The fee paradox

LCP investment management fees survey report

April 2017

Welcome to our sixth survey on investment management fees which explores the fee paradox – managers' fee rates are down, but investors are paying more.

For further information about investment management fees and LCP's investment manager research please contact Matt Gibson, or the partner who normally advises you.

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Contents

Why are investment managers charging more… but not actually doing more?

Matt Gibson
Partner and head of investment research, LCP

Welcome to our sixth survey on investment management fees which explores the fee paradox – managers' fee rates are down, but investors are paying more. Fees are important - they are a drag on returns, but paying for assets to be well managed may well be worth it. Therefore, ensuring you are getting value for money is key.

Investment managers have done very well out of increases in assets under management over recent years – raising fee revenue. This has been driven primarily by general rises in equity and bond markets, which raises the question "why are investment managers charging more... but not actually doing more?"

We found that while a number of headline fee rates have fallen since our fee survey in 2011, this has not been enough to offset the income-boosting benefit of investment market growth.

For example, our survey found that for an active global equity mandate, originally of £50m, that has matched the return of the global equity index, investors could be paying around £260k more in fees than they were six years ago (a 70% rise).

This is not new. For several years our survey has highlighted that active managers are primarily rewarded to retain client assets, and not necessarily to achieve outperformance. There is, therefore, a danger that investors are rewarding mediocrity.

Along with our in-depth analysis of the fees charged by investment managers, we have included a review of transaction costs. We continue to see a lack of consistent and transparent reporting in this area.

For example, for a £50m UK equity mandate, reported transaction costs vary from £400k to £20k. We cannot explain this degree of variation as coming from different levels of portfolio turnover alone; the difference arises as managers are reporting these costs using different approaches and including different items within their figures.

As well as highlighting key issues and trends with investment fees, we hope you find our survey to be a useful resource to help you:

- benchmark existing manager fee arrangements;
- negotiate fee levels; and
- compare fees for investment manager appointments.

With the Financial Conduct Authority's (FCA's) **Asset Management Market Study** findings imminent, there's plenty keeping the investment consultancy and asset management industries on their toes. No doubt more regulation is on the way, and we hope that this will help to bring about greater clarity on costs.

Matt Gibson

About the survey

126
Asset management organisations surveyed

77
Responses received

48
Asset classes covered

516
Different products covered

The FCA is the financial regulator in the UK with principal responsibility for regulating the asset management industry.

2. At a glance summary

Mediocre performance is rewarded with a substantial fee increase

For most investors, even if your manager has delivered index-like performance, the total cost of investing has risen substantially due to the strength of investment markets. For example, for managers of £50m mandates, that delivered index-like returns, the typical fee increase (since our 2011 survey) was:

£281k
89%
UK property manager

£262k
70%
Global equity manager

£40k
27%
UK corporate bond manager

See page 8

Average fee rates are mostly down

Of the median fee rates for the most popular 21 asset classes covered in our survey (compared to our 2011 survey):

13 **Fallen**

8 **Increased**

1 **Unchanged**

See page 10

Reported transaction costs show a lack of consistency

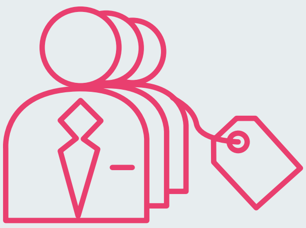
£380k

£380k was the difference between the minimum and maximum transaction costs reported by UK equity managers managing £50m mandates.

See page 12

Are the managers who charge more worth it?

Our analysis has shown that there is not a noticeable link between charging a higher fee and delivering better performance.



See page 15

Total costs for a £50m investment - highest and lowest

£590k (1.2%)
UK property

£38k (0.08%)
Passive UK equity

See page 11

Costs have a huge effect on outcomes over the long-term

£9.9m

For £50m invested over the past 20 years in UK equities, the average active manager would have received £9.9m more in fees than a passive manager.

£18m

This fee differential would have led to an £18m difference in the portfolio value today.

See page 14

DC platforms can offer benefits over accessing funds directly

£5.5k lower fee (a 30% discount) to access a passive global equity fund via a DC platform, when investing £10m in the fund.

See page 16

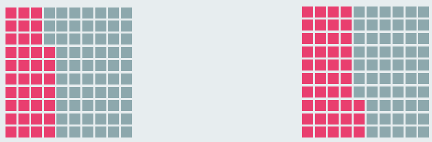
If you don't ask, you don't get

Benchmarking alone won't reduce fees, but asking and negotiating might. In this case study we take you through the approach taken by our client who reduced fees by 20%.

See page 19

Prices, profits and performance – the FCA get tough

The FCA is concerned about investors not getting value for money from the asset management industry. They reviewed fees, profits, performance and the industry's structure.



36% is the average profit margin for the asset management sector (vs UK average of 16%).

43% of all assets managed by UK asset managers is for UK pension funds and other institutional investors.

We discuss what this might mean for investors

See page 20

LCP fee survey data room

Investment management fees by asset class

Visit our interactive data room to discover how charges vary across managers.

Access the fee survey data room here:
investfeesurvey2017.lcp.uk.com/

3. *Key findings from the survey*

Fee changes in major asset classes

Mediocre performance is rewarded with a substantial fee increase

70%

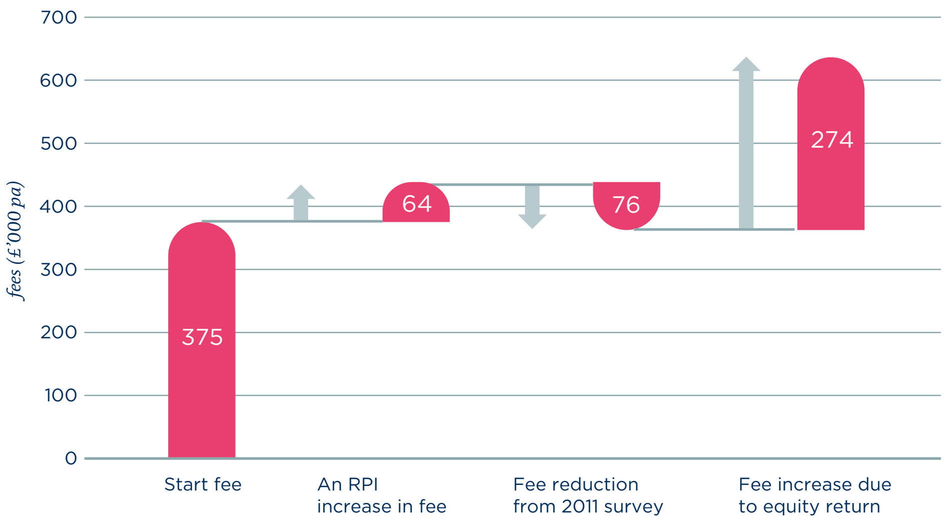
Average rise in total asset management fee for a £50m active global equity mandate funded in 2011.

