MAY 2022

Value for Money Industry Report

FMA and Supervisor report for Managed Investment Scheme Managers and KiwiSaver Managers on:

- FMA and Supervisor findings from the Value for Money implementation pilot;
- Topics arising from Value for Money reviews meriting industry discussion; and
- Next steps for embedding Value for Money reviews as business-as-usual.

FMA
FINANCIAL MARKETS AUTHORITY
TE MANA TĀTAI HOKOHOKO

Contents

Pilot

1.1 In early discussions about implementing the Managed fund fees and value for money guidance (**the VFM Guidance**) the FMA and Supervisors agreed that a consistent implementation approach was critical for the review process to:

- get buy-in from the industry; and
- successfully contribute to investors in New Zealand managed funds receiving value for money for the risks they are taking and the costs they are paying (and to avoiding regulatory arbitrage).

1.2 Learning by doing was necessary for both the FMA and Supervisors to achieve a consistent implementation approach but risked significant burden on Managed Investment Scheme Managers (**MIS Managers**) if all MIS Managers were involved in the initial learning process. Accordingly, piloting implementation with a small selection of willing MIS Managers was the most balanced approach.

1.3 To maximise the learning opportunity of the pilot, Supervisors chose a variety of MIS Managers, selecting one or two funds from each managed investment scheme. Several MIS Managers also volunteered to be part of the pilot. The 14 funds chosen and volunteered were a combination of:

- KiwiSaver and non-KiwiSaver funds
- Active and passive funds
- Bank and non-bank funds
- Long-only funds and other strategies
- Funds with and without performance fees
- Funds with varying approaches to offering, charging for, and disclosing the cost of advice.

1.4 Each participating MIS Manager was provided with a self-assessment tool developed by the Supervisors and the FMA. The self-assessment tool drew on the principles and questions set out in the VFM Guidance. The Supervisors and FMA then evaluated responses and provided feedback to each participating MIS Manager, in most cases prompting further engagement and discussion.

Good features

1.5 The value of the pilot was significantly improved by the overall effort participating MIS Managers put into their responses. These responses included considerable detail about participating MIS Managers' business models, growth plans, cost structures, and fund and industry performance data. This greatly assisted insight into the pilot funds, industry practices, and the Value for Money process in general.

1.6 Performance data relative to appropriate market indices and logically chosen pools of competitors shows genuine, repeatable competence is present among MIS Managers with passive and active strategies. The drag of fees, however, reduced the benefit of this competence to investors in some funds. Fee levels were substantially driven by costs paid to external parties, such as trail commission to financial advisers and other third parties; and performance fees to underlying investment managers. These costs also impacted the profitability of some participating MIS Managers.

1.7 The FMA's engagements with MIS Managers outside of the pilot had already developed our understanding of the assumptions and trade-offs embedded in MIS Managers' business models, and how these affect their thinking about scale and profitability metrics (which vary by Manager but commonly include increasing operating margin and having sufficient profit to pay dividends to shareholders). Based on the pilot, further increasing FMA and Supervisor understanding of these assumptions is an important, ongoing focus of our MIS Manager engagement.

1.8 The pilot also provided examples of active MIS Managers with a disciplined approach to managing capacity. Capacity is an issue in some active strategies (often those involving smaller companies and/or more concentrated portfolios where individual investments can be large) where the more money under management, the harder it is for the MIS Manager to execute ideas, and to buy and sell securities without unhelpfully moving the market. Capping money under management in such strategies preserves the Manager's ability to produce the performance their investors expect. It also caps scale, and therefore fee revenue, and must be considered when evaluating whether fees are reasonable and the fund provides value for money. A strategy where limits have been imposed to avoid/mitigate capacity issues may have higher fees (and commonly, higher risk), because the Manager has made a trade-off between enabling the strategy by imposing hard limits on maximum assets under management, and what fees to charge to remain profitable within those constraints.

