Moving beyond costs

THE NEED FOR TOTAL TRANSPARENCY IN FIDUCIARY MANAGEMENT

Kempen

Cost transparency has become an increasingly important issue in the UK asset management market over recent years. That's in part because the double-digit returns that seemed commonplace in the early years of the new millennium have become a distant memory, forcing cost reduction as a means of maximising net returns into the spotlight. But trustees have found pinpointing the exact detail of the underlying costs of their schemes' investments problematic, making it difficult to assess whether their service providers represent good value for money.

'The numerous explicit and implicit costs and charges that hit pension fund investments can account for one-third of the value of the fund over the life cycle of the pension fund according to some pension experts. Obviously, saving an element of this cost each year can make a big difference to pension fund values and will help secure member benefits.'

SOURCE

A practical guide to Pension Fund Investment Costs, Clerus

The UK is not the first country to consider this issue – there have been many international initiatives to benchmark and report on costs. The Netherlands, for instance, has a long history of debating and then enshrining in law processes to ensure cost transparency, starting in 2007 with the Financial Assessment Framework. This led to a well-defined, consistent framework for reporting on costs and a clear understanding about how these costs are attributed. This Dutch disclosure model has formed part of the inspiration for the Local Government Pension Schemes' transparency code in the UK, which is likely to influence all UK pension reporting requirements going forward. That said, it is important to note the Dutch model itself was not without its teething problems in its early years.

As a fiduciary manager with Dutch roots, we are familiar with – and great advocates of – transparency when it comes to costs. But we believe that this is just one part of a much bigger transparency story. To be able to determine whether pension fund clients are receiving value for money, which is what our clients ultimately care about, there needs to be total transparency not just about all costs, but about the performance of their scheme and the nature of their service model, because it is these matters that determine the appropriateness of the relationship between fiduciary manager and client.

In this article we discuss Kempen's approach not just to cost transparency in fiduciary management, but to transparency across our entire fiduciary management service.

When you're looking at costs, don't just focus on management fees

It's not just the obvious headline costs – namely the fees fiduciary managers charge for their services, and the management fees levied by the companies running the underlying funds – that matter. There are a whole host of other fees to consider, including administration, legal, custody, auditor and actuarial costs.

And one of the biggest considerations for any pension fund – and probably the most difficult to quantify – is the impact of transaction costs: the charges managers incur when buying and selling securities for the funds they run. If a manager adopts a highly active approach, resulting in high portfolio turnover, these fees can be hugely significant, especially if they are dealing in relatively illiquid asset classes.

We need to talk about transaction costs

While most investors focus their attention on ongoing management fees, at Kempen we believe there needs to be much more consideration of how to control transaction costs. MiFID II transparency requirements have already shown that European investors have been paying a third more in transaction costs than they realised.

EXAMPLE

For example one equity fund could charge a management fee of 0.7% and incur transaction costs of 0.02%, while another could at first glance appear much cheaper with a management fee of just 0.05%, but rack up transaction costs of 1.5%. Of course that's not to say that the fund with lower transaction costs is necessarily the best option – investors need to consider which one will best help them meet their investment goals. Costs are only one element of that decision, however important they may be.

At Kempen we recently carried out a small survey on cost transparency with some UK pension scheme Chairs of Trustees in collaboration with Winmark, a peer-learning and research company. It was clear that many trustees struggle to quantify how much they are paying in terms of transaction fees and that they see this as a major problem. Another consideration is that transaction costs can be highly volatile – after a period of quiet they may jump quickly if a manager starts making lots of trades. This makes it very difficult for trustees to plan certain aspects of their strategy in advance.

Regulators step up to the plate

The growing realisation of the effects of costs on pension funds' ability to meet their members' goals has meant that fiduciary managers are now coming under much closer scrutiny from regulators, and investors are expecting more of their service providers in terms of how they report on fees.

Last June the Financial Conduct Authority (FCA) in the UK published its Asset Management Market Study. This was particularly pertinent for providers of fiduciary management services as the FCA expressed concerns about the way fiduciary managers go about their business. The report's recommendations included the disclosure of a single, all-in-fee to investors and the consistent disclosure of costs and charges to institutional investors.

But cost transparency isn't just a UK phenomenon. MiFID II regulations, which cover the whole of the European fund management market, place considerable importance on transparency when it comes to fund management fees. Since January this year asset managers have been obliged to make clear all of the fees their clients have to pay, breaking them down into:

- the ongoing management fee
- one-off fees, such as entry and exit charges
- incidental charges such as performance fees
- any transaction fees incurred in running the product.

MANAGERS ALSO NEED TO MAKE CLEAR ANY COSTS RELATED TO THIRD PARTIES UNDER MIFID II REGULATION.

At Kempen we've been providing our clients with a breakdown of transaction costs in relation to their portfolios' rebalancing and asset allocation for several years. This enables them to see exactly what our decisions are costing them in relation to the value we add.

The next step total transparency

The need for transparency about costs is no longer a new issue. New regulations are being devised or are already in place to enforce asset managers to disclose breakdowns of all the charges that their services incur, and clients have already become much more discerning and are asking tough questions of their prospective service providers before they choose to invest.

This is all good news. But it's only the beginning. Cost transparency isn't enough, in our view.

We've long argued that fiduciary managers need to be totally transparent with their clients about the exact nature of the service they provide, not just about the fees they're subject to. So the next step needs to be a complete change in behaviour and thinking about how fiduciary managers treat their clients.

Let's consider some of the questions that clients need their fiduciary managers to be fully transparent about.