Total costs for global equity mandates rise substantially

The total asset management fee for a £50m active global equity mandate funded in January 2011, has, on average, risen 70% in the 6 years since our 2011 fee survey, from £375k to £637k. This rise has largely been driven by the increase in equity markets.

The average headline fee rate for the asset management of the same portfolio has fallen 7% from 0.75% to 0.70% in the last 6 years.

Change in fee paid for global equity mandate - since LCP's 2011 fee survey
Original £50m of assets - fee in £'000



We show the fee increase that would have been justified by an inflation increase alone as a comparison. Equity returns, and hence the asset value of the portfolio, have far outstripped inflation in the past six years, leading to a big fee increase overall. (We have assumed the fund returned in line with global equities after fees, and did not achieve any outperformance.)

This highlights that managers are primarily rewarded to retain client assets and not necessarily to achieve their performance objectives of beating benchmark indices.

Our viewpoint

In most growth asset classes, we expect returns to beat inflation. Nearly all asset managers charge as a percentage of assets, this means that as long as performance has been good enough not to precipitate redemptions, asset managers can expect an above-inflation fee increase most years. The outcome for the manager, even with an unspectacular performance, is increased revenue. If the manager attempts to outperform, there is the risk it will not succeed and underperform, leading to investor redemptions and a significant loss of revenue. The typical fee structure, therefore, is skewed; it gives the manager an incentive to take little risk and to deliver index-like performance.

Other fee structures could help get round this issue. A well-structured performance fee or even a flat-fee can better align the interests of the manager and the investor.

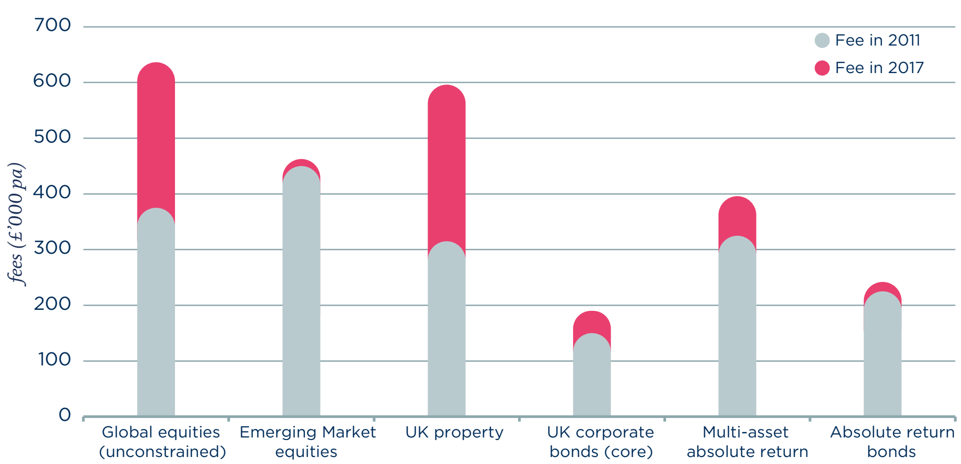
Fees in other asset classes also up

In other asset classes, fees have also risen. For six of the most popular asset classes, the chart below shows the average fees paid in 2011 for £50m invested, and the fee an investor would now be paying after applying a market increase to the assets and adjusting for 2017's average fee.

Fees in global equities and UK property in particular have risen significantly faster than inflation over the period.

There are no market indices for diversified growth funds or absolute return bond funds, so we have used the average return from a sample of popular funds.

Increase in fees in select asset classes between 2011 and 2017 surveys



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Of the 22 major strategies we have covered, only 8 have seen rises in the average fee rate.

Average fee rates are mostly down since 2011

Average fee rates quoted by managers for managing assets have mostly reduced since our fee survey of 2011. Of the 22 major strategies we have covered, only 8 have seen rises in the average fee rate whilst 13 saw falls. This means a new investor today is typically coming in at a lower fee rate. If existing investors have not recently asked for a fee reduction, they could be paying more than other clients of the asset manager.

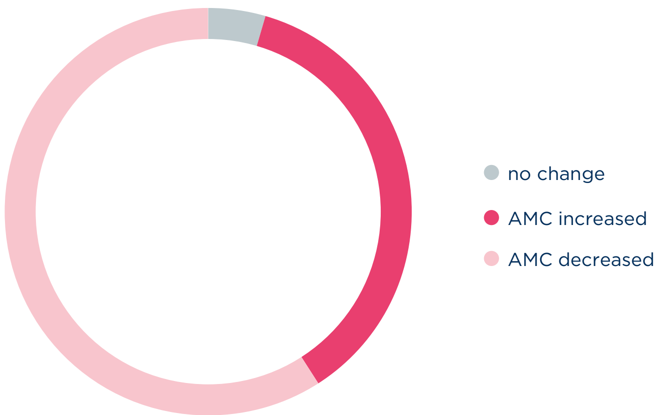
Managers have been telling us that there is strong pressure for fee reductions. The availability and increasing popularity of cheap index-tracking funds has led to increases in assets under management for these type of products and reductions in assets for traditional actively-managed strategies.

Change in average asset management charge from 2011 to 2017

+ Annual Management Charge (AMC)

The headline quoted annual fee rate applied to the value of assets under management. The AMC is often quoted in the form of basis points per annum (bps pa). A fee of 50 bps pa (or 0.5% pa) means that each year the manager would earn £5,000 for every £1million of assets managed.

Movement in AMC for various asset classes since 2011



Turn to page 29 for a list of potential costs investors could incur.

