Written evidence from Dr Anna Tilba (PCT0027)

1. Do higher-cost providers deliver higher performance, or simply eat into clients' savings?

   There is no conclusive evidence about higher-cost providers delivering higher performance. Indeed, there is more empirical evidence to suggest that higher-cost (active) managers charge higher fees with no corresponding performance. In fact, persistent inefficiencies in pension fund governance and lack of trustee understanding of operating costs of pension funds are eroding future retirement incomes. This is coupled with asset managers' unwillingness to disclose all the explicit and implicit costs attached to each investment.

   Pension fund investment costs differ significantly between actively managed and index-linked funds and their impact is often little understood by investors, who are not always aware that they are being overcharged. For example, Bogle (2014)[1] uncovers some estimates of the additional costs that investors incur when they invest in actively managed funds – costs which are not incurred by index-linked funds. These additional costs include: transaction costs, cash drag, sales loads as well as excess taxes. Bogle (2014) suggests that the portfolio transactions costs alone for active fund managers have increased substantially as the fund portfolio turnover has leaped almost fivefold from 30% in 1960s to 140% today. This reflects a misalignment of incentives and of decision-making power, exacerbated by groupthink and bias. Investors are often a diffuse and uncoordinated group. Yet, it is near impossible for investors to figure out how much their investments are costing them because additional costs are hidden and too high (Haslem[2], 2004; 2006; Ellis, 2012[3]). Indeed, the all-in fund costs have rarely, if ever, been estimated because the data on such costs is almost impossible to quantify.

   Notwithstanding progress made in calculating the all-in investment costs, Bogle (2014) demonstrates that, over the long-term, compared with costly actively managed funds, low-cost index funds create extra wealth of 65% for retirement plan investors, providing a truly remarkable improvement in the standard of living to retirees.

   Pitt-Watson et al[4]. (2014) provide a comprehensive overview of published literature on investment costs in Britain and around the world – finding that pension fund costs are obscure and inaccurate. One of the few indications of the loss of value in retirement income comes from the report of pensions charges in Ireland. This report collected information on the level of pension charges levied on pensions' arrangements in order to assess whether charges are reasonable and transparent. Worryingly, the report identified significant differences between disclosed and all-charges for different retirement arrangements where all-charges on average are 3% higher than disclosed charges for every retirement arrangement (Department of Social Protection[5], 2012).

   FCA's Asset Management Market Study[6] also highlighted the lack of value for money in many active managers as well as opacity of investment costs and charges, creating a special Institutional Disclosure Working Group (IDWG) and tasking it to develop reporting templates

---

[1] Bogle, John. 2014. 'The Arithmetic of 'All-In' Investment Expenses.' Financial Analysts Journal, Vol. 70, no. 1: 13-21.

[2] Haslem, John A.A. 2004. 'Are Mutual Fund Expenses too High? A Commentary'. Journal of Investing, 9Fall): 8-12.

[3] Ellis, Charels D. 2012. 'Investment Management Fees Are (Much) Higher Than You Think.' Financial Analysts Journal, vol. 68, no.3 (May-June):4-6.

[4] Pitt-Watson, D., C. Sier, S. Moorjani and H. Mann (November 2014), 'Investment costs: An unknown quantity. A literature review and state of play analysis' http://www.fscp.org.uk/publications/pdf/investment_%20david_pitt_%20watson_et_al_final_paper.pdf.

[5] Department of Social Protection, 2012. Report on Pension Charges in Ireland 2012.

[6] FCA (2016) Asset Management Market Study [available at: https://www.fca.org.uk/news/press-releases/fca-publishes-final-report-asset-management-sector]

on costs and charges to help combat the above problems This is a significant step forward in terms of creating more transparency and accountability around investment costs and charges and ultimately improving consumer understanding of the value they get for the money they spend.

2. Is the Government doing enough to ensure that workplace pension savers get value for money?

   Questions arise as to whether market forces are sufficient for protecting investors' interests, because the monitoring of investment costs falls through the lines of responsibilities within pension fund boards. These problems are exacerbated by behavioral biases and herding within trustee boards, which is evident from Tilba, et al. (2016)[7] study and the latest CMA investigation into the investment consultancy market[8]. The FCA is yet to publish the Institutional Disclosure Working Group's templates on investment costs and charges. It will be up to the Regulator to enforce the uptake of these templates by pension fund clients and their investment fund managers as there is currently seems to be a malaise and passive resistance by the asset management industry to utilize these templates.

