.BVI

Frankfurt am Main,
22. January 2018

Fund Fees: Money for Value

When it comes to the choice of a suitable investment strategy for retail investors, actively and passively managed funds are often directly compared and played off against each other. The general debate of active vs. passive management is narrowed to the comparison of fees charged for the management of those vehicles. However, in order to obtain a multidimensional picture of the issue, one should take into account several aspects as depicted below, aiming to improve the understanding of passive and active asset management styles.

In simple terms, actively managed funds apply a defined portfolio management strategy where the manager makes specific investments by picking and weighting assets on the basis of his investment discretion. Actively managed funds often attempt to beat the benchmark – usually an index – by using different tools and procedures which come with higher expenses. At the same time this approach implies that a fund manager can deliver better returns to retail investors than by simply replicating the index.

In contrast, the investment strategy of passively managed Exchange Traded Funds (ETFs) is based on index replication (either by directly investing in the relevant index components or by using derivative techniques in order to gain index exposure, or by a mixture of these techniques). Thus, they are able to offer a lean cost structure on the one hand while being tied to the performance of the relevant index, for better or worse, on the other. The development of ETFs started 25 years ago. Based on volume growth, such “passive” ETFs can be considered one of the most successful financial innovations in recent decades. However, the ETF universe has recently expanded from passive index-trackers to include also ETFs which weight index components differently (“smart beta” ETFs) and “active” ETFs which use quantitative approaches to define and adjust a given investment universe. Interestingly, within both “smart beta” and “active” ETF products one can find cost structures which are similar to or even higher than those observed in comparable actively managed funds.

Due to the focus on costs, it is a widespread view that investors should better opt for passively managed funds. In BVI’s[1] opinion, this view is based on incomplete information, neglects important specificities of actively managed funds and hence in many cases fails to meet the needs of investors. Active and passive fund management solutions are designed to serve different investment needs. The decision on which solution best suits the investor’s interests can therefore only be made on the basis of an individual assessment taking due regard of the following:

1. **Higher management costs in active management reflect higher operational expenditure:**

   Active investment management comprises individual asset picking and weighting for a fund portfolio. This process is obviously much more complex and elaborate than a mere replication of a given

[1] BVI represents the interests of the German fund industry at national and international level. The association promotes sensible regulation of the fund business as well as fair competition vis-à-vis policy makers and regulators. Fund companies act as trustees in the sole interest of the investor and are subject to strict regulation. Funds match funding investors and the capital demands of companies and governments, thus fulfilling an important macro-economic function. BVI’s over 100 members manage assets of nearly 3 trillion euros for private investors, insurance companies, pension and retirement schemes, banks, churches and foundations. BVI’s ID number in the EU Transparency Register is 96816064173-47. For more information, please visit www.bvi.de/en.

BVI
Bundesverband Investment
und Asset Management e.V.

Kontakt
Fon +49 69 15 40 90 0
www.bvi.de

BVI Berlin
Unter den Linden 42
10117 Berlin

BVI Brüssel
Rue du Trône 14–16
1000 Bruxelles

BVI Frankfurt
Bockenheimer Anlage 15
60322 Frankfurt am Main

Geschäftsführung
Thomas Richter Hauptgeschäftsführer
Rudolf Siebel Geschäftsführer

index, and consequently involves higher personnel and operational costs. However, higher management fees charged by active funds do not remunerate solely the services of fund management itself. A significant proportion of fees is used in order to pay for services that are necessary or more sophisticated in the context of active fund management only or would have to be paid on separate terms by investors in passive products.

In the first category fall, inter alia, costs for investment research which has to be obtained for active fund management in order to facilitate investment decisions. Investment research is either internally compiled or obtained from external sources. It comprises analyses concerning certain financial instruments, their issuers, specific industries or markets which might be relevant for, and capable of adding value to, investment decisions. Since the active fund manager makes these decisions on the basis of his investment discretion within a given strategy, he has to base them on reliable and qualified information. Certain operational requirements such as investment limits observation or in general risk and liquidity management are more onerous in active than in passive management. Also the broader means of shareholder engagement (see below) come at a price.