Usefully, it is quite simple to tell beyond doubt when capacity discipline is in place, as the fund using it will be closed to new investors and to additional money from existing investors. It may even be returning capital to investors (as even if inflows are capped, performance grows assets under management). That the fund reaching its capacity limit occurs only through performance or inward investor flows – which tend to be correlated once a track record is established – is directly relevant to value for money (albeit performance must still add value after fees relative to an appropriate market index).

Areas for improvement

1.9 The FMA and Supervisors' findings from the pilot are set out below. These have been discussed with the participating MIS Managers, and discussions are ongoing.

1.10 Some findings, and some matters raised by MIS Managers in their feedback, are symptomatic of broader issues in the industry. The FMA is conscious some of the MIS Managers participating in the pilot were volunteers, and all were "test subjects". So, while the FMA and Supervisors believe it was appropriate to seek resolution by participating MIS Managers of findings specific to the Manager; it was not appropriate or proportionate to take the same approach with broader industry issues. Instead, the FMA and Supervisors believe it would be useful to address those industry issues – specified below at 1.18 to 1.20 and from 1.26 to 1.29 – with industry as a whole.

1.11 The FMA and Supervisors are conscious of industry burden and seek feedback from the industry – potentially through industry groups – when their capacity permits. Feedback should include industry views on how and when discussions could occur (see 1.18 and 1.26).

Use of market index

Findings

1.12 Some participating MIS Managers are using an inappropriate market index. Typically, this involves using a cash-based market index:

- within a fund's set of composite market indices, for non-cash exposure (in one example, using NZX 90-day bank bills as the market index for all the fund's fixed income exposure);
- as the benchmark for a performance fee applying to an equity-based fund. Even within the small group of MIS Managers in the pilot, different Official Cash Rate (OCR) based methods were evident. One Manager applied a margin – a hurdle – to the OCR before performance fees could be paid, another did not. One participating MIS Manager on this point provided information showing a very wide range of margins applied to cash benchmarks by KiwiSaver and non-KiwiSaver MIS Managers, to determine performance fee eligibility.

1.13 The Financial Markets Conduct Regulations 2014 require MIS Managers to use an appropriate market index – appropriate in terms of assessing movements in the market in relation to the returns from the assets in which the specified fund directly or indirectly invests.[1]

1.14 The FMA's published guidance also sets out a clear expectation with respect to performance fees that the performance fee benchmark is "…generally the expected return from the standard fund asset mix under normal expected market conditions' while a cash-based benchmark 'may, in certain circumstances, be… appropriate… for a true absolute return investment fund [provided] the fund's track record over time [reflects] the absolute investment style."[2]

1.15 The VFM Guidance is clear. If the investments and risk of a fund's market index are significantly different to the investments and risk of the fund, the selected market index may not be a reliable indicator of the MIS Manager's competence. On performance fees, the VFM Guidance states:

> *…it is not in members' best interests to pay a fee for outperformance of a cash-based benchmark, for an equity-based fund, as the risk of the benchmark and the fund are materially different and the benchmark will, over time, be simple to beat (and does not represent value added by the manager).*

1.16 In our engagements on this topic with MIS Managers participating in the pilot, FMA and Supervisors have sought to understand:

- how using cash-based market indices and benchmarks for equity or fixed income exposure – and therefore equity or fixed income risk – is in their members' interests;
- how claims a fund has an absolute return strategy – to justify use of a cash benchmark – are substantiated by the fund's structure and outcomes. Especially, can the MIS Manager show fund volatility reflects that of the cash benchmark; and is the risk control typically a key purpose of an absolute return strategy, evident in mitigating the scale and frequency of fund drawdowns.

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[1] Financial Markets Conduct Regulations 2014, regulation 6(3)(b).
[2] See *Guidance Note: KiwiSaver Performance Fees*, April 2021, page 2.

1.17 The FMA and Supervisors will continue to focus on use of appropriate market indices as a reference for risk-adjusted fund performance and as performance fee benchmarks.

