tomorrow's company

Tomorrow's Company response to FCA Asset Management Market Study

Tomorrow's Company welcomes the preliminary conclusions of the "Asset Management Market Study". We have proposed remedies to only a few of the specific questions posed in your preliminary report. As part of the broad objective 'to make the asset management sector work better for both institutional and retail investors' our primary recommendation is increasing the disclosure and transparency on investor stewardship.

We support the FCA's existing proposals to increase cost transparency. We recommend that transparency on costs might be further enhanced with a mandatory disclosure to calculate the effect of such fees on the customer, particularly when compounded through time.

However, we believe that focusing on cost is only one side of the equation. Transparency and competition should also be used to improve the impact of the investment chain on the underlying performance of listed companies. This is what we mean by stewardship, and ultimately it is the only way the asset management sector may enhance returns for an average saver; through time an average saver's gross return can increase only if the underlying income streams from companies or other investee assets can be sustainably improved. We therefore recommend a mandatory disclosure for asset managers to state how they expect their activities can positively influence the earnings of listed companies, or other investee assets they own on a customer's behalf.

In order to fully realise this second recommendation, we advocate a strengthened implementation, and perhaps even a new wording, of the UK Stewardship Code.

While this submission has focused on the specifics of the FCA preliminary 'Asset Management Market Study' we believe that some industry solutions are broader in scope. We would like to draw the FCA's attention to a report commissioned by the APPCG in response to the Green Paper on Corporate Governance: Promoting long-term wealth: reshaping corporate governance.

Tomorrow's Company is an independent non-profit think tank that exists to inspire and enable companies to be a force for good in society. It believes that business can create more value for shareholders and society by adopting an approach that focuses on purpose, values, relationships and the long term. It succeeds in its goal by convening business leaders, investors, policymakers and NGOs to develop practical solutions. See more detail at tomorrowscompany.com.

Transparency on asset management fees

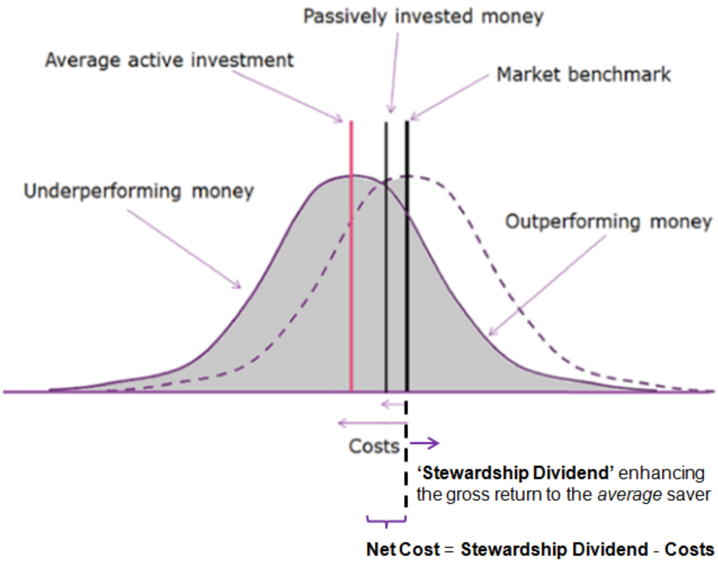
We fully support measures to increase the effectiveness of competition through transparency on fees and other means. The *Interim Report* is correct to observe that, over the last few decades, asset management fees have not fallen in line with the decline in asset yields. The industry is now taking a higher proportion of the returns available to savers.

The UK market dividend yield is less than 4%, therefore a 1% annual fee would absorb more than 25% of dividends paid by the underlying companies. The FCA's finding that the clean OCF for active management is just under 1% - means that significant drag is being placed on returns for their investors. We also wish to draw attention to the effect that such fees have on returns when compounded through time. For any sum invested over a forty year period, the effect of a 1% fee is to absorb one third of the final pot.

