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The FCA Asset Management Review

Over recent years the FCA's Retail Distribution Review (RDR) and Financial Advice Market Review (FAMR) have been focused on delivering an advice market that is client centric, transparent and professional and demonstrably delivering value to the end investor. The FCA has now turned its attention to the Asset Management industry. Their review which commenced in 2015 and included a round of industry consultation was concluded and published last week. It included a series of initiatives that aim to:

- Improve independent governance of asset managers and impose a greater level of investor protection
- Help investors better understand the objective and the total cost of the product
- Create a more consistent and appropriate use of benchmarks and return targets
- Enable investors to easily compare products and identify the best and most suitable product
- Increase the focus investors place on the total cost of the product and the value chain
- Promote competition process pressures and create a greater correlation between price and performance
- Ease the restrictions placed on asset managers to switch clients to cheaper share classes

Each of these areas are intended to create a more efficient, accountable and competitive market place that provides greater investor protection and a clearer more tangible demonstration of value for money. In turn, and potentially an ulterior motive, the FCA is looking at this review and the resulting reforms as a means of ensuring that the UK remains an attractive place for investors to do business, especially in a post Brexit era.

What does this mean for Investors?

On the whole the review and its proposed remedies appear well balanced and seem to be genuinely driving towards a more client friendly industry for asset managers. The idea of simplifying and clarifying fund objectives, along with creating a single all-in-fee displayed as a percentage, pounds and pence and in respect to its effect on investment return makes sense.

Also focusing on enabling investors to identify value for money again makes sense, however how easy it will be to create such a metric in order to display to investors is likely to be a real challenge. It will require genuine collaboration across the industry to produce such a measure, something that will no doubt raise questions around what is considered good value. Some will argue it's investment returns, some will suggest it's risk adjusted returns and some will want to include other factors such as stewardship. What is clear is that the current rating / best buy list approach is likely to need a re-think.

The prohibition of asset managers profiting from box management, something SEI does not carry out, and the return of those profits to investors in the fund is a positive move. As are the questions being raised around

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performance fees that are earned on performance that does not exceed the most ambitious return target, especially in the Absolute Return sector.

One unintended consequence of the review and a potential risk to investors is the greater focus on costs. It is recognised of course that this is in the context of value for money, but the danger is that investors focus more on costs and potentially to the point of making it the key decision making driver. This could result in low cost passive funds seeing a greater attraction of inflows and active managers struggling to justify their higher fees. This poses wider risks to the market in that active managers not only play an important role for investors, but they also play an important role for the efficiency and accuracy of the market itself. Understanding the costs is clearly important and this will see a reduction in asset management fees over the coming years, but basing decisions on costs alone is risky.

What does this mean to advisers?

We don't think there will be a significant direct impact on advisers. The review findings appear to have a higher focus on unadvised clients and the FCA has recognised that the RDR, FAMR and MiFID II have gone / will go a long way to ensuring that clients are being well protected, fairly charged and put first by advisers. What we might see is that alongside MiFID II, asset managers will go further to assist advisers in enabling them to meet their requirements. That could be through better disclosures, clearer more consistent comparators and lower costs.

Whilst asset management fees are likely to reduce, albeit marginally, this does present advisers with the option of providing a lower total cost to investors or offsetting any reductions against their own fees. While this seems hard to imagine, in some cases it may make sense. The proposed sunset on all pre-RDR trail commissions could dent the P&L of some adviser firms which could be countered by asset managers reducing their fees.

As a key theme throughout the report, identifying value for money is an area that is likely to affect advisers. Alongside suitability and appropriateness, this could become a crucial part of the investment recommendation process. Assessing cost is the easier part but like asset managers advisers will need to be able to demonstrate why the recommended investment is good value. This will require clear collaboration between advisers and asset managers to ensure that what is presented by providers is what is recognised by advisers.

On the whole advisers have had a tough few years with regulation changes and now it seems that it is their turn to take half a step backwards and let the asset managers manage the flux.

What does this mean to asset managers?

A lot.

Firstly the good news. One of the biggest fears in the industry was that this review and its proposed remedies was going to be either at odds with MiFID II, PRIPS and SM&CR or would look to 'platinum plate' these EU wide regulations that are coming into force in 2018. Fortunately the FCA appears to have taken an unusually pragmatic approach and acknowledged that the existing regulatory changes that the industry is busy grappling with will in part help resolve some of their findings. They have left the door open to some tweaks to what MiFID II is implementing such as the costs & charges disclosures but in the main they have recognised them which are positive.

Having said that, there are still a lot of actions that asset managers are going to have to complete in order to adhere to the FCA's new requirements. Some are more straightforward than others and are things that should perhaps have been dealt with already through best practice reviews. These are things such as greater independence on fund boards, the removal of box management as a revenue stream and the evolution of performance fees to ensure they are representative of outperformance of the highest target. The latter two will of course impact the bottom line, but deep down I am sure those asset managers deploying such activities know that they should have made this change some years ago.

Additionally there is going to be a need for better disclosure of objectives, costs and performance. This is not easy by any stretch, however if the industry can provide clear guidance on a set of harmonised disclosures, it is ultimately all doable. The real challenge could come if asset managers are required to provide a total cost that includes distribution by a range of third parties. Under MiFID II this is also captured but the requirement lay with the end distributor who has the client relationship. The rest of the value chain is then required to supply the necessary information along the chain to allow the end distributor to provide the client with the information

required. If this obligation falls to the asset manager for unadvised business, this may become very difficult to obtain and then present the total cost including the varying costs of multiple distributors. This is an area that needs some further thought!

The biggest challenge that the asset management industry is going to face however is the demonstration of value for money. As touched upon earlier, the industry consultation that took place after the interim report was published in November 2016 threw up a number of questions around what constitutes good value for money. Many industry participants, particular those from active asset managers argued that value comes in multiple forms, some less obvious and tangible as others such as stewardship. It appears as though the FCA has acknowledged that there is no silver bullet for calculating value for money, however it seems that they have settled on risk-adjusted net returns as the most pertinent measure of value for money from the perspective of the investor. A positive outcome I suspect as at least this is a measure familiar to the asset management industry.

Another area of review that the FCA report has touched upon in relation to the notion of good value is asset management profitability and the benefits of economies of scale. The FCA has suggested that the average margin earned by asset managers suggests that they could charge less for their services. By their admission the FCA has noted that this analysis did not include smaller asset managers which will have reduced this average but its view remained unchanged. This is an interesting perspective and one that will raise some questions around fees, however asset managers like all companies in the private sector do have to strike a balance between customer pricing and shareholder performance. This debate I suspect will continue but for now the FCA doesn't seem to be pushing this agenda any harder. More pertinently the FCA has expressed a view that they want to see asset managers actively control all costs better, even those paid to third parties and provide benefits of scale to the end investors.

Interestingly the FCA was keen to distance them from the passive vs active debate and proactively noted its neutrality in respect to the two styles, despite the distinct slant that the interim report portrayed. One result of the reforms could be the creation of a clear demarcation between active and passive products and even between benchmarked and un-benchmarked products. This may be a function of how fund objectives will be displayed going forward or how costs are distinguished and displayed, however it makes sense for investors to be able to easily identify which is which. This will potentially make the partly active / closet tracker funds charging fully active fees extinct, a result that the FCA I suspect will be pleased with.

One final area that the FCA did display some clear concerns around was the Absolute Return sector. They did concede that these types of products can play a positive role in a client's portfolio, however they highlighted that on average a high number were persistently delivering negative net returns, which defies the objective of the product and the rationale for investing.

What does this mean for SEI?

Firstly we welcome this review. While we believe the asset management industry is already displaying good levels of competition, efficiency and client centricity, we are always striving to do more and with the regulators help this is easier.

In respect to these reforms, if the impact on the industry as a whole is to be significant and there is a typical bell curve distribution then SEI Asset Management will fortunately fall into the category of the lesser impacted asset managers.

So why is this?

- The board of the SEI Global Assets Fund and SEI Global Master Fund already contains two independent directors
- SEI does not employ box management
- SEI does not employ performance fees
- SEI's Strategic Portfolios do not employ an arbitrary benchmark
- SEI's Strategic Portfolios are fully active and competitively priced

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- SEI is on track to be MiFID II compliant by 1 January 2018

While we are in a good position, there are still areas of impact that we do not escape such as the better communication of clear and understandable objectives, plus the display of fees, although as a business that supports advised clients this will be solved under MiFID II. However, these are areas that we are constantly trying to enhance anyway and again we welcome guidance from the FCA and the industry as to how we can do this most effectively.

One other area along with all other asset managers we cannot escape is that of identifying value for money. However, again we feel confident that as a goals-based investment provider, both the principles and practicalities that the FCA is driving towards are already being demonstrated by SEI and our strategic fund solutions.

As a starting point goals-based investing puts the client at the heart of the advice and investment process and allows the client to set the objective. The SEI Strategic Portfolio that is mapped against that objective is simply the vehicle identified through a series of complex calculations that is most likely to help the client meet that objective. So we don't think of the objective of the fund but rather the specific personalised objective of the client. We even go one step further and provide the client, via their adviser, with a percentage probability of achieving that goal, or objective, which in turn gives a very clear expectation to the client and helps highlight where the objective may be unattainable within their current circumstances. The calculations take into account the fees of the fund, platform and adviser and inflation to ensure that the actual real result after all costs is what the client sees and agrees to.

SEI's goals-based investing solution also provides reporting in a way that we believe the FCA is really working towards, goal or objective achievement. Use of benchmarks is appropriate perhaps when dealing with single asset class funds to ensure that they are performing well in a specific context, however benchmarks are ultimately arbitrary to the end client as they do not reflect what is most important to them. We report our goals-based funds in the context of the progress made toward the achievement of the goal, providing an initially and regular revised upper and lower likely return, again accounting for all fees and inflation.

We have also considered client objectives differently to the traditional approach which often applies a linear view of risk and return with risk being determined by volatility. We recognise that the biggest risk to clients looking for wealth preservation is loss and not volatility, so we have designed and implemented our stability focused funds to manage to drawdown to ensure that what the clients are ultimately looking for is paramount to the investment process. Again this is something that we believe the FCA considers critical in respect to objective setting and matching those objectives to the most appropriate investment.

Delivered using technology, SEI's goals-based investing solution provides advisers with the tools to be able to deliver their advice in line with how clients think about their life and wealth objectives and crucially in the context of the FCA review, how the asset management product is fully aligned to that client centric approach.

Summary

The FCA's role is to perform these types of reviews to ensure that the financial sector is operating both efficiently and in a way that provides the most value to investors. We value the work the FCA has undertaken to complete this particular review and while it will take significant effort from the industry and SEI to meet all the requirements we look forward to building on our goals-based solution, which we believe has already taken a significant step to achieving what the FCA has set out, and working towards an even better asset management industry and client solution.

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