   In a separate stream, the investigation in the investment consultancy industry by the Competitions and Market Authority also produces useful remedies to improve value for money when it comes to investment management and investment advice. The Government should endorse CMA's recommendation to extend the FCA's regulatory perimeter to include the relevant services provided by investment consultancy and fiduciary management firms. The CMA's proposals also included mandatory tendering when first moving to fiduciary management, and a requirement for firms to give customers clearer information, such as fees and investment performance. It also called for trustees to set their investment consultants strategic objectives and for firms to report against these. These remedies will go a long way in improving value for money for present and future pensioners.

3. What is the relative importance of empowering consumers or regulating providers?

   It should be a balancing of both. The FCA needs to have more powers over the investment consultants and also have 'more teeth' when it comes to enforcing of the use of the standardized IDWG templates for costs and charges. Consumers also need to be more engaged in this process. My own experiences of consulting pension funds trustees suggests that there is a need to create more awareness around the issues of the costs and charges and behavioral biases when making investment decisions as well as what information would trustees need to ask of their IC and FM. The Pension Regulator should be looking at these issues alongside developing guidance to support pension trustees.

4. How can savers be encouraged to engage with their savings?

   FCA's review of the asset management industry has revealed that one of the significant challenges relates to the lack of innovation and disruptive change in the financial sector. For example, there is a lack of product innovation when it comes to Pension Dashboards or Investment Platforms. An 'Investment platform' is a single technology enabled point of access to the entire investment market and they are increasingly used by consumers and financial advisers to access retail investment products and to manage investments. The platform market has steadily grown over the last 8 years, with Assets Under Administration for both adviser and direct platforms increasing from £108 billion in 2008 to £592 billion in 2016 (FCA,

[7] Tilba, A., Baddeley, M. and Yixi, L. (2016) Report for the Financial Conduct Authority. 'The Effectiveness of Oversight Committees: Decision-Making, Governance, Costs and Charges. UK Financial Conduct Authority, Available at: https://www.fca.org.uk/publication/research/tilba-baddeley-liao.pdf

[8] CMA Investment consultants market investigation https://assets.publishing.service.gov.uk/media/5b4f4db2e5274a730e4e273b/investment_consultants_market_investigation_provisional_decision_report.pdf

2017). However, it is unclear whether these platforms actually help investors make good investment decisions and whether such investment solutions offer good value for money.

Furthermore, it appears that there are a lot more areas for concern in this market. Firstly, switching from one provider to another is difficult and there are unclear accountability relationships with investment advisors. The fact that there are only a few 'big players' on the market suggests that the competition may not work effectively. In some cases, using platforms may actually add extra charges as opposed to reducing costs. As noted in the FCA Asset Management Study, platform advisors may not interested in passing the benefits of economies of scale to the consumer. For example, platform discounts may be available only to new consumers and the level of discounts is very low, with average discount of only 0.05%. Therefore, 'the value for money' is more assumed than demonstrated. Questions also arise about the actual economies of scale for these platforms as some fund groups refuse to play impact of vertical integration. There are three key questions that we need to be asking about investment platforms:

- **How can platforms make investment fund managers compete harder?**
  This is a simple 'chicken or the egg' dilemma – as a fund manager, you cannot get platform clients unless your fund is on a platform but you can't get on a platform without client demand. There also seems to be a form of 'social inequality' amongst fund managers coupled with increased regulation, platforms can become barriers to market entry, making rich even richer.
- **How can platforms reduce complexity?**
  There are 5,500 investable stocks globally but there are 76,000 investment funds available globally and out of those only 20% earn their fees.
- **How can platforms help drive better value for money?**
  With a 1% fee the investment pot is 1/3 lower. Value for Money should equal to Outperformance before fees and expenses divided by fees and expenses.

There is also another very important thing missing in most policy and financial services discussions, namely, what I do not hear in many other discussions in the City, is the voice of the 'next generation', as the interests and the ways of thinking and doing of the young 'millennial' generation is extremely underrepresented. How can we begin to create better ways of achieving better value for consumer's money if we do not attempt to engage and understand financial innovators and the entrepreneurs of tomorrow? What will be the nature of work, the way the young generation thinks of spending and saving money? The trend towards 'portfolio careers' where young people more from project to project or small independent technology-driven start-ups suggests that traditional approaches to saving for retirement may be obsolete in 20-30 years' time. Furthermore, proliferation of market comparison websites such as www.gocompare.com or www.moneysupermarket.com are good indicators of future investment trends. If we are so used to using mobile banking and market comparison sites, why aren't we using these revolutionary ideas in relation to asset management and savings? Similar questions have been asked in relation to pensions by Henry Tapper, founder of the PensionPlayPen and Director of First Actuarial in his blog (https://henrytapper.com/2017/12/12/the-pension-dashboard-is-changing-but-for-the-better/).