Therefore, in additions to the proposals put forward in the FCA report, a further inclusion could be for asset managers to explicitly disclose the share of gross returns that are being absorbed by fees (perhaps over a rolling one-year and three-year period). This would be supported by an additional statement that calculates the effect that such fees will have on any final pot when compounded over many years.

Undone by its own success

A review of competition should not look at fees and costs in isolation. Delivering better value to savers requires a focus not only on the costs incurred, but also on the value that is delivered. An average saver's return is the sum of the gross return from underlying assets minus the asset management fee, and the gross return is not set in stone. In fact, the asset management industry has the ability to enhance this gross return through time by effective stewardship of the underlying companies.



We acknowledge that mathematically the aggregate of all share traders cannot outperform the market. Historically, the asset management industry was able to outperform, but only because it was a small portion of the market. When asset management began to grow meaningfully in the 1920s and 30s, customers paid a management fee to a professional fund manager who would then outperform versus the majority of the market who were amateurs. The issue is that professional asset managers now own nearly 90% of UK shares. It has become increasingly difficult for asset management to outperform the market, because it has become the market. Asset management has been undermined by its own success.

John Kay stated in his 2012 report that "competition between asset managers on the basis of relative performance is inherently a zero-sum game"[1]. Theoretically, active trading cannot outperform in the aggregate, and evidence shows that active managers underperform by the amount of their fees, as shown in the *Interim Report.* And yet this doesn't stop them trying. Active managers devote the majority of their resources to gain informational edges to help them deliver outperformance versus their peers.

Given that such outperformance cannot on average cover the cost of fees, a shift towards index funds among retail investors is occurring while some asset owners are taking their funds in-house. There is, however, an opportunity for asset management to deliver better returns for the average investor. This approach shifts the focus away from trading activities towards stewardship of the underlying assets – to the benefit of savers, companies and the wider economy.

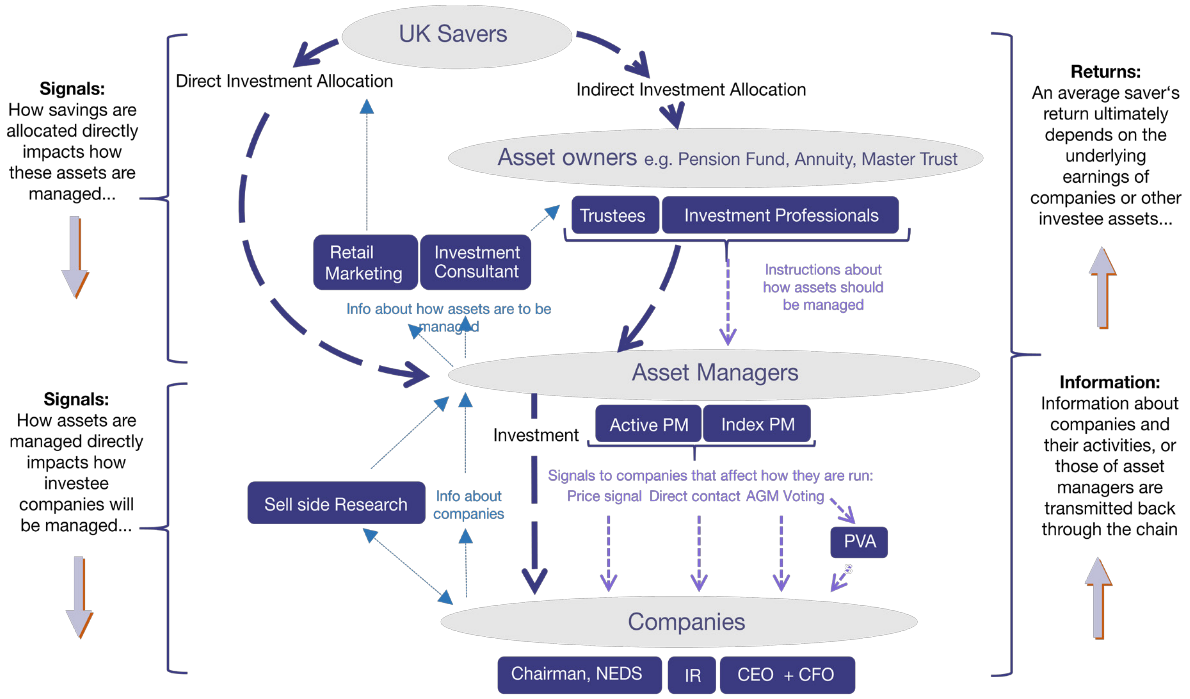
A new model of returns through stewardship