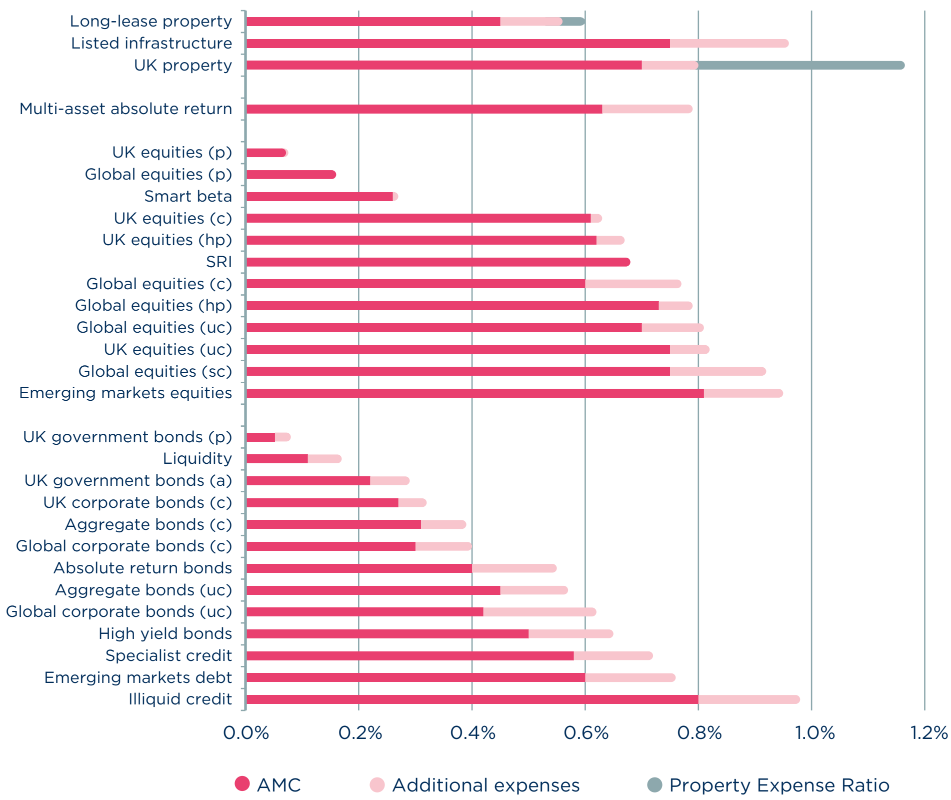
"Total" costs for investors using funds

For investors using funds, there are additional charges on top of the asset manager's fees. In the appendix we set out a comprehensive explanation of the potential costs investors could incur (see page 29).

The chart below shows the total cost broken down into the asset management charge, additional costs and costs specific to property investments for a £50m mandate. The costs covered here are only the explicit charges payable by the fund. There are other additional costs incurred by investors, which we will discuss on the following page.

We have excluded strategies that are rarely used by our clients because of their complexity or high fees, such as certain hedge fund strategies and private equity. On average, over 80% of the total fund cost is the asset management charge.

Overall costs for a range of asset classes



p=passive
c=core
hp=high performance
uc=unconstrained
sc=small cap
a=active

+ Transaction costs

The costs for buying and selling investments, which includes broker dealing commissions and taxes where relevant, eg stamp duty on UK equity and property transactions.

Transaction costs reported lack consistency

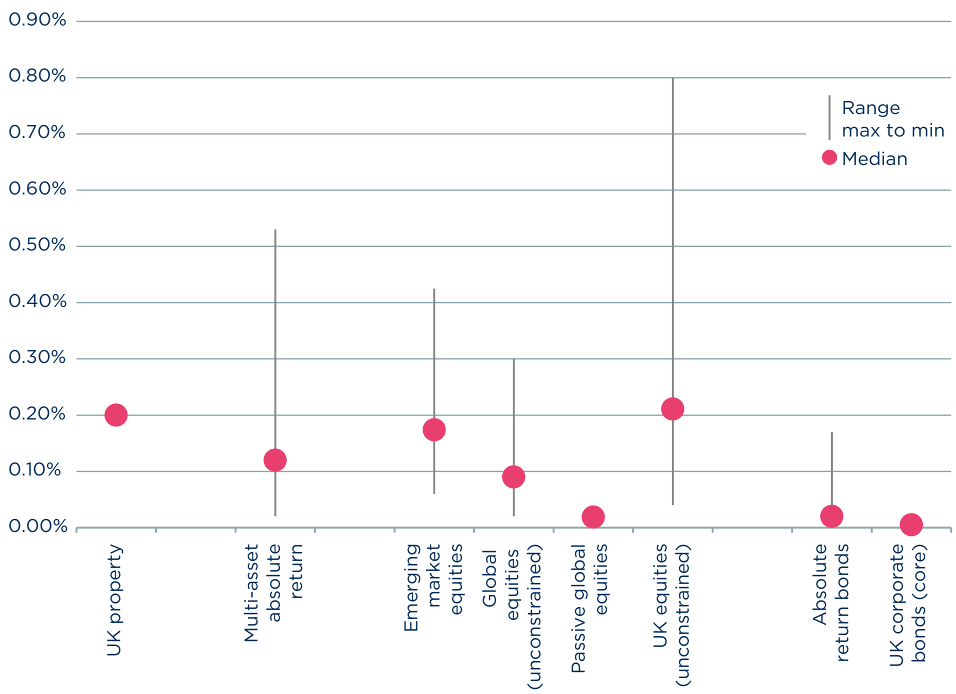
Transaction cost estimates were provided by the majority of managers responding to our survey. Some managers who did not respond said they are waiting for guidance from various upcoming regulations about what to report. We discuss these regulation changes on page 27.

Managers that did report transactions costs took a wide variety of approaches. Some only reported the explicit commission costs in trading; some included an estimate of the costs implicit in the bid-offer spread of a security; and some included an estimate of the market impact (eg the effect of the price of the security rising because the asset manager is attempting to purchase it).

Some managers reported the total cost incurred by the fund for all transactions, while others removed the cost of transactions that were related to investing subscriptions and raising cash to meet redemptions from the fund. They argued that subscribing or redeeming investors paid for these transactions through an adjustment to the fund price, and so there was no cost to the fund as a whole.

With all that uncertainty, any figures need to be interpreted carefully. The chart below shows the average and range of transaction costs reported to us in some of the major asset classes.

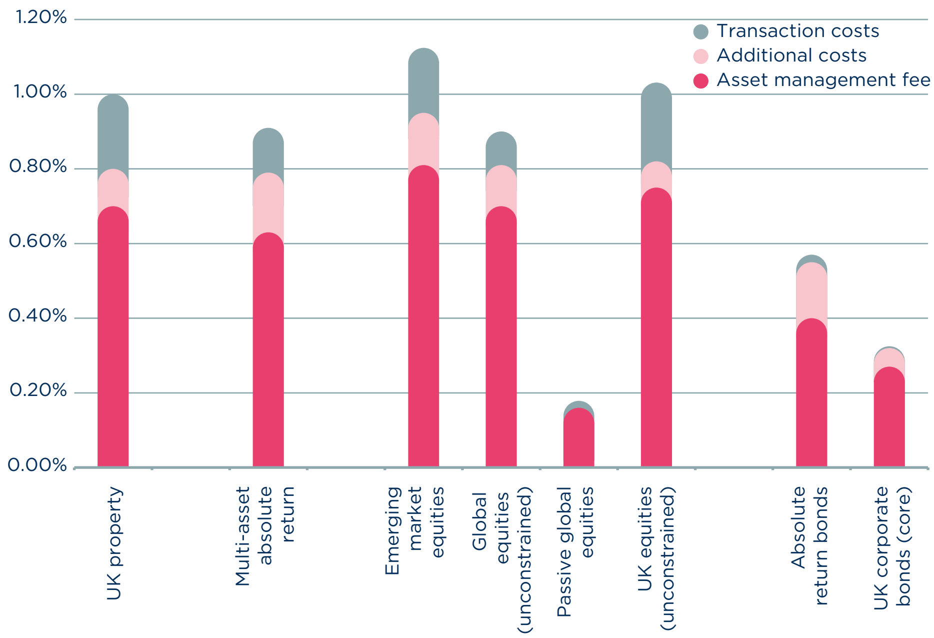
Median and range of transaction costs per annum as a % of the fund value