Secondly, the costs of active funds comprise remuneration for advice and other distribution services provided to investors in line with current and future requirements of the MiFID regime. These additional benefits must be taken into account when comparing costs of passive and active investment funds. It is important to note that already today commission payments for distribution must be used in order to enhance the quality of the distribution service for the relevant client subject to strict requirements. Such quality enhancement can be achieved for instance by the provision of efficient high quality infrastructure, qualification of personnel or client information in excess of the regulatory requirements. According to MiFID II, from 2018 onwards the client will be provided with additional benefits such as regular suitability checks on his portfolio or access to analyses and valuation tools in exchange for commissions paid out of the management fees. Moreover, MiFID II aims to create transparency in terms of distribution costs by requiring that any commission payments out of a product be deducted from the product costs and shown to investors as costs of distribution. This new approach should for the first time inform investors about the actual costs of fund management while also allowing for comparison of distribution costs in fee-based and commission-based distribution channels.

Passive funds, on the other hand, are usually either bought via non-advised channels or sold by way of fee-based advice for which the client incurs additional costs not covered by the fund charges. In either case, investors in passive funds which are generally exchange-traded have to bear further costs included in the bid-ask spread of the purchase or sale transaction. Such costs need to remunerate the market-making activity of the ETF's authorised participant and potentially also cover expenses related to the creation and redemption process of ETF shares. The latter correspond to the transaction costs incurred at the fund level in actively managed funds as a result of fund unit issuance and redemption, but are externalised and thus not visible as part of the product costs[2] due to the specificities of ETF trading.

[2] From 3 January 2018, MiFID II requires fund distributors to inform potential investors in funds about all product costs, including costs of transactions at the fund level. Such transaction costs can also be triggered by a surplus of unit issues or unit redemptions which necessitates further purchases or sales of fund assets. In ETFs, fund assets are generally contributed in kind by the ETF's authorised participant who receives compensation for the associated costs by adjusting the bid-ask spreads for ETF trading.

2. On average, costs of active funds have not increased since the financial crisis:

Since 2009 costs of actively managed funds have remained essentially stable.[3] This is a remarkably positive result for investors considering the huge wave of new regulations targeted at or having indirectly affected the fund industry in the aftermath of the financial crisis and the increased regulatory requirements resulting therefrom for the ongoing fund operations. In some fund categories, the ongoing management costs even decreased during this period. This pertains for instance to equity funds which charged on average 1.63 percent in 2009 as compared to 1.52 percent in 2016. The average management costs of money market funds have even shown a dramatic decrease by more than half from 0.64 percent in 2009 to 0.26 percent in 2016 which is in parts due to a narrower definition of those funds after 2011.[4]

3. Outperformance of a benchmark is only possible by way of active management:

While many voices of criticism claim that only a minority of actively managed funds manage to outperform their respective benchmarks in the long run, it must be clarified that in the index fund universe, no single fund is able to generate such outperformance. Net returns on passive investment strategies will always be lower than the index performance due to transaction and other costs deducted from the fund portfolio. Thus, a positive alpha can only be achieved by way of active investment strategies which deviate from a simple replication of the market by applying a more focused or more sophisticated investment approach.

4. In time of market uncertainty actively managed funds can better play to their strengths:

Since the financial crisis in 2009 global markets have experienced a persisting period of upward movement. Such a long-lasting market upturn is quite untypical from the long-term perspective. In booming market times as seen in the latest years, it is indeed difficult for actively managed funds to deliver returns better than the market. Whereas passive investments by definition follow the market in upwards and downwards movements, active managers will typically exploit the market investment opportunities in good times while attempting to limit capital losses in times of increased market volatility or market stress. Subject to a fund’s investment strategy, an active manager will be equipped with the necessary investment tools to limit loss of capital and will have investment discretion to make adequate use of it. Such tools include hedging strategies like stop-loss, steering of investment degree, application of VaR-based risk limits and in general the use of derivatives for hedging purposes in a fund portfolio.