What pension fund clients should be able to understand is the Total Cost of Ownership (all of the individual costs associated with that service) and where these costs are coming from.

How is my scheme performing?

Once a trustee has detailed information about the costs their scheme is incurring, they need to be able to evaluate those costs relative to the value their fiduciary manager has added as a result of the decisions it has made on their behalf. Only then will they be able to determine whether their fiduciary manager is providing them with value for money.

So the next thing a trustee requires is transparent performance reporting that clearly sets out the drivers of their scheme's returns (long-term strategic allocation, tactical asset allocation, etc.). It's also vital that this reporting is clear about exactly which elements of the scheme's return the fiduciary manager has influenced themselves and those that are the result of external factors, such as a change in actuarial assumptions or sponsor contributions.

What happens when my relationship with your company ends?

All providers of fiduciary management services need to be completely transparent with their clients about what would happen if the client chooses to move to another fiduciary manager.

WHY IS THIS IMPORTANT? Many consultants and asset managers providing fiduciary management services use pooled arrangements. While this can lead to cost benefits thanks to the economies of scale it results in, it also means the fiduciary manager effectively owns the relationship between the client and the underlying asset managers whose funds the client invests in. So if the client chooses to terminate the relationship with the fiduciary manager, they have no option but to terminate the relationship with the underlying managers too. This is likely to result in time out of the market and the high costs involved in building a portfolio from scratch once again. Ideally, a client should be able to have their assets back the next working day if they end their relationship with a fiduciary manager. In short, a pension fund should be working with a fiduciary manager because they want to, not just because they're stuck in the relationship.

With Kempen's fiduciary management services, our clients are in complete ownership of their relationships with the underlying managers of their funds. But they still benefit from the considerable purchasing power that we have as a result of the £40 billion of assets our fiduciary management clients have entrusted to us.

Do you use in-house products as well as external funds?

Another element of transparency that clients need to consider is whether their fiduciary managers use in-house funds as part of their service proposition. Using in-house funds in itself need not be an issue as long as clients are aware of the potential conflicts of interest that doing so could lead to. Clients should be prepared to provide their fiduciary manager with guidelines about the kinds of fund (such as active or passive, single or funds of funds) that they're willing to invest in. And if they're prepared to invest in their manager's in-house funds, they should set out some clear rules about what proportion of their assets can be allocated to these products.

The most important consideration here is that TRUSTEES NEED TO BE CONFIDENT that their fiduciary manager will replace any asset manager – in-house or external – if their performance is poor or if any development at that manager gives rise to doubts about the future return potential of the funds they run.

At Kempen we get around any of these problems by always using carefully selected third-party funds in our fiduciary management mandates – unless one of our clients specifically requests that we use our in-house funds. This ensures that our investment strategy and portfolio management decisions are driven not by the revenue streams of our own products, but solely by what's best for each of our clients.

How will I understand the value you add?

The final step in ensuring total transparency of the fiduciary management service model is to ensure the manager forms strong relationships with every one of its clients. At Kempen an important part of how we achieve this is in the way we communicate information with them and mutually agree a framework by which we can assess how much value we add on their behalf through our decisions (this may take the form of a balanced scorecard that assesses quantitative and qualitative factors to review our relationship and our performance). Independent oversight from a third-party consultant – which all of our UK clients have in place – can also play a critical role in helping strengthen the relationship.

Determining Value

Value for money needs to be assessed on a number of different dimensions to ensure a balanced view

FINANCIAL PERFORMANCE	Improving funding level	- Outperformance of risk-adjusted liability based return target (3 years) - Added value components DAA & Manager Selection (3 years)
	Value for money	FM and investment management costs vs. industry surveys
ADVICE & EXECUTION	Support trustee decision making	- Clear investment beliefs & objectives - Quality and timeliness of advice
	Effectiveness and speed of decision making	Development of strategies that meets the schemes ambitions and conversion into a workable plan.
	Development of long term plan	Frameworks to improve scheme development
	Compliance	Investment plan adherence to areas such as ranges, guidelines, breaches, incidents
	Other services contributing to efficient management of plan	Rebalancing, overlay management, custody management, collateral management, securities lending, cash management, transitions, clarity, quality
RELATIONSHIP	Working together	Continuity, presence, availability, quickness of response, clear explanations
	Training	Trustee training and education
	Monitoring	Reporting that's timely, accurate and complete, presentable, readable
INNOVATION	Strategic thinking, new asset classes, dynamic risk management, responsible investment	- Insights from meetings, forums, asset classes being considered & rejected etc - Raising relevant insights and making it happen

In the end, being clear and open with our clients about their goals and providing them with a customised solution on which we regularly and transparently communicate is the key to a successful relationship.

CONCLUSION

Cost transparency is a vital consideration for any investor, and it's particularly important for fiduciary management clients as this is an area of the asset management industry that has been accused of opacity in the past. Certainly the industry is on the path to achieving greater transparency relating to the total costs of investment.

However, to understand the relevance of these costs they need to be viewed in relation to the service model, relationship and ultimately the performance of the fiduciary manager. Key to achieving this transparency is empowering pension scheme Trustees and Sponsors to ask the right questions of fiduciary managers in order to ensure alignment and value for money.

At Kempen, we see no need for fiduciary management to be opaque. We've long ensured that we're fully transparent about every aspect of the service we provide our clients. That's not just in terms of all of the costs that they're subject to, but in terms of the performance of their assets, the funds they invest in, what would happen were they to choose another fiduciary manager, and the value we're adding on their behalf in relation to their goals.

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