Transaction costs add to overall costs of investing. The chart below shows the size of the average transaction costs that managers reported, in the context of other charges in a pooled fund. On average transaction costs are around 7% of the total costs of the fund. Given the different approaches taken by different managers in reporting these figure, with some managers excluding certain components, the true transaction costs are likely to be higher than this.

Transaction costs are, therefore, a reasonably significant part of the overall costs of investing and asset managers need to demonstrate that they can monitor the costs and control them.

Transaction costs and other costs



> *Transaction costs are a reasonably significant part of the overall costs of investing and asset managers need to demonstrate that they can monitor the costs and control them.*

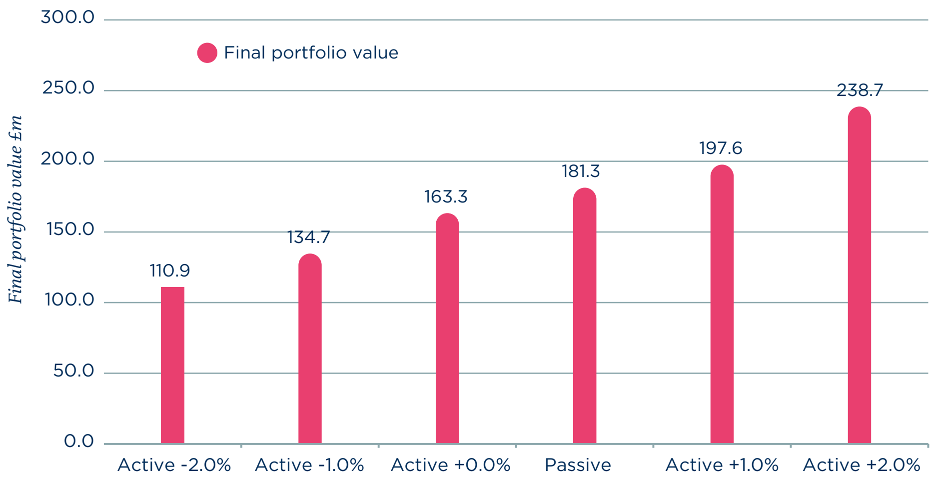
Costs and performance

Costs and performance have a huge effect on outcomes over the long-term

We illustrate the effect of costs over the long-term by showing the different portfolio values an investor would have achieved by investing in a passive UK equity fund or an active UK equity fund, assuming different levels of outperformance for the past 20 years.

The chart below shows how a £50m starting portfolio in 1996 would have grown, after average fees, over the last 20 years, for various levels of performance.

End asset value of investing £50m in a UK equity portfolio over 20 years (Dec 1996 to Dec 2016)



If the active manager achieved a return on the underlying portfolio that matched the index (Active +0.0%, in the chart above), the final asset size, with all dividends reinvested, would be £163m. This is £18m below the assets a passive investor would have today.

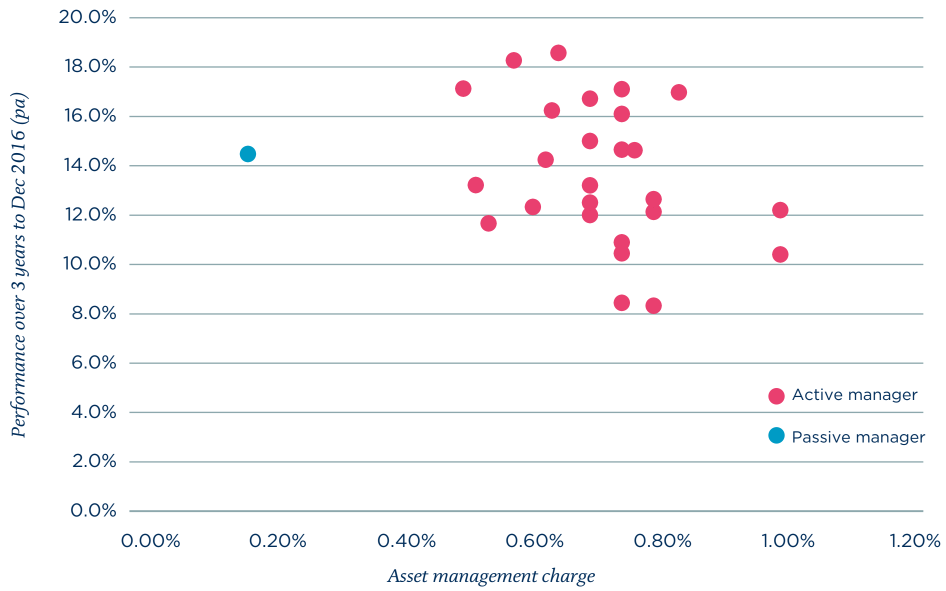
Costs have a double-effect on an investor's outcome.Not only do they need to be paid, but costs reduce the pot size that can earn returns in the future. In our Active +0.0% scenario, at the average fee rates, the investor would pay £9.9m more in fees than someone using a passive manager. The total effect of the fees on the outcome, an £18m shortfall, is nearly twice the size of the fees themselves.

Even if the manager achieved outperformance of 1% pa over 20 years, it added only 9% to total returns after fees. The effect of fees on portfolio outcomes is huge. In those asset classes where investors have the option to invest passively at low fees, managers do need to demonstrate their fee is worth paying. Managers need to achieve significant outperformance after fees are paid in order to justify taking the risk on active management.

Are the managers who charge more worth it?

We investigated whether managers that charge higher fees justify it through better performance. The chart below shows the performance of global equity managers over the past three years compared to the fee charged.