In short, UK financial services industry needs to challenge itself and its thinking much harder in creating disruptive positive change in the face of new technologies and innovation. The focus should be on the future, not the past. The debates in the City should no longer be about fixing yesterday's problems, but trying to anticipate the needs of the future generation.

5. How important is investment transparency to savers?

   As an Ambassador for the Transparency Taskforce (TTF) (founded by Chris Sier and Andy Agathangelou) I believe in the TTF idea that 'Higher levels of transparency are a pre-requisite for fairer, safer, more stable and more efficient markets that will deliver better value for money and better outcomes. Furthermore, because of the correlation between transparency, truthfulness and trustworthiness, we expect our work will help to repair the reputational damage the sector has been suffering for decades'. As the sunlight is said to be the best disinfectant and the electric light the most efficient policeman, transparency in financial services is mostly a preventative measure and a surrogate for trust which has been lost. It is not going to fix all the problems, but it will certainly make it easier for consumers to compare and help make an informed decision about the true value of investments.

6. If customers are unhappy with their providers' costs and investment performance/strategy, are there barriers to them going elsewhere?

   CMA's review of the investment consultancy market found few barriers when it comes to changing the investment advisor, but it is harder and more expensive to switch between fiduciary management service providers. Broadly, both FCA and the CMA Reports indicate that there are low levels of switching, particularly when it comes to investment consultants. My research into pension fund trustee investment decision-making[9] suggests that lack of switching is more a behavioral problem as people tend to just 'carry on' with their providers.

7. Are Independent Governance Committees effective in driving value for money?

   I would assume that having Independent Governance Committees is better than not having them at all.

8. Do pension customers get value for money from financial advisers?

   The UK's investment consultants and fiduciary managers advise on, or manage, at least £1.6 trillion worth of pension scheme assets. Their influence means that it is vital both sectors work for the benefit of the end investor and ensure optimal value for money for British pension schemes.

   Levels of transparency regarding investment consultant performance are extremely low. CMA's investigation into the investment consultancy market reveals that investment consultants fail to add value in their product recommendations, i.e. investment consultants are failing to recommend products that outperform net of fees. Specifically, they found No clear statistically significant evidence that collectively ICs 'buy rated' products outperform benchmarks net of fees. This evidence is supported by the latest academic research into investment consultants performance by Tim Jenkinson (and colleagues) finds no evidence that recommended by investment consultants products perform better. Authors find no evidence that investment consultants have manager selection skills[10].

   Similarly, my own research[11] into pension fund governance and trustee investment decision making highlights the lack of consultants' value for money and a lack of trustee engagement

---

[9] Tilba, A., Baddeley, M. & Yixi, L. (2016). FCA Asset Management Market Study: Research Report on the Effectiveness of Oversight Committees: Decision-Making, Governance, Costs and Charges. London, Financial Conduct Authority. https://www.fca.org.uk/publication/research/tilba-baddeley-liao.pdf

[10] See Tim Jenkinson's work, in particular:
Picking winners? Investment consultants' recommendations of fund managers. Journal of Finance, 2016 (with Howard Jones and Jose Martinez)
Investment consultants' claims about their own performance: What lies beneath? Working paper, July 2017, ssrn.com/abstract=3214693 (with Gordon Cookson, Howard Jones and Jose Martinez)

[11] Tilba, Anna & Wilson, John F. (2017). Vocabularies of Motive and Temporal Perspectives: Examples of Pension Fund Engagement and Disengagement. British Journal of Management 28(3): 502-518. http://dro.dur.ac.uk/25868/
Tilba, A., Baddeley, M. & Yixi, L. (2016). FCA Asset Management Market Study: Research Report on the Effectiveness of Oversight Committees: Decision-Making, Governance, Costs and Charges. London, Financial Conduct Authority. https://www.fca.org.uk/publication/research/tilba-baddeley-liao.pdf
Law Commission's Consultation Paper No 215: Fiduciary Duties of Investment Intermediaries http://www.lawcom.gov.uk/app/uploads/2015/03/cp215_fiduciary_duties.pdf Pages 7, 17, 38, 40, 41, 44, 53, 144, 193, 194

and challenging of the investment consultants, which leads to the loss of value of the pension savings for consumers. The lack of engagement is particularly worrying as the CMA Report's evidence indicates that 'less engaged schemes in investment consultancy pay higher prices than more engaged schemes'. Furthermore, in the context of the move away from the Defied Benefit to the Defined Contribution arrangements, the lack of trustee engagement within the DC arrangement is particularly worrying.

September 2018

Tilba, A. & McNulty, T. (2013). Engaged versus Disengaged Ownership: The Case of Pension Funds in the UK. Corporate Governance: An International Review 21(2): 165-182. http://dro.dur.ac.uk/25869/