MS15/2.3: Annex 3

Market Study

Asset Management Market Study

Final Report: Annex 3 – Segregated Mandate Pricing Analysis

June 2017

Annex 3: Segregated Mandate Pricing Analysis

Background

1. In the interim report, we analysed pricing data to understand pricing trends over time and price dispersion. We found that the OCF for actively managed funds had not changed significantly over 2005-15, while the prices for index tracker funds had generally been falling over the same period.[1] We also found that for active funds there was clustering around certain price points for the headline AMC, and that headline prices did not appear to vary by size of fund. We found that institutional investors typically negotiate prices. Therefore discounts from the headline AMC are more common for institutional than retail investors. We did some further analysis since the interim report to look at the prices of segregated mandates, and the discounts offered to retail investors in funds.

Overview of data

2. We sourced data on the prices faced by segregated mandates from a sample of 27 asset managers for the period 2006-15.[2] Since prices are commonly tiered for segregated mandates, and prices are typically negotiated, we ensured the dataset captured the actual (i.e. not headline) annual average management charge of these products faced by investors. The actual annual average management charge was calculated by dividing the total annual revenue from management charges by the average AUM over the year for each mandate.[3]

3. Firms provided us with the actual annual average management charge[4] and the AUM in different datasets, which needed to be merged together. For a small number of asset managers this proved to be a difficult exercise as we could not accurately identify the data relating to the same mandate in each dataset. We only used the mandates which we were able to accurately match and undertook checks to ensure that this was not introducing any bias into our sample.

4. Firms provided us with their data on a best-endeavours basis. However, in some cases firms were unable to provide us with data going back for the full period due to the difficulty they had in extracting historical data. As a result, the majority of the observations in the dataset relate to recent years. For example, whilst our final dataset contains information about 5,061 segregated mandates in 2015, there are only 659 mandates for 2006.

[1] In this analysis we considered GBP denominated open-ended funds available to UK investors.

[2] These were UK-managed segregated mandates, which cover all asset classes, including both active and passive products. These mandates are more likely to represent DB investors.

[3] Firms adopted a range of techniques for calculating the average AUM, including taking an average of monthly, quarterly or annual AUMs. After consulting with the firms concerned, we believe that these methodologies provide an accurate representation of the prices faced by segregated mandates. 6 firms used the year-end AUM rather than an average AUM to calculate prices. We consider that charges calculated this way may not be an accurate representation of prices actually faced by investors. For example, if a segregated mandate had a sudden increase or decrease in AUM over the course of a year, using the end of year AUM in the denominator would give an inaccurate price. We therefore recalculated the actual annual average management charge by using an average of the year end AUMs for the current and previous year.

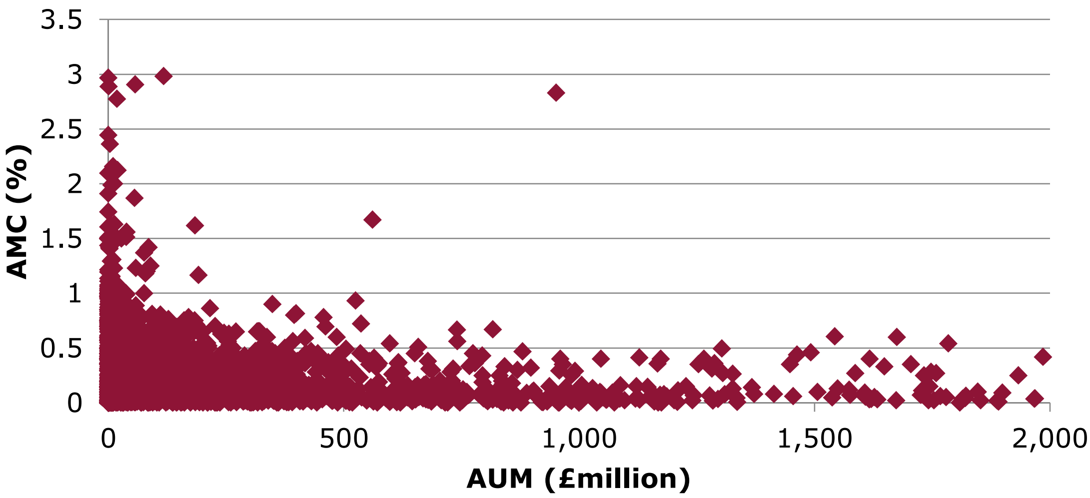
[4] In this section we are only comparing charges and do not compare outcomes.

5. Although AUM data was provided to us in GBP for around 75% of the mandates in our final dataset, the remainder were in different currencies. We converted these to GBP using historical exchange rates sourced from the Bank of England's Statistical Interactive Dataset.[5]

Segregated Mandates: Relationship between price and size

6. As shown in Figure 1, we found that the actual annual average management charge for segregated mandates tends to fall as the size of the mandate increases.[6] This could be caused by asset managers passing on economies of scale in their mandates in the form of lower prices, or investors in larger mandates being able to negotiate larger discounts (or a combination of the two).

Figure 1: The distribution of actual annual average management charge against AUM for mandates (2015)



Source: Actual management charge and AUM data for segregated mandates, from a sample of asset managers across all asset classes

Segregated Mandates: Pricing trends over time

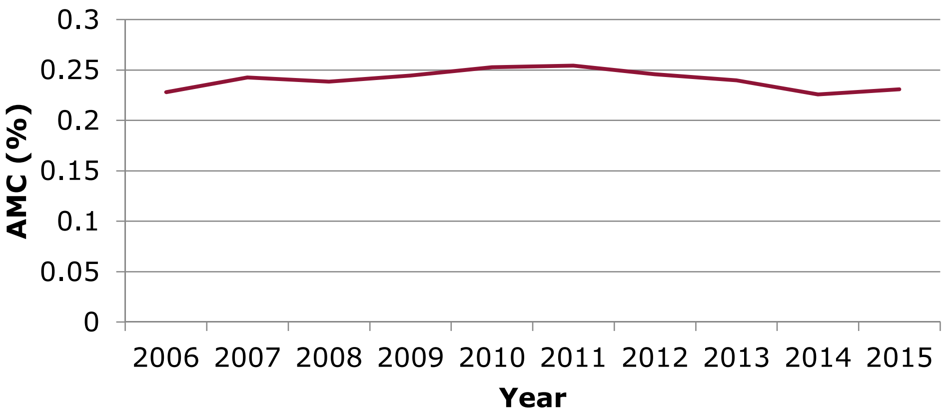
7. We looked at trends in the actual annual average management charge over time for mandates and found that prices were broadly constant over the 2006-15 period. There were only a limited number of observations for earlier years so the dataset was conditioned to include only mandates which were active for the whole period. [7]

[5] These were sourced from the Bank of England's Statistical Interactive Dataset containing daily spot exchange rates against sterling: http://www.bankofengland.co.uk/boeapps/iadb/Rates.asp?TD=29&TM=Dec&TY=2006&into=GBP&rateview=A

[6] Separately we undertook a sensitivity using data from a different point in time and this did not change our result materially.

[7] We acknowledge that this, however, introduces survivorship bias into our analysis.

Figure 2: Trends in the AUM weighted actual annual average management charge over time for mandates which were active for the whole period 2006-15



Source: Actual annual average management charge and AUM data from a sample of asset managers

8. We have also examined pricing trends for all clients over the 2011-15 period, and therefore include mandates that were not active for the entire time period. For all clients, we find that average prices are higher than in Figure 2, and these have been fairly stable over the 2011-14 period, although appear to fall in 2015.

9. This data has to be interpreted with caution, as there may be asset class mix effects. Since asset classes have different prices, price movements potentially reflect changes in asset allocation, as opposed to genuine changes in prices. However, our dataset did not include information about asset classes to allow us to control for this.

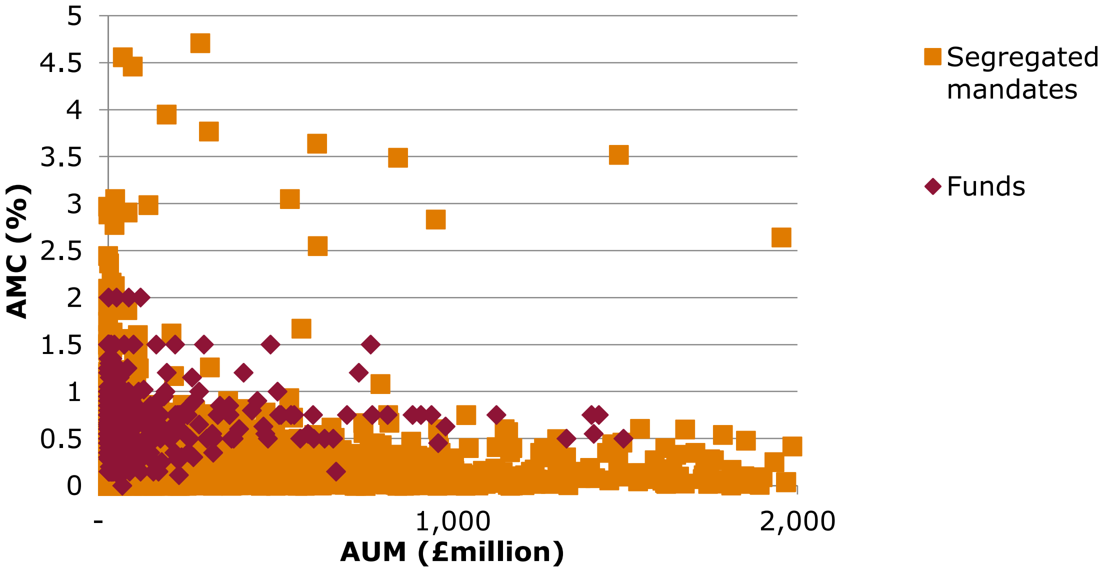
Comparison of prices of segregated mandates with retail funds

10. Figure 3 compares the AMC for funds in Morningstar Direct with the actual annual average management charge for segregated mandates in 2015.[8] This analysis focused on clean primary share classes of active funds in December 2015. We chose the primary share class for this analysis as this represents the share class which is deemed by the IA to be the most common consumer experience of a retail version of a fund.[9] We used the AMC of funds rather than the OCF as this captures just the management charge, and is therefore comparable to the management charge of segregated mandates. We looked at allocation funds, as we believe that this is likely to be the most appropriate comparator for segregated mandates which in our data set also represent a mix of different asset classes. However, we performed sensitivities using other asset classes to check the robustness of our results.

[8] We have also separately undertaken a sensitivity where we compare the prices of segregated mandates with institutional products in eVestment and find similar results

[9] The methodology for selecting the primary share class has been outlined by the Investment Association and is available at https://www.theinvestmentassociation.org/assets/files/sectors/20150204-primaryshareclasses.pdf

Figure 3: The distribution of AMC against AUM for mandates and allocation funds



Source: Actual annual average management charge and AUM data for mandates from a sample of asset managers. AMC data for allocation funds from a sample of asset managers enriched with information from Morningstar Direct. AUM data for funds from Morningstar Direct.

11. Our findings show that for a given level of AUM, mandates tend to be cheaper than funds. We find that in 2015 the annual average AMC for actively managed allocation funds available to UK investors was 0.69% of AUM, when we include passive funds as well this reduces to 0.67%.[10] This compares to the actual annual average management charge for segregated mandates which was 0.23%. Analysis of the profitability data[11] we collected for this market study shows that while costs per AUM are higher in the retail segment than in the institutional segment, revenue per AUM is even higher for the retail segment, meaning that margins are higher for the retail segment. The profitability data therefore suggests that higher costs only partly explain the higher prices of retail funds relative to comparable (in terms of size and asset class) segregated mandates.

12. Higher margins earned in the retail segment could indicate that competition is less intense than in the institutional segment. A possible explanation for this is that segregated mandates (and investors in institutional funds) are better able to negotiate prices than retail investors in funds. We note that a key difference between mandates and funds is that a single entity represents a mandate, and negotiates charges on behalf of all of the money pooled in the mandate. By contrast, pooled funds are sold through a large number of distinct distributors, with the effect that buying power is reduced as each distributor can only negotiate over a portion of the total AUM in a fund. Further, distributors of retail funds may not be as effective at negotiating charges as mandates because a distributor cannot threaten to switch funds directly, and must rely on the collective actions of hundreds and potentially thousands of individual and heterogeneous clients.