5. In less efficient (liquid) markets actively managed funds could be at an advantage:

There are indeed arguments that the more efficient a given market operates, i.e. when it incorporates and reflects all information relevant for this market, the less likely it is to gain outperformance via active management. If a market is less efficient, on the other hand, such likeliness increases. In these circumstances, the value management approach usually relying on a quantitative preselection in order to pick and choose investments on a qualitative basis is often a better option for inves-

---

[3] For funds distributed in the German market, the average ongoing costs of fund management amounted to 1.33 percent in 2016 (average of 3,655 ISINs) as compared to 1.29 in 2009 (average of 1,762 ISINs); source: BVI statistics.

[4] The statistical base for cost figures in money market funds has been impacted by the CESR Guidelines on a common definition of European money market funds which lead to a major market shakeout in 2011. While the average cost figure for 2009 has been established on the basis of 43 ISINs (which classified as money market funds for distribution in Germany), the value for 2016 is an average out of 7 funds.

tors. Many funds focusing on alternative investments (e.g. commodities, real estate or other real assets) or alternative strategies are able to deliver constant positive performance for investors.

6. Shareholder engagement could be better positioned via active managers:

Fund managers generally conduct in-depth analyses of the undertakings they envisage investing in and engage with the management during their investment. While pre-investment research primarily aims at distinguishing profitable investment opportunities, the ongoing engagement of fund managers is part of the investment process and involves mutual exchanges with the relevant companies with the objective of developing closer relations and exercising influence over their business policies and practices. Shareholder engagement is relevant in principle for all funds regardless of the specific stock-picking strategy. However, managers of actively managed funds would be able to divest and use that possibility to exercise influence when engaging with companies. For funds pursuing environmental, social or governance (ESG) strategy or fund managers investing generally sustainable, the manager will also account for these aspects in the investment process and will be guided by them in his engagement with the portfolio undertakings. In contrast, index-replicating funds have no possibility to deviate from the composition and weightings of the relevant index and thus less able to push for changes when engaging with individual companies. Against the backdrop of the upcoming debate on fiduciary responsibilities in relation to fund management, it is thus fair to say that active fund managers create true added value for investors, other shareholders and the society.

7. Issue of "closet indexing" is already tackled:

A recent initiative of ESMA dealt with an alleged practice of European fund managers of "closet indexing", i.e. claiming to perform active management while in fact managing the fund more or less closely to a benchmark. We fully agree with the need for clear and comprehensive communication towards investors about a fund's investment objectives and strategy. This issue has been addressed by BaFin in the recent months by changes of its supervisory practice requiring a more standardised, clear-cut approach as regards description of a fund's investment strategy and its use of a benchmark in the fund prospectus. The prospectus shall also include graphical information on the fund's performance in comparison to a potential benchmark as well as specification of the maximum tracking error if relevant for the purpose of internal risk management. Retail equity funds launched in Germany are bound to adapt their sales prospectuses accordingly by the end of 2017.[5] In this context, it must be noted that the market investigation conducted by BaFin in 2016 on the basis of the criteria developed by ESMA has not brought into light any relevant shortcomings in the German market. BaFin did not find evidence of any fund which was purportedly active while solely replicating an index. Nearly all funds which were suspected of closet indexing have been discharged after closer scrutiny of their investment strategies. The remaining few have charged management fees which were far below those of comparable active funds. Moreover, they are no longer actively marketed to investors.[6]

[5] Cf. the public statement by BaFin from 4 April 2017: https://www.bafin.de/SharedDocs/Downloads/EN/Auslegungsentscheidung/dl_Angaben_in_Verkaufsprospekten_en.doc?__blob=publicationFile&v=1

[6] For further details, please refer to the relevant BaFin communication from 22 December 2016: https://www.bafin.de/SharedDocs/Veroeffentlichungen/EN/Meldung/2016/meldung_161221_closet_indexing_en.html