Performance of a selection of global equity managers vs asset management charge - performance over 3 years to 31 Dec 2016



Whilst this is based on relatively few managers, and a short period, there seems to be little evidence that managers who charge more deliver better performance. Indeed, the two highest charging managers in our sample achieved some of the lowest returns. The FCA recently conducted a review of the asset management sector (see page 20). As part of its report, the FCA reviewed previous research in this area and conducted its own analysis. It concluded that "…there is no clear link between price and performance…"

The FCA concluded that "…there is no clear link between price and performance…"

DC investment-only platform costs

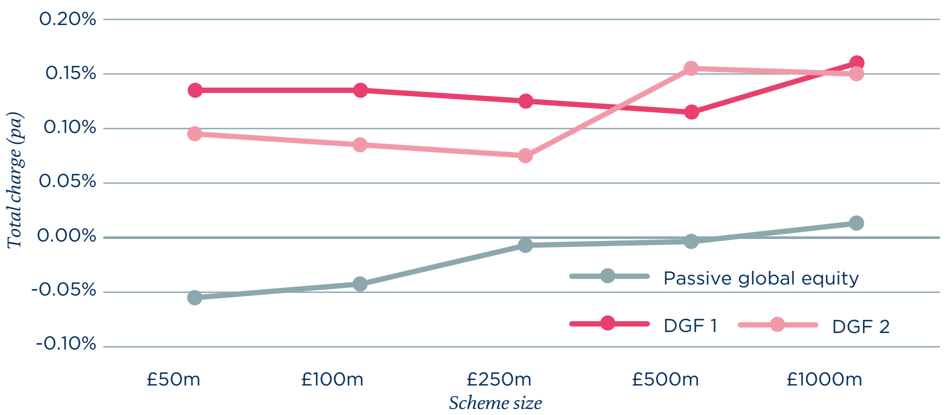
Many DC schemes will access asset management services through a DC platform, which offers a range of funds. The DC platform will charge a fee for its services, adding to the total cost of investing. In theory, the fund platforms negotiate with the underlying funds and may be able to get a lower fee than any individual pension scheme, because of the larger pool of assets to invest.

We asked a number of DC platforms about the total fees pension schemes of varying sizes would be charged for investing in a passive global equity fund and two different diversified growth funds (DGFs).

Since the total fee is made up of a platform fee, which can vary by total scheme size, and the fund fee, which varies by amount invested, we need to specify both to quote a fee. The chart below shows how the fee varies by scheme size and assumes 20% of the total scheme assets are invested in the specific fund.

Difference in total cost between investing through a DC platform and investing directly

+ Difference in total cost between investing using the DC platform and investing directly in the fund for three common funds used by DC schemes – assumes that the fund has 20% of the scheme's assets.



At lower levels of assets, the DC platforms are able to negotiate lower fees for the passive global equity fund, which more than offset their costs.

For the diversified growth funds, accessing the funds through the DC platform is more expensive than investing directly.

In theory the DC platform should have the negotiating power of pooling all its clients' assets and be able to negotiate a lower fee than any one client could. In practice, we have seen some large schemes negotiate further discounts directly with the asset manager for their investments through the DC platform. The platform fees here, therefore, should be seen as the maximum fee a scheme would pay.

Our viewpoint

DC platforms have generally been able to negotiate some fee discount from asset managers and pass these onto to their clients. This is generally not enough to completely offset the DC platform's fee. For the vast majority of clients, however, investing directly and administering the scheme in-house is not an option. The DC platform, therefore, offers an important service at a reasonable fee level.

At larger investment sizes, investors may be able to negotiate a reduced fee directly with the asset manager, but still use the DC platform as the route to invest.

4. Getting value for money

The difference between cost and value

Fees are important - they are a drag on returns, but paying for assets to be well managed may well be worth it. Therefore, ensuring you are getting value for money is key.

There are some obvious steps to take to increase your chances of getting value for money from an active manager, such as:

- selecting a manager that has the experience, skills and resources to have a good chance of beating the average investor in the market; and
- negotiating the lowest fee possible.

We also think it is crucial that investors monitor their managers regularly to ensure that:

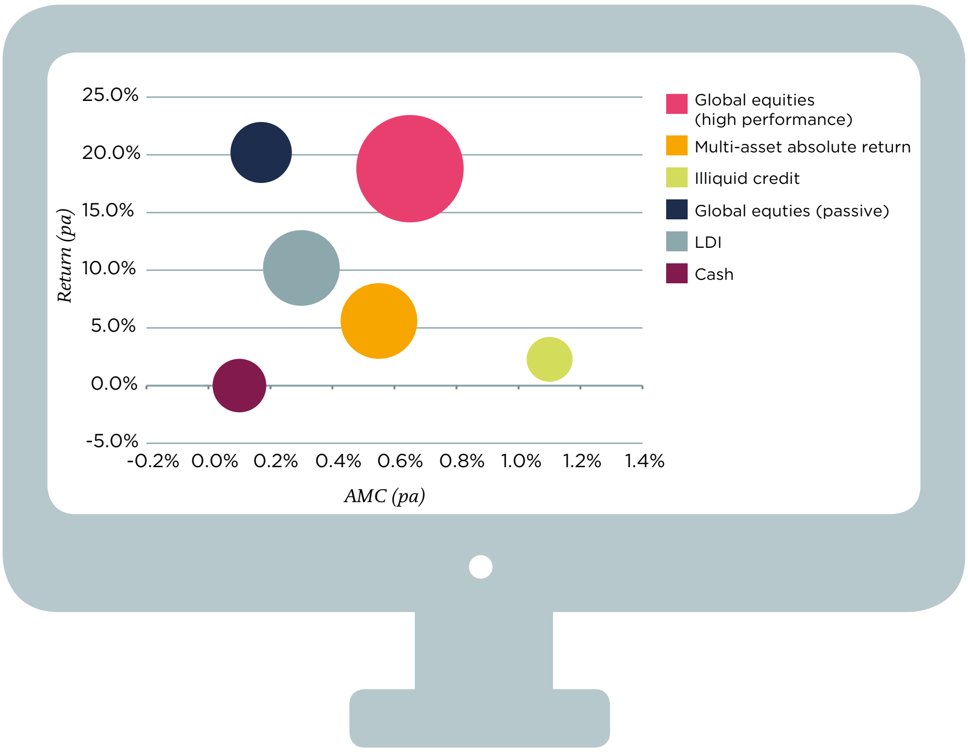
- none of the factors behind the original decision to invest have deteriorated;
- performance is on track to deliver the outperformance you expected; and
- the risks taken by the manager are acceptable and in line with those you expected.

Monitoring investment managers

We advise our clients to use real-time tools (like LCP SpotLight) to monitor their managers and make sure they are getting value for money for the fees they are paying. The chart below demonstrates how monitoring performance, and fees on a single dashboard can lead to better and more informed investment decisions.