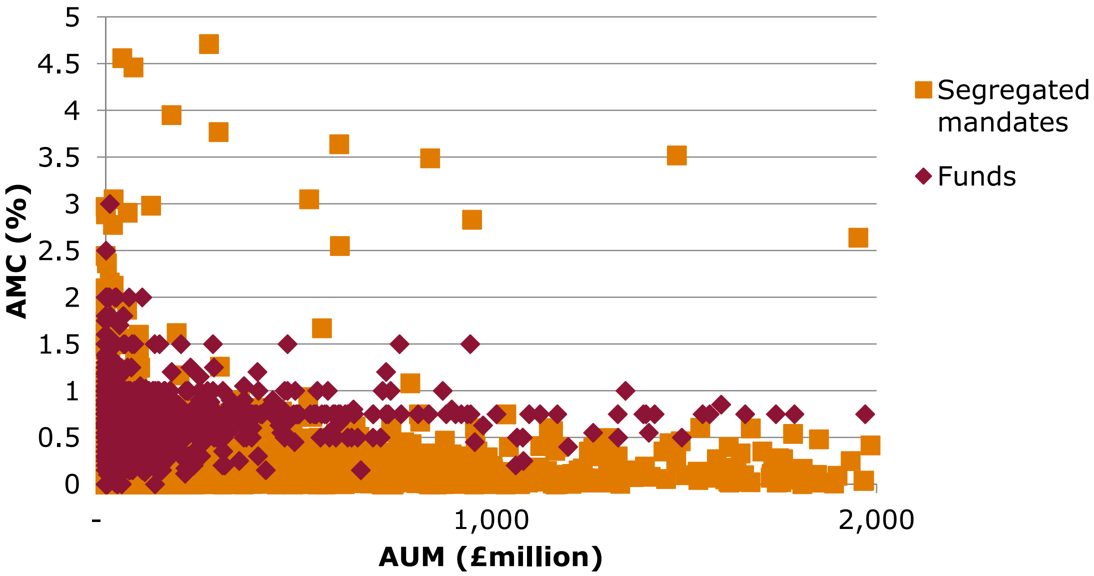
13. As a sensitivity, we re-ran the analysis including funds in all asset classes[12], and as shown in Figure 4, this did not materially impact our results.

[10] Asset-weighted average Annual Management Charge for the clean primary share classes of allocation funds.

[11] See annex 8 to the interim report

[12] We also undertook a sensitivity looking at just equities and again this did not materially change our results

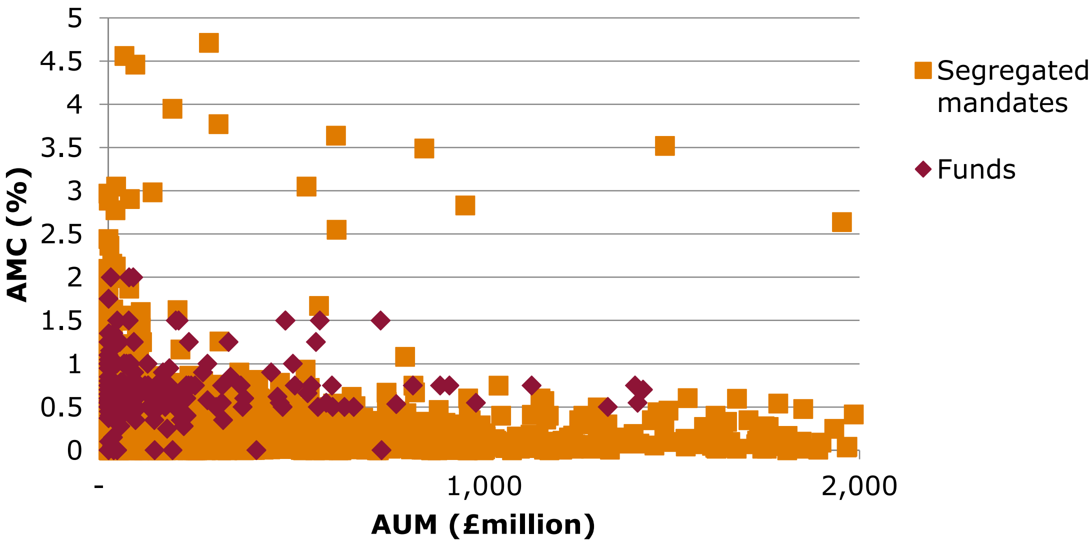
Figure 4: The distribution of AMC against AUM for mandates and funds of all asset classes



Source: Actual annual average management charge and AUM data for mandates from a sample of asset managers. AMC data for funds from a sample of asset managers enriched with information from Morningstar Direct. AUM data for funds from Morningstar Direct.