The case for stewardship is built on a simple truth: Ultimately the return to an average saver is generated entirely from the underlying earnings of assets, such as bond coupons, equity dividends or rents. At any point in time the market may capitalise these earnings at a higher or lower multiple, this can only affect the *timing* of returns and not their total value over time. Therefore, the only way the asset management industry can improve the average saver's gross return is through enhancing the *underlying* earnings of the assets they own. Kay made this point clearly, "the asset management

1 https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/253454/bis-12-917-kay-review-of-equity-markets-final-report.pdf

industry can benefit its customers – savers – taken as a whole, only to the extent that its activities improve the performance of investee companies"[1]. By improving the sustainable incomes from underlying assets, the gross return for all savers can rise. We might describe this effect as a "stewardship dividend".

The asset management industry can achieve this stewardship dividend by sending the right signals to the underlying companies, as shown in the diagram below:



Signals from the investment chain can affect and improve almost any area of company decision-making, from strategy or capital allocation to issues affecting ESG. These signals can arrive in the form of direct contact, AGM voting, or even just movements in the stock price as investors buy or sell in response to news. In fact, the pursuit of *alpha* by active managers through trading *can* have the secondary effect of enhancing market *beta* as the resultant price signals may improve the way listed companies are being managed.

Our goal must be to better harness the talent and energies of the sector so that the generation of a stewardship dividend can be a *core* activity, rather than just a small *residual* effect of trying to achieve something else. Indeed, the scale of industry resources available to deliver a large potential upside from stewardship is sizeable. Today assets under management by UK based institutions sum £6.9 trillion[2]. Assuming an average fee of 0.5%, this would equate to annual income of roughly £35bn. If the industry can be made to better channel these resources towards enhancing the performances of companies and the wider economy – almost in the same way a management consultant should – the true 'net cost' of its activities could be substantially below the ~£35bn currently charged, and perhaps even negative.

The asset management industry does perform a valuable function in holding management to account, and some asset managers dedicate significant resources explicitly to stewardship. Others perform good stewardship implicitly through the way they invest and engage. But many do not. In fact, to the extent that signals are sent to investee companies, it is possible that currently their general effect is currently negative, not positive.

It is certainly not uncommon to hear asset managers criticised for their short-termism. The problem is that these narrow time-horizons can then be transmitted into the decision-making by company executives. Earnings can always be boosted over the short-term at the expense of the long-term. For example, cutting the R&D budget or culling staff costs to the detriment of morale over time. Or using

[2] IA Annual Survey 2015-16

artificially high investment hurdle rates might increase cash available to shareholders over the near-term, but prevent companies from investing in their true potential.

Our view is that signals from the investment chain may be causing UK or foreign companies to 'gild rather than build' thus undermining, not enhancing, their sustainable earnings. If this is true, then on top of its £35bn annual fee the UK asset management industry is also effectively imposing on savers a *negative stewardship dividend*[3].

We therefore wish to ensure that competition can channel industry resources and energy into delivering better stewardship of the underlying assets. Our objective should be to create regulatory conditions in which this can best be achieved.

Stewardship transparency and competition

A key barrier to increased resource allocation to stewardship is that retail or institutional investors have insufficient information to judge the stewardship intentions and credentials of asset managers. Instead, competition typically relies upon recent fund performance and usually the claim of some informational advantage, and thus trading edge, to attract funds. But paradoxically, trading is one activity in which asset managers mathematically cannot deliver better returns for savers in aggregate.

The solution is to use the instrument of transparency not only in placing downward pressure on fees, but also in creating an upward pressure on gross returns through better stewardship. We need more transparency not just on what asset managers are charging, but also on what exactly the effect of their efforts can achieve for the average saver. Asset managers should state clearly how their activities are expected to have a positive effect on the sustainable performance of companies or other investee assets.

This disclosure could include explaining exactly *how* they engage with companies. In meetings with their executives what types of decisions are they looking to promote in crucial areas like capital allocation, strategy and culture? And how do they focus management on risk on areas such as disruptive technologies, ESG or employee morale? This disclosure could also include reporting of *how* they trade - what causes them to buy or sell positions? Because buying effectively sends signals to companies that promotes more of such behaviour, while selling will do quite the opposite. Disclosure should also extend to basic portfolio data, such as, the time horizon for trades, average holding periods, the amount of portfolio diversification and annual churn, as well as how employees are incentivised. These statistics can hold helpful clues as to whether an asset manager's activities may have a positive or negative impact on investee assets.

Asset owners and investment consultants who advise them also have a crucial role – to ensure the mandates that they set are aligned with the focus on this sustainable performance. We would like to see the FCA use its influence to ensure that all investors can receive a clear account of the mandate to which an asset management fund is working.

The point of improving transparency on stewardship is to shift competition away from short-term performance against a benchmark, towards how the asset manager will perform stewardship. This is to enable the average asset owners to select a manager on the basis of the one criterion that can actually benefit them – by sustainably improving the performance of *underlying* assets. Our hope is that as more funds are attracted towards those able to evidence good stewardship, asset managers will be incentivised to adapt their strategies to better deliver it. With this small regulatory modification, the asset management industry can become better wired to deliver a *positive* stewardship dividend.

Better stewardship does not even have to come at a price. It often will simply involve different behaviour in the way asset managers trade and interact with companies. And not only will asset owners benefit on average, but also individually – because the short-term drivers of share prices are over-valued by the market, funds that instead focus on the long-term should be able to outperform, although perhaps with higher volatility. The evidence suggests that investment trusts have

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[3] We can show £30bn loss from a net distribution of income to owners rather than investment.

consistently outperformed unit trusts, arguably because they enable a longer-term approach.[4] When stewardship does require additional resources to be expended by an asset manager, asset owners will face an incentive to free-ride. But with better disclosure of stewardship by asset owners to their beneficiaries, this problem can be limited.

Supported by enhance stewardship across the chain

In 2010, Tomorrow's Company began work with a select group of asset managers and asset owners to produce the 2020 Stewardship report. This work laid the foundations for the adoption by the pensions industry of a Stewardship Framework and a new guide for investor engagement published by the ICSA. After publication, the group continued to work together in dialogue with the relevant industry associations and the regulator (the FRC) to monitor progress on the Stewardship Code. The UK Stewardship Code was the first of its kind, and has since stimulated other imitations around the world.

This 'Stewardship Alliance' has been focusing on how the UK Stewardship Code can be better implemented across the investment chain. This could be achieved by a voluntary code, or by a modification to the UK Stewardship Code itself. Towards this goal, a copy of our document 'Better Stewardship – A Call to Action' can be made available to the FCA on request. Tomorrow's Company would be delighted to contribute further to this discussion.

Increased stewardship can also be supported by additional changes to the structure of the industry as we outlined in our recent policy report, Promoting long-term wealth. In this document we set out policies to increase patient capital, and the effectiveness of board decision-making. We believe that both can complement the increase in stewardship transparency that we have outlined in this submission.

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[4] Citywire, How investment trusts beat other types of funds, January 2015.