Industry discussion on use of market indices

1.18 Feedback from participating MIS Managers suggests reasonably widespread industry scepticism about the value of using a market index as a reference for the risk-adjusted performance of a fund *at all*. Resistance to the use of market indices from participating MIS Managers included:

- market indices do not reflect the impact of fees or tax;
- composite market indices for diversified funds (as typically used in KiwiSaver but also in non-KiwiSaver funds, particularly where those funds 'mirror' KiwiSaver funds offered by the same MIS Manager) do not reflect some assets held in the funds, or their currency hedges, and so are of limited use;
- investors care more about performance relative to peers or 'just getting a good return', not performance relative to a market index.

1.19 Using a market index is core to any MIS Manager demonstrating value for money ('Risk and return are critical' is a principle of the VFM Guidance). The FMA and Supervisors seek industry discussion to understand the causes of this scepticism and how to resolve it in the best interests of scheme members. In respect of the objections raised in feedback the FMA considers that:

- Objection to market indices not reflecting the impact of fees and tax fundamentally misunderstands the purpose of a market index. The purpose of a market index is to reflect the objective and risk of a fund, and demonstrate what returns are possible *without* the overlay of the MIS Manager's strategy or process for achieving that objective, and without the impact of fees and tax, which are under the MIS Manager's control (tax to a lesser extent but still a function of the MIS Manager's chosen approach). The contrast between index performance and fund performance shows if an active manager is adding value with their strategy, after fees and tax; or if a passive Manager's process closely replicates the desired market return, after fees and tax. An appropriate market index is *not supposed to be easy* to match or outperform.
- A composite market index can – and likely should – be structured to reflect a MIS Manager's hedging and other choices. Additionally, a MIS Manager (we assume active MIS Managers) that chooses to hold assets not reflected in the market index is doing so because they expect those assets to generate a similar return to the index for less risk; or a greater return for the same risk, because there is no other reason to hold these assets. This is how active Managers can add risk-adjusted value through security selection, while still being anchored in the market index.
- Information on a fund's performance relative to peers allows an investor to compare returns over similar periods for MIS Managers pursuing roughly similar strategies. However, this information is supplementary to performance relative to market index because, unless the investor is aware of the market index used by each Manager in the peer group, peer comparison says little or nothing about whether the higher-performing managers are *genuinely better.* The MIS Manager with the higher after-fee return may instead:
  - have a different strategy which is effectively not comparable;
  - have a comparable strategy but is taking on an imprudent amount of additional risk;

– have just been lucky in the period.

1.20 Most fundamentally, if a MIS Manager is not using an appropriate market index relative to their strategy then how can they know their strategy (or, more accurately for passive managers, their implementation) is successful? For active MIS Managers, an appropriate market index eliminates the market return from the strategy return, leaving only that return potentially attributable to active management skill. For short periods, the additional return could be down to luck, but if an excess return persists over time, it is more likely skill is involved.

Embedded advice fees and trail commissions

Findings

1.21 The VFM Guidance is clear that investors need help to make good investment decisions, that advice is valuable and there should be as few barriers as possible – including regulatory barriers – to New Zealanders receiving this help. However, the guidance is also clear the FMA wants to avoid fees for advice being embedded within fees paid by all members, where the fees are not transparent to all members. Additionally, the FMA wants to avoid MIS Managers competing on size of their trail commission payments to financial advisers (or other third parties) to effectively buy investors, rather than competing for investors based on the fund's value proposition.

1.22 The guidance expresses a clear preference for fees for advice to be charged separately to the member, but acknowledges the KiwiSaver market is still maturing, balances are lower than for other managed funds, and even a moderate, optional fee for advice may dissuade KiwiSaver members from using or seeking it.

1.23 Accordingly, the guidance does not prescribe how fees for advice should be charged, but says:

- advice should be received, not just offered;
- advice should be ongoing – at least annual – not just at on-boarding;
- the fee for advice should be reasonable;
- the fee for advice – the sum, and who receives it – should be disclosed to and discussed with members.

