.

The functions of the foundation were transferred to ASIC in 2008 and we are yet to see how some of the aims, particularly in regards to education, will be put into practice.

The Ideal Fund paper suggests a

different if the requirement was to act in the best long-term interests of members.

Would this lead to different fund structures? Removal of daily unit pricing? Reduced switching? Reduced (or no) investment choice?

In terms of trustee structures, Australia effectively has two models:

- approved trustees
- equal representation

The first model is most similar to the European framework and hence the issues raised in the Cooper Review Governance Issues Paper on conflicts and trustee duties, where approved trustees are associated with service providers, may be addressed by some of the paper's suggestions.

The involvement of independent directors along similar lines to Compliance Committees under the Managed Investment Scheme regime may have relevance.

Where funds have equal representation it could be argued that investor representatives already have a seat at the

This has been reflected in the financial reporting Exposure Draft 179 Superannuation Plan and Approved Deposits Funds (which is to replace AAS25).

No mention has been made of disclosure of distribution costs and it would be interesting to know to what extent the European experience of 64 per cent of total costs relating to distribution is replicated here.

#### PRODUCT DESIGN AND TRANSPARENCY

There are many Australian similarities to the issues posed in the European context, including product proliferation, given the difficulty and costs involved in product rationalisation.

Choice of Fund and portability standards have increased the need for Australian superannuation funds to hold greater amounts of liquidity.

The SIS legislation requires trustees to formulate and give effect to an investment strategy rather than managing to an investment option, resulting in funds redeeming from asset classes and crystallising losses at a time when those asset classes represent good value.

The media and ratings agencies have a role to play through continued publication of short-term returns and in rating short-term fund attributes as attractive, for example, daily unit pricing even where these attributes add to operating costs and may not be important in the context of long-term outcomes.

IFSA's draft super charter proposes that where investment options have a strategic asset allocation of more than 25 per cent of funds under management in illiquid assets they should be required to have application/redemption policies, possibly beyond the SIS 30 day rule.

#### CONCLUSION

There may be much debate about what constitutes the Ideal Fund and, in both Europe and Australia, we may be some way from where we would like to be.

The Cooper Review provides us with an opportunity to reconsider our superannuation system and perhaps reassess how we have pursued "the best interests of members" and whether the target should be extended to "the best long-term interests of members". **SF**

---

*Claire Keating is a Sydney-based partner with PricewaterhouseCoopers. For the full paper go to [www.pwc.com/au](http://www.pwc.com/au)*

In terms of trustee structures, Australia effectively has two models – approved trustees and equal representation.

much more far ranging long term and co-ordinated education program than is currently being considered in Australia.

#### ADVICE

The aspiration of basic advice on retirement planning on an independent basis is clearly something under consideration in Australia with the Parliamentary Joint Committee (PJC) Inquiry into Financial Products and Services in Australia due to hand down findings in November. Furthermore, IFSA's draft superannuation charter released in June 2009 and the FPA's discussion paper both support a move to fee based remuneration for financial planners.

Another proposal under consideration is tax deductibility of financial planning to create a more level playing field vis-à-vis the deductibility of commissions.

#### GOVERNANCE

Under SIS and trust law trustees must act in the best interests of members. It is interesting to consider what might be

table, making the need for a government appointed representative unnecessary.

#### FUND COSTS

In the Australian context, attempts have been made to improve disclosure of fees through standard definitions of Managed Expense Ratios, Indirect Cost Ratios and Other Management Costs.

These calculations are typically unaudited and often rely on disclosure from underlying funds which in some cases can be hard to obtain (for example, hedge funds).

Similar to the European experience, performance fees typically do not reflect risk adjusted returns.

The 2007 Parliamentary Joint Committee on Corporations and Financial Services recommended the superannuation industry work with the Australian Accounting Standards Board to make disclosure of promotional advertising, sponsorship expenses and executive remuneration compulsory.