14. We recognise that this analysis does not necessarily constitute a like-for-like comparison as the management charge for segregated mandates reflects discounts whilst the headline AMC for funds do not. Therefore, we undertook a further sensitivity to better understand the impact of discounts on this result. By using data on discounts which we received from a direct to consumer platform, we calculated the actual AMC faced by the end investor in December 2015. As shown in Figure 5, we did not find that including discounts changed our results significantly. Again, we undertook sensitivities using different asset classes, but this did not materially impact our finding that mandates tend to be cheaper than funds.

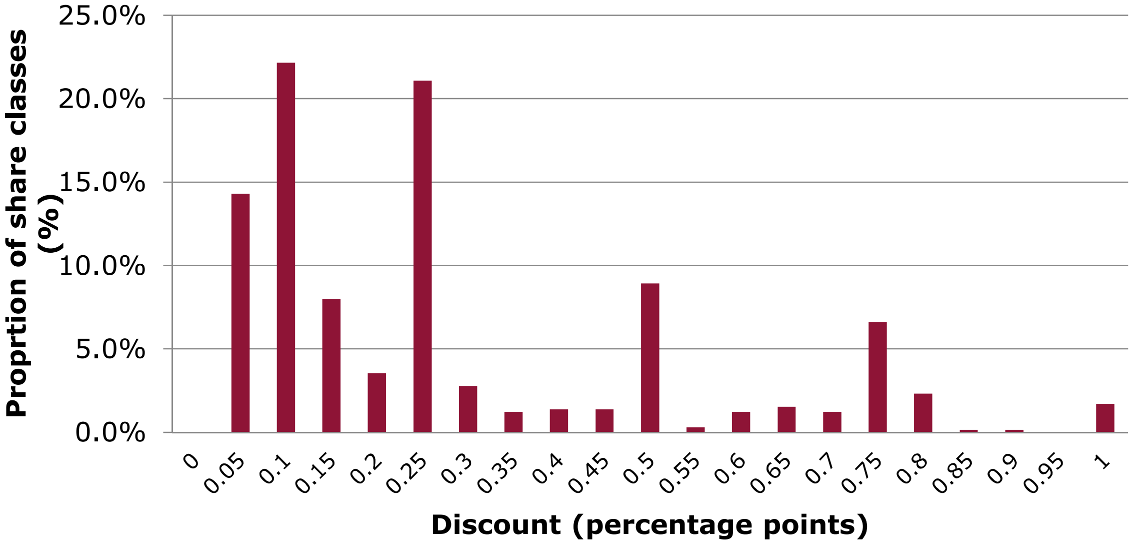
Figure 5: The distribution of the AMC after discounts against AUM for mandates and allocation funds within a platform



Source: Actual annual average management charge and AUM data for mandates from a sample of asset managers. AMC data for funds from a sample of asset managers enriched with information from Morningstar Direct. AUM data from Morningstar Direct. Discount data from a D2C platform.

15. Figure 5 reflects the fact that retail funds in the past have not typically received substantial discounts. According to the discount data which we received from a D2C platform, only 22% of clean share classes received a discount in 2015. As shown in Figure 6, the majority of these discounts (70%) were less than 25bps.

Figure 6: The distribution of discounts for share classes within a platform



Source: Discount data from a direct to consumer platform.

Conclusion

16. The interim report found that actively managed fund charges had not changed significantly over 2005-15, while the prices of passive funds had generally been falling over the same period. We also found that for active funds there was clustering around certain price points for the headline AMC, and prices did not appear to vary by size of fund. We found that institutional investors typically negotiate prices and therefore discounts from the headline AMC are more common for institutional than retail investors.

17. Subsequently, we have examined prices faced by segregated mandates. We find that the actual annual average management charge for segregated mandates tends to fall as the size of the mandate increases. We find that trends in the AMC faced by mandates have been fairly constant over the 2006-15 period. We also find that management charges faced by segregated mandates tend to be substantially lower than retail funds, even after controlling for size and asset class. We find that in 2015 the actual annual average management charge for segregated mandates was 0.23% of AUM, whilst for actively managed allocation funds available to UK investors this was 0.69% and for both active and passive funds it was 0.67%.[13] Analysis of our profitability data suggests that higher costs of servicing retail investors only partly explains the higher prices of retail funds relative to comparable segregated mandates.

[13] Asset-weighted average Annual Management Charge for the clean primary share classes of allocation funds

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