Using monitoring tools together with a qualitative assessment of managers provides a comprehensive picture of whether managers are providing value for money and whether they are on track to achieve their performance objectives.

LCP SpotLight provides our clients with real-time metrics on their investments – both at asset class and manager level.



Fee negotiations: you don't ask, you don't get…

Our research team identified an interesting private credit manager in 2016.

The manager scored well on all aspects of its investment ratings and operational controls. We determined that, subject to a client's specific needs, it was suitable for us to recommend for investment. However, the quoted fee for the fund was 1.25% pa. We believed that many of our clients would be put off investing in the fund at this level of fee.

What negotiating strategy should we take?

When is the best time for us to go back to a manager and ask for a better quote on fees? At this stage, no client had seen the manager at a beauty parade, and certainly none had expressed an interest in investing. We had no leverage of an imminent investment to use with the manager.

We could wait to get that leverage. But once a client has expressed an interest, they have done a lot of work, spent a lot of time and probably had some agonising debates deciding on which manager to appoint. Asset managers know this and know there is a lot of momentum behind just getting the deal done.

We, therefore, told the manager we thought the fee was high and would be a barrier to getting investors; we shared the summary of the results of LCP's fee survey for private credit managers showing its fee was above those managers we were recommending.

The manager came back with a proposal that would give a significant discount for all LCP clients that we believed would be acceptable.

Those clients now invested in the fund got a significant discount from the headline fee and they did not have to spend time negotiating directly with the manager. None of our clients attempted to get a further reduction, but they were not tied by our arrangement. If a client felt they could get a better deal, they were of course free to try.

Note: To be absolutely clear… LCP negotiates fees on behalf of our clients. We never take commissions from asset managers and any fee discounts or rebates go to the investor, not to us.

5. FCA review

The FCA is currently undertaking a review of the asset management industry. It published its Interim Report in November 2016, and requested responses by February 2017. We expect the final report to be published in the summer of 2017.

The FCA has looked at the industry because it "wants to ensure that the market works well and the investment products consumers use offer value for money".

The FCA's review covers many aspects of the industry. Some of the key objectives were to investigate what prices, profits and performance say about how competition is working; and whether asset managers are willing and able to control costs.

FCA Review – fast facts

Fund management is a very profitable business... The average margin for the asset management sector is 36%, compared to a UK-wide company average of 16%. The asset management margin rises to around 45% if you think that front-line staff's bonuses are really a share of the profits and not a cost.

And you don't even have to be very good at it... Institutional, actively managed products do not, on average, outperform their benchmark after costs to any significant extent.

Fund investors don't benefit from scale... Fees for funds do not generally fall as the size of assets in the fund as a whole rises. Some larger investors may be able to use share classes with lower fees as their assets in the fund rise.

Some active funds are not really active... There are a significant number of funds that charge high fees, but offer a similar exposure to a passive fund – which is normally available at a far lower fee.

UK asset managers manage around £6.9 trillion... Of which, around £3 trillion is on behalf of UK pension funds and other institutional investors.

The UK is an international centre... UK asset managers manage around £2.7 trillion for overseas clients, including £1.2 trillion on behalf of European clients. As with most things Brexit, it is not clear what the effect of exiting the EU will be on this important export-service for the UK economy.

Transaction costs are not transparent to investors... Costs charged to investment funds for trading underlying assets are, generally, not reported clearly. Although we have seen some improvement from previous years, responses to questions on transactions costs in our survey still left much to be desired. The FCA is conducting a separate exercise to place a duty on asset managers to provide a full disclosure of these costs.

The FCA's proposals

Some of the FCA's initial proposals are:

- place a strengthened duty on asset managers to act in the best interests of investors in funds;
- introduce an all-in fee approach to quoting charges for funds;
- requiring increased transparency and standardisation of costs and charges information; and
- requiring greater and clearer disclosure of fiduciary management fees and performance.

The FCA has identified that the asset management industry has some shortcomings in controlling costs and charges. In particular, its findings show that fund investors get a rough deal in being charged high fees for performance that is, on average, no better than a passive fund.

At the heart of this issue is a debate about what an investment fund is, who owns it, who runs it, and who it is there to benefit. **Is a fund independent of its asset manager or an extension of it?**

If the fund is independent of the asset manager, should we expect its board to negotiate as a single large client and secure institutional level fees for all its investors?

A fund is legally a separate entity to the asset manager. It has its own directors or trustees who have a responsibility to the fund's investors. The central debate is whether the fund is there to act like an independent institution. Is it there to represent all its investors, to negotiate with the asset manager (and other service providers) to get the best deals it can? Or, is the fund is merely a conduit for the asset manager to deliver its service to individual and institutional investors in a convenient way; convenient to the asset manager that is.

Our viewpoint

Our view is that the directors or trustees of an investment fund (the fund board) should be acting in the best interests of investors. Fund board members should have a degree of independence from the asset manager.

Based on our survey of 149 UK funds used by institutional investors:

30%
only 30% of boards had either an even split or a majority of independent members

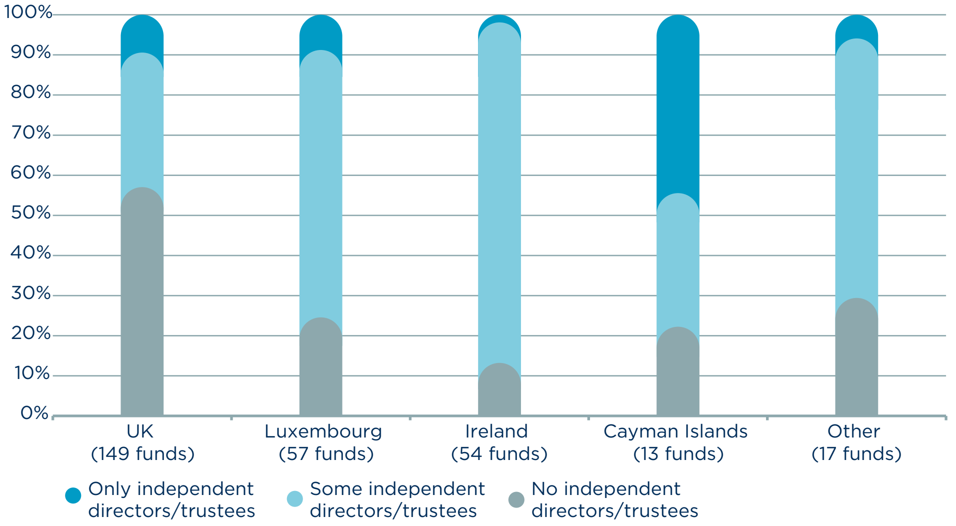
>50%
more than 50% of boards had no independent members

In other countries the degree of independence of fund boards is far higher

LCP's reaction

Our view is that the directors or trustees of an investment fund (the fund board) should be acting in the best interests of investors. Fund board members should have a degree of independence from the asset manager. In the US, this is the usual market practice: the majority of the fund board's members must be independent.