1.24 With respect to participating MIS Managers, the FMA and Supervisors found:

- It is still common for MIS Managers to pay substantial sums in initial and/or ongoing trail commission to third parties to acquire members;
- The acquired members' interaction with the adviser or third party rarely involves ongoing advice, and more typically involves just an induction discussion or *no discussion at all*;
- The cost of trail is embedded within fund management fees paid by all members, despite widely varying proportions of a fund's member base being acquired through the adviser or third party receiving the trail commission;
- Deficient, or non-existent, disclosure to members that the management fee they *all* pay includes a material sum arising from the cost of trail commission paid to acquire *some* members.

1.25 We address many of these issues in 1.26 to 1.29, but have already engaged with MIS Managers participating in the pilot on their disclosure to members paying trail commissions. This discussion involved several key points:

- Some MIS Managers stated they, not members, met the cost of trail commissions because it was paid from management fee revenue. This is nonsense. The management fee is paid by the member and has been sized by the MIS Manager to, in part, enable the payment of ongoing trail commissions. Members pay the cost of trail commissions.
- Some MIS Managers said they did not itemise other costs, such as marketing, that contribute to the size of the management fee paid by all members, and trail commission was no different. However, trail commission is fundamentally different. Unlike marketing, where the fee revenue arising from acquiring new members can only be forecast and ultimately requires the member to decide to join, fee revenue from trail commission is a direct, concrete result and is intermediated by a referral, introduction, or recommendation. Additionally, there is potential for conflicts of interest between the financial adviser/third party referring or introducing the member to a scheme or fund and the member (unlike marketing). This itself justifies MIS Managers disclosing the cost of trail commission separately to members.
- Some MIS Managers said itemising the impact of trail within fee disclosures was inconsistent with regulatory requirements that those disclosures be a simple total. A version of this rationale was provided by one Manager embedding the cost of ongoing trail commission in a fund management fee paid by all members, despite most having joined the fund directly. The Manager explained not disclosing the existence or size of the cost by saying they "expected to reasonably rely on the regulatory regime to ensure compliance".[3] The nature of trail commission set out in the preceding point means appropriate disclosure is meaningful to members and in their interest and consistent with good conduct.
- Some MIS Managers said they had "no reason to believe" the third parties to whom they paid trail were not meeting their responsibilities to disclose the existence, and sum, of the trail to the members they referred or introduced to the MIS Manager's scheme. This is lazy, at best, and the relevant MIS Managers were reminded that, however they joined, the members *were the manager's members* and it was in their interests to understand from the MIS Manager what they were paying, to whom and for what.
- The FMA and Supervisors believe members should understand from fee and other disclosures by the third party *and* the MIS Manager:
  - the management fee paid by *all* members includes the cost of initial and ongoing trail commission paid by the MIS Manager to third parties to acquire *some* members; and
  - the quantum of the cost (e.g., 0.25% of the member's balance).

[3] The non-disclosure, particularly in respect of those members who have joined directly, could potentially also be a breach of Part 2 fair dealing provisions, prohibiting false or misleading conduct and representation, with respect to the price of financial products or financial services. The FMA has taken this up with the manager.

Industry discussion

1.26 Discussion with MIS Managers about these matters quickly became about business models for building scale. Especially in KiwiSaver, non-bank MIS Managers (i.e., those without branch networks) have three key distribution channels to acquire new members: paying trail commissions to third parties, marketing, and incentives.

1.27 The FMA's recent VFM Guidance has set firmer expectations and clearly identified conduct constraints relevant to trail commissions and marketing. The FMA has also signalled tightening expectations for incentives and will update existing guidance on how incentives are offered subject to consultation.

1.28 Accordingly, given the overall focus on ensuring New Zealanders get the help they need to make good investment decisions, the FMA and Supervisors are interested in an industry discussion on how MIS Managers can facilitate this through all three key distribution channels. The FMA and Supervisors acknowledge the change in advice legislation, including the removal of the class advice distinction, is a factor.

1.29 MIS Managers will have views on what such a discussion should cover – likely including the participation of the advice and banking sectors. The FMA and Supervisors believe the following would be useful:

- What help and advice KiwiSaver members need;
- How would such an offering be structured to represent value for money, reflecting an ongoing, but irregular, member need for help and advice;
- How the value proposition of an appropriate offer commonly available but differently accessed by members, is best disclosed to all members;
- What the FMA can do to assist.

