

The FCA's Asset Management Market Study

by Martin White

In November last year, the Financial Conduct Authority, FCA, published a very substantial 200 page “interim” report, and the annexes are in addition and even longer. But, in spite of the length, we welcome it!

The report was the outcome of a large research project into the operation of the asset management industry, primarily from the perspective of the customers – us. The conclusions were what we already know – that the industry is massively profitable, but that the customers generally get a poor deal and, most importantly, are significantly poorer in retirement as a result. They also concluded that active management was generally not worth paying for, that investors in cheap passive vehicles did better, and the fact that the FCA had come out saying this caused consternation throughout the industry.



Martin White
UKSA Director

So well done the FCA. Using colourful language of my own, I would say they have exposed the world's most profitable con trick, the asset management industry, for what it is. There was a fair bit of press coverage of the report following its publication in November, so you might have noticed the story back then.

Now before I get into more trouble, there are a few things I must say. I'm not criticising the good intentions of individuals working in the sector. And I'm not saying there is no place for employing investment managers to make decisions for you, which is what active management is. There clearly are a few investment managers who outperform the overall market. But they are few, and what happens with them is they get so much money to manage that they either stop outperforming, or they have to close their fund to new money.

Incidentally, some of us believe that it makes huge sense for us to dodge the financial sector as much as possible, make our own investment decisions, and avoid paying an annual percentage of our wealth to anyone. But the financial sector puts out the subtle message that it's all too difficult for individuals to manage their own affairs. And all arms of Government seem to ignore the role and importance of the individual as investor. But we are definitely not giving up on this. It was one of our criticisms of the FCA's recent study, as you will see later in this article.



You can find the FCA's report at <https://www.fca.org.uk/publication/market-studies/ms15-2-2-interim-report.pdf> Responses to the report were requested by 20 February 2017.

As a member of the UKSA policy team, I was the main author of UKSA's response to the FCA's interim report, and you can find this response in full on our web site at http://www.uksa.org.uk/sites/default/files/2017FebUKSA_AssetManagementStudyResponsePDF.pdf

Our response: two parts

There are two parts to our response, which I need to explain. The first takes the form of a 6 page letter signed by me as an UKSA director. And “we” in this letter means UKSA. But as part of the response we also attached a nine page document which I personally had submitted to the FCA before it was formally in operation and signed by me; “I” in that other document means me. I was not an UKSA director at the

time, and as the entire thing was to express my personal views I was very careful to emphasise that I was not speaking on behalf of anyone else. Members' comments to the editor would of course be very welcome!

A few words on my personal submission of December 2012

This current article would be too long if I were to say much on it now. Back in October 2012, the document "Journey to the FCA" was issued, all about the plans and aspirations of the not-yet-live FCA (somebody must have had a sense of humour: the go-live date in 2013 was 1 April). This can still be found at <https://www.fca.org.uk/publication/corporate/fsa-journey-to-the-fca.pdf>. It was all well-meaning stuff, and comments were invited. On the front cover were the words "to make financial markets work well so consumers get a fair deal". I felt it was OK, but naïve in places and missing some important things, and I was worried that unless they had the necessary clarity of thought and courage, there was a risk of their being outmanoeuvred by the industry. So I put in a big effort and produced my submission.

I didn't even get an acknowledgement. I was very cross. I chased them up, to be told that it had been passed to someone in PR! Were they frightened by what I was saying? Anyway, I gave up on it at that point. I had been really keen that what I had said should get into the public domain, but none of the submissions received in response to the "Journey to the FCA" were published.

However, looking on the FCA web site more recently, I discovered that only 3 private individuals had put in responses in 2012, and it did look as if some of the points I had made were noted. And now looking at the 2016 Asset Management Study, I would argue that my 2012 response was totally vindicated and I would say that it is entirely valid today. Hence the decision to include it with the recent UKSA submission.

I will write more about the 2012 submission, which was much more wide ranging than the 2016 Asset Management Submission, in a future edition of TPI. I believe it does contain some ideas for UKSA in this David and Goliath world of individual savers and the financial sector.

Back to the 2016 Asset Management Study Report

Below I reproduce the general section of our report:

"First we would like to congratulate the FCA for shedding a light on both the profitability of active management today, and the poor outcomes for customers. We welcome this Report and generally support the analysis and the conclusions. The measured style of the published material makes the starkness of the conclusions very powerful.

The fact that journalists such as Anthony Hilton in the Evening Standard are referring to the current Report as "controversial" is a good sign that there may be a will to tilt the balance more in the interests of individual customers, or consumers.

The nature of the analysis carried out, concentrating as it has on the fund management sector, does mean that the full impact on the outcomes for ordinary savers of the way in which the financial sector works – and we mean here the total costs including advice, distribution and investment management – was not brought out in the Report. However, it is very clear from the Report that the FCA recognises this and is minded to take the issues further.