Level of governance independence by fund domicile



Rather than placing a strengthened responsibility on the asset manager to act in the interests of the investors, we believe the FCA should focus on reinforcing the governance structure that is already in place. It should ensure fund boards are more independent and better represent investors' interests. In particular, the fund board should be negotiating fees with the asset manager, and its other service providers, effectively.

All-in fee

The FCA has proposed funds quote a single, all-in fee for all charges.

A fund uses many different service providers: an asset manager, a custodian, an auditor, a lawyer, and others. Given our views on the governance of a fund, the fund board should be negotiating each of these contracts separately. It would, therefore, be difficult for the fund to fix a single charge in advance.

The fund could and should quote the total cost, including transaction costs, it **expects** to have.

Our view is that the directors or trustees of an investment fund (the fund board) should be acting in the best interests of investors. Fund board members should have a degree of independence from the asset manager.

Mark Nicoll

Partner

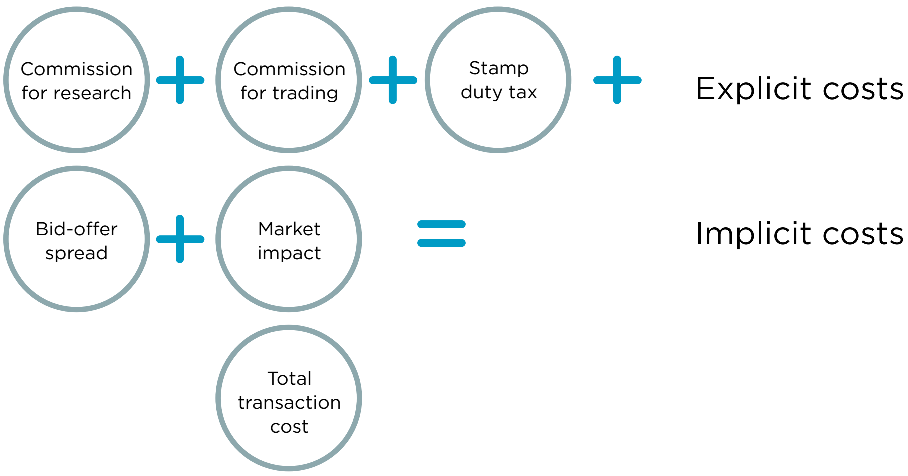
6. Transaction costs - the fog is clearing

Many of the costs of investing in a fund are explicit and details are readily available. When it comes to transaction costs, though, it is much more difficult to get consistent and transparent information. In this section, we try to unravel some of the costs incurred during transactions, and discuss a couple of new regulations that should make this clearer.

Trading costs

When a manager buys or sells a security for the fund, there is cost. Some of these are explicit such as a broker's commission for arranging the deal, or a stamp duty tax on the transaction; some are implicit such as the difference between the buying and selling price of the security (the bid-offer spread), or the effect on the price of attempting to buy or sell it (the market impact cost).

Transaction costs



Market impact costs can be substantial. When IT company Dimension Data entered the FTSE All Share index, bids by index-tracking managers pushed the price up by around 50% in only a few minutes.

Implicit costs are harder to pin down. Most would agree that a bid-offer spread is a real cost, but how much is it? Is it right to classify the difference between the buying (or selling) cost and the amount you value the security at as a transaction cost or should it simply be reflected in performance as a change in value? The manager tried to buy a security and the price jumped 5% - was that because of its bid or someone else's actions? It's complicated, but there are recognised ways of estimating implicit costs to tackle these issues.

Untangling the Gordian knot of costs

Different markets have different conventions. Broker commission in the equity market is usually an explicit cost, whereas in the bond market the commission is usually part of the bid-offer spread. This makes comparisons of different funds and market costs problematic.

Managers buy and sell securities for two main reasons: to make a change to the portfolio's allocations (a dynamic trade); or to invest / raise cash because an investor has subscribed / redeemed from the fund (a reactive trade).

Most funds operate on the principle that the costs of reactive trades should not be borne by all investors, but paid by the investor that is causing these trades by investing or redeeming from the fund. When an investor buys or sells units in a fund, there is usually an "anti-dilution" fee that applies to the trade. The intention of this fee is to pay for the costs associated with reactive trades.

When a manager makes a dynamic trade, these costs are borne by all the investors in the fund. For long term investors trying to work out their transactions costs, they will want to know explicitly the cost of the dynamic trades. These can be material so receiving the right information means better monitoring, and the ability to put pressure on managers to control these costs if needed.

With all these variables, different approaches are inevitable. Our survey asked for a best estimate of transaction costs from managers and we had a wide range of responses. Some declined to answer, some provided only the explicit costs, some attempted to quantify the implicit costs as well.

On the plus side, the response rate to our question on transaction costs was higher than two years ago. We had 60% of global equity managers provide some level of response in 2017, compared to 40% in 2015.

Maybe there is some clarity coming to this area with two regulatory changes...

> *Brokers can be like tourist currency exchanges: "commission-free" trades aren't really commission-free, the commission is part of the poor exchange rate they offer you.*

DC pension trustees have to disclose transaction costs…

…but mostly they can't, because their asset managers can't yet tell them reliably what they are.

Since 2015 trustees of DC pension schemes must report on the level of transaction costs in their annual Chair's Statement. Many have found this difficult to do because the asset managers do not provide them with this information or, if they do, no two managers calculate the costs in the same way, making the figures largely meaningless.

The FCA recognised the issue and is in the process of setting guidelines on what information asset managers must provide and how these transactions costs should be calculated.

The initial proposal is for asset managers to calculate a comprehensive figure covering all explicit and implicit transaction costs. However, some managers have raised issues about the practical difficulties of calculating the figure using the FCA guidelines.

The proposal only covers asset managers providing services to DC pension schemes. We hope the final recommendation will be adopted more widely so that all investors can benefit from a consistent, transparent figure for transaction costs.

> *…asset managers do not provide them with this transaction cost information or, if they do, no two managers calculate the costs in the same way, making the figures largely meaningless.*

Control of costs for research

The second regulatory change comes from an EU regulation: the Markets in Financial Instruments Directive – level 2 (MIFID II). This is due to come into force in January 2018. Our understanding is that even with a pending Brexit this will still become applicable to UK institutions; at least until the UK actually leaves the EU and maybe beyond.