Matters the FMA wishes to reiterate

1.30 Several issues resurfaced in feedback and direct MIS Manager engagement during the pilot, which have been ongoing since the consultation for the guidance was published. The FMA believes our stance on these matters is worth reiterating for clarity.

On the argument that no clear case has been established for market failure requiring FMA intervention

1.31 A number of submitters on the VFM Guidance argued, and some feedback during the pilot repeated, that competition, overall quality and member focus in the KiwiSaver and non-KiwiSaver investment management sectors meant there was little or no case for the FMA to intervene on value for money (other, perhaps, than with specific outliers). Market forces, in this view, were a better solution to poor value for money than FMA intervention.

1.32 The FMA has never disputed the market has a significant role in addressing and eliminating unreasonable fees. However, the FMA will continue to do what we can – and should – to enable the market to do so *sooner* and make the obligations on MIS Managers clear. Material movements by some KiwiSaver providers to remove or reduce fees in the months following the publication of the guidance support our view. More importantly, FMA intervention should begin to influence what remains clear in performance and financial data about KiwiSaver and non-KiwiSaver managed funds in New Zealand (some outliers supporting the rule by exception, aside), in particular:

- where scale exits, its benefits are typically not shared with members;
- there is no systematic relationship between fees charged and return received;
- there is no systematic relationship between fees charged and degree of active management;
- active funds typically do not, as they should, outperform their market index after fees over meaningful periods (i.e., their recommended minimum investment timeframe and longer); and passive funds typically do not, as they should, closely replicate their market index after fees over meaningful periods.

The purpose of the guidance

1.33 The VFM Guidance was published by the FMA to assist MIS Managers and their Supervisors to meet *existing* requirements in respect of fees and value for money.

1.34 For KiwiSaver, this includes the statutory obligation not to charge unreasonable fees.

1.35 Across all MIS Managers, it includes the FMA's expectations for good conduct and the overarching statutory duty to act in members' best interests. This duty applies when a manager exercises a power or performs a duty. When exercising or performing such functions, we expect managers to follow a decision-making process which can be evidenced as providing support for acting in the best interests of scheme participants – including considering value for money where relevant (e.g. when setting fees for scheme participants or choosing their investment approach).

1.36 The VFM Guidance provides managers with an approach – and the FMA and Supervisors have also provided a self-assessment tool – to support their decision-making process when assessing value for money. Having a common approach across Supervisors and the FMA also offers the benefit of being consistent for all MIS Managers.

1.37 We consider providing value for money, and being able to demonstrate that to members, is not a peripheral aspect of acting in members' best interests – it's a core aspect of that responsibility. A simple test is how easy and comfortable it would be for a MIS Manager to explain to their investors, supervisor and the FMA why *not* robustly examining and evidencing reasonable fees and value for money is in their members' best interests. Once more, it is clear some providers agree, having taken steps accordingly and cited value for money as the reason for doing so.

On the argument that the "underlying agenda" is pushing the industry toward passive – a 'race to the bottom'

1.38 A small number of participating MIS Managers, and submitters on the VFM Guidance itself, have argued that the VFM Guidance reflects an agenda to push schemes towards being passive and low fee. The FMA does not accept this argument. The guidance explicitly states value for money does not necessarily mean "cheapest". In focusing on after-fees performance relative to a market index, however, the VFM Guidance does enable scrutiny of whether active and passive funds are delivering the desired results (respectively, outperformance or close replication of market index performance after fees) and, if not, whether members of those funds are receiving value for money. As such, it is a *good outcome* for fund investors and the managed fund sector overall if this scrutiny prompts MIS Managers of serially underperforming active funds to change strategy to passive (and charge less accordingly); or for MIS Managers of serially underperforming active or passive funds to exit those products.