We believe that the issues identified in the Report are part of a wider set of problems in the ownership chain that lead to sub-optimal outcomes not only for individual savers and investors but also for individuals as employees and for the economy as a whole. For those wanting a really good understanding of these

problems, we recommend two books by John Kay, *Other people's money* and *The long and the short of it* (the subtitle of which is "a guide to finance and investment for normally intelligent people who do not work in the industry"). The way these problems manifest themselves is perhaps best captured as follows. There are three stages in the ownership chain between most individual savers and the underlying companies which they own. The first is financial advisers, the second fund managers, and the third is the senior executives and boards of the underlying companies. The way each is remunerated is effectively by taking an annual percentage of the individual savers' wealth. This is what the methods of "incentivising" senior executives and boards of companies now amount to, and since fund managers with the votes to control company behaviour use the same model themselves they can hardly be expected to reject the theory of incentives on which executive pay now rests.

The only way to achieve fundamental change is to tackle the basic "take an annual percentage of the clients' wealth" model at each stage in the ownership chain. **This model is directly contrary to the principle of stewardship, which is what acting in clients' interests should amount to.**

The scale and the scope of the underlying problems are outside the scope of the FCA to tackle alone. But the FCA may still be the most important regulatory body here, since its scope covers both retail financial advice and financial services generally, including investment management.

Overall, we believe this is a strong and effective analysis, and we agree with the Report's main conclusions. In this letter we touch on both these conclusions and the Report's proposals for the way forward. For us, the most important conclusions of the Report are that competition is not working and that retail savers and investors in particular are getting a poor deal. It would have been helpful, however, if the Report had included at least some analysis of the opportunities available to retail investors as a whole. We believe that a "self-select" service, where you just pay the stockbroker a fixed annual charge, plus a fixed charge for each trade, and where you do not pay any fund percentages to investment advisers either, is the smart option for those with the knowledge and confidence to use it. Under this route, you don't have to select individual company stocks; you can instead buy ETFs if you wish. The trick is to avoid anything that pays a commission, in other words pretty well all the funds "promoted" on the major platforms.

The big question is how to help people make sensible choices; something is needed alongside the current "advice" model. It is our belief, given the inherent conflicts of interest between the customers and the financial sector as it currently works, that "help" is not going to come from the financial sector and it is also difficult to see how regulators can do it unaided. We think there is scope for considering how savers and investors can help each other; it is difficult to see who else there is that they can trust to act in their best interests. At the UK Shareholders Association, we will be directing some of our policy thinking in future to the theme of "savers take control of their own financial future".

UK Shareholders' Association: our perspective and motivations

To conclude, it may help to set our own perspectives and motivations in relation to the subject matter. The UK Shareholders' Association was founded in 1992 in recognition that there was no organisation to represent the interests of private investors. We are a voluntary body, modestly funded by members' subscriptions. Our members tend to be relatively sophisticated investors in that they take their own investment decisions; they tend to use investment funds, especially actively managed funds, less than the general population. We exist to help our members in the investment process, and we provide a network through which people with shared interest in investment can communicate with each other and represent their interests with outside bodies, government, etc.. However, in most of our representation activity we aim to take a more general public interest stance. There are two themes to this. The first theme is that we would like to see all individuals better informed and empowered in relation to their personal financial management, especially their long term financial planning. We believe that the scope for improvement here is considerable. We also believe that investing directly in shares would make sense for many more

people than currently do so. This first theme is completely fundamental to the Asset Management Market Study. The second theme is the proper stewardship of companies, which is now very much in the political agenda (excessive executive pay, short termism, etc.), as reflected in the BEIS Green Paper. We believe that the more people are interested, as long term investors, in the behaviour of companies, the better for society as a whole.

We believe that the operation of the asset management sector is more of a negative than a positive in relation to both of the two themes we explain above. First, it operates as a wealth extraction industry rather than as an agent working in the interests of its principals. And second, because the business model is based on taking an annual percentage of its clients' wealth rather than being truly aligned with their long term interest, there is little by way of incentive for the asset management sector to take a real interest in the quality of stewardship achieved by the boards of the investee companies. It is very important to note that there are a number of investing institutions who are exceptions to this latter point; some focus on the identification of high quality companies and holding them for long periods. Others focus on the behaviour of companies in terms of their impact on customers, the environment, their employees etc.. So there are instances where we, representing individuals as investors, work alongside investing institutions.

As well as this letter, we also attach as part of our submission a document written in 2012 addressed to the FCA in response to the document "Journey to the FCA" that was published in October asking for comments".

What Next?

Stepping back for a moment, the asset management sector is only part of what the FCA is responsible for regulating. There is the financial advice sector too. Together they affect people's lives in terms of financial outcome, but it is not sufficiently appreciated how they also affect people's lives as employees because of the short term pressures they place on companies generally.

So I would regard addressing the many problems as potentially transformative for our society. I see the corruption inherent in commission-based (especially trail commission) sales, and indeed the whole sales-driven "how much money can we make out of x", or "how can we achieve our high target return on capital" approach of the industry, leading not only to systematic customer detriment, but also leading to our whole ownership chain falling short of its potential to generate wealth and deliver it to the underlying owners. The "ownerless corporation" coined by Paul Myners exists because there is self-seeking where stewardship and fiduciary duty should be.

We will be determining what part we at UKSA should play in this essential transformation.

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