The MIFID II rule tightens up the regulations around commission costs. Currently asset managers receive research from brokers analysing, for example, a company's prospects and the likely effect on its share price. This research may be paid for by the asset manager directing trades to the broker and the broker taking commission from those trades. In other words, the asset manager's clients are paying the brokers for the research, rather than it being a cost to the asset manager.

Asset managers in the UK have, for a number of years, had to show that the research they receive from brokers is substantive and relevant. Previously almost anything research-related could be paid for through commission – it was relatively common for market data from, for example, Bloomberg or Reuters terminals to be paid for this way.

MIFID II now takes this a step further and says the asset manager must either pay the cost of all research or agree with their clients in advance each year a maximum research budget.

If an asset manager takes the research budget option, it would need to agree the research budget with the fund board, for pooled funds; or directly with the investor, for segregated accounts. As we discussed above, fund boards in the UK tend to be affiliated to the asset manager, so this could create a conflict of interest that would need to be managed.

Only a few managers we have spoken with have decided which option they will take. Of those that have, all will opt to pay for the research costs themselves.

If you thought the asset manager's fee was meant to pay for the research, you are in good company. Back in 2001, Paul Myners reviewed institutional investment in the UK and thought asset managers should be paying for their own research. His recommendation was never implemented – for the UK to take this step unilaterally would have put its asset management industry at a significant disadvantage to other countries.

LCP fee survey data room

Investment management fees by asset class

Access the fee survey data room here:
investfeesurvey2017.lcp.uk.com/

In those asset classes where investors have the alternative to invest passively at low fees, active managers do need to demonstrate their fee is worth paying. Managers need to achieve significant outperformance, or better control risks, after fees are paid in order to justify active management.

Ken Willis

Partner

7. Appendix: Potential costs incurred by investors

Cost paid to…	Function…	Approximate amount (estimates based on a global equity fund)
Fund directors / trustees[1]	Oversee all aspects of managing the admin of the fund.	Part of additional fund charges[2]
Investment consultant	Independent adviser to the investor.	Specific to investors requirements
Fund manager	Makes investment decisions on the portfolio.	0.7%
Administrator[1]	Takes subscription and redemption orders; publishes price of units, keeps records of units held by each investor; and manages accounts of the fund.	Part of additional fund charges[2]
Custodian	Safekeeping of assets, holds assets under its name as nominee.	Part of additional fund charges[2]
Depositary[1]	Oversees fund as independent body, provides reporting to Fund directors / trustees.	Part of additional fund charges[2]
Auditor[1]	Annual audit.	Part of additional fund charges[2]
Platform provider	Provides a venue where funds may be bought, sold or switched.	Varies
Legal adviser[1]	Provides legal and regulatory compliance advice to the fund.	Part of additional fund charges[2]
Brokers	Execution – under the instruction of the fund manager, finds buyers or sellers to trade with or executes orders on the exchange.	Explicit transaction cost[3]
Brokers	Research – provides research to the fund manager. Supplementary fee is taken as a percentage of each trade executed in the market by the broker (or taken directly in some private markets).	Explicit transaction cost[3]
Other parties	Research – provides research to the fund manager. Supplementary fee is taken by the broker as a percentage of each trade and then passed to third party providing the research (commission sharing).	Explicit transaction cost[3]
Fund manager	"Soft commission" (not all jurisdictions / not all asset classes) – the benefit is not taken as a cash fee, but as a service eg provision of market data or index data. A supplementary fee is taken by the broker as a percentage of each trade who then pays for the fund manager to receive the service.	Explicit transaction cost[3]
Broker or trading counterparty. Bid-offer spread	The difference between the cost of buying and selling when transacting in securities.	Implicit transaction cost
Existing fund investors for anti-dilution	Compensation paid by a unitholder buying or selling units paid to existing fund investors for the costs incurred in trading in the underlying markets because of their decision to subscribe for / redeem units.	0.1%-0.2%
Government taxes	Stamp duties on buying / selling; withholding taxes on dividends / interest payments and other taxes.	Varies
Market impact	The change in price because of the fund manager's decision to buy or sell an asset. Benefit goes to whoever you are buying from or selling to (a virtual cost?) .	Unknown

[1] Commonly incurred by pooled funds, some may be incurred by segregated accounts.
[2] Additional fund charges – the total varies considerably by asset class. Approximately 0.1% for a global equity fund.
[3] Explicit transaction costs – the total varies considerably by asset class. Approximately 0.1% for a global equity fund.

7. Appendix: List of respondents

Thank you to the following 73 respondents in our survey. There were a further four respondents that did not wish to be named.

Aberdeen Asset Managers Limited
Acadian Asset Management (UK) Limited
Aegon UK
Alcentra Limited
Alliance Bernstein
Allianz Global Investors
Artemis Investment Management LLP
Aviva Investors
AXA Investment Managers
AXA Wealth Limited
Baillie Gifford & Co
Beach Point Capital Management LP
BlackRock
BlueBay Asset Management LLP
BMO Global Asset Mangement
Cantillon Capital Management LLP
The Capital Group Companies, Inc.
Credit Suisse AG - Asset Management
Dimensional Fund Advisors
Fidelity International
First State Investments
Franklin Templeton Investments
Fulcrum Asset Management LLP
Goldman Sachs Asset Management
Henderson Global Investors
Heronbridge Investment Management
HSBC Global Asset Management
Insight Investment Management (Global)
Invesco Ltd
Investec Asset Management
IronBridge Capital Management, L.P.
J O Hambro Capital Management Limited
Jupiter Asset Management Limited
Legal & General Investment Management
Lazard Asset Management
Lindsell Train Ltd
Longview Partners
Loomis Sayles Investments
M&G Investments
Macquarie Asset Management
Martin Currie Investment Management Ltd
Mayfair Capital Investment Management Ltd
Mobius Life Limited
Morgan Stanley Investment Management
Natixis Global Asset Management
Newton Investment Management Limited
Partners Group
Pictet Asset Management Ltd
Pioneer Investments
Principal Global Investors
PGIM Fixed Income
Putnam Investments
Pyrford International Ltd
RARE Infrastructure
Record Currency Management Ltd
River and Mercantile Asset Management LLP
Royal London Asset Management
Ruffer LLP
Russell Investments
Schroder Investment Management
SEI Investments
Standard Life Investments
Stone Harbor Investment Partners LP
T. Rowe Price
Threadneedle Asset Management Ltd
Trilogy Global Advisors, LP
UBS Asset Management (UK) Limited
Vanguard Asset Management
Vontobel Asset Management
Wellington Management International Ltd
Woodford Investment Management Ltd
Willis Towers Watson
Zurich Life Assurance

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