1.39 A related point made during the pilot is passive funds are not a useful performance reference point for active strategies. This is nonsense. Second to judging performance relative to an appropriate market index, judging the performance of an active fund relative to passive implementation of the same or very similar exposure is a key indicator of if, and how, the active Manager is adding value with their idea generation and position management. This objection is symptomatic of broader scepticism about the use and value of market indices – and therefore, worryingly, of reluctance to adopt robust, published reference points to judge investment management competence generally (discussed above at 1.18 to 1.20).

Next steps

MIS Manager feedback sought on revised self-assessment tool

2.1 All MIS Managers involved in the pilot provided feedback on the draft self-assessment tool used in the pilot to ensure consistency of process. The self-assessment tool was subsequently revised by the FMA and Supervisors. A copy is **attached** for feedback from all MIS Managers by 31 May 2022, for the FMA and Supervisors to finalise by 30 June 2022. Note feedback should be on the tool. The FMA will not revise the guidance.

2.2 Broadly, the revisions to the tool recognise and address two key issues which are discussed below:

- Better triage to reduce the time burden of completing the assessment
- Enabling MIS Managers to articulate their broader thinking on value for money and scale.

Better triage to reduce the time burden of completing the assessment

2.3 The piloted tool made reviews unnecessarily time-consuming to complete (substantially because of the data-gathering implications of many of the questions). Revisions to the tool with respect to fund fees and performance mean the review process will be straightforward for funds where (consistent with the guidance principles):

- Net-of-fees performance relative to market index is satisfactory relative to the recommended minimum investment timeframe (and/or to another meaningful period)
- The market index is appropriate
- The fund does not charge fees significantly higher than comparable funds (viewed through the preceding lens of net-of-fees performance relative to market index).[4]

2.4 The review process will also be simpler for funds without features such as:

- Performance fees
- Advice fees (however structured, priced and disclosed)
- Separate other management or administration charges
- Other fees (such as exit fees)
- Other revenue sources charged to the fund (such as securities lending)

2.5 A fund not meeting one or more of the fees and performance criteria and/or with one or more of the specified fund features, does not mean the fund is regarded as poor value for money. It means the relevant MIS Manager must answer more questions in the tool – potentially including identifying

[4] In KiwiSaver, underpinned by regulation 12 of the KiwiSaver Regulations 2006

sources of value other than performance and/or different measures of fund performance, supported by data – to better inform the value-for-money review by the MIS Manager, their Supervisor and, if necessary, the FMA.

Enabling MIS Managers to articulate their broader thinking on value for money and scale

2.6 A fund's value proposition and scale metrics can be highly specific to that fund, scheme, or MIS Manager. Revisions to the tool therefore provide MIS Managers with the opportunity to articulate:

- the value proposition of a fund (which should be substantiated by metrics and other content within the tool); and
- how they think about scale as it applies to the fund under review – including, for example, profitability, business model – to better inform the discussion required by the VFM guidance, about whether a fund's members are sharing the benefits of scale.

Report from the pilot process

2.7 In April or May 2022, the FMA will publish a public report about the themes arising from the pilot, focusing on what the FMA believes is relevant for the fund management industry, its investors, and the broader New Zealand public.

2.8 Content will accordingly reflect what is set out in the preceding sections, but written for a broader audience. Note the public report will not identify any individual MIS Managers or funds.

Value for money reviews as ongoing practice

First reviews complete by 30 April 2023 but MIS Managers are expected to act earlier

2.9 Due to the pilot taking longer than expected and the need for further feedback on the self-assessment tool, the FMA and Supervisors now expect the initial Value for Money review of all funds to be completed within a year of the finalisation of the tool – likely, by 31 May 2023.

2.10 However, consistent with what the FMA and Supervisors have said since the publication of the VFM Guidance in April 2021, MIS Managers should be reviewing the value for money they provide to their members as a matter of course as Managers carry out one or more of their functions, including the managing and/or administration of scheme. This is especially the case where a fund does not meet the criteria and/or has one or more of the features set out above at 2.4.

2.11 We note again some MIS Managers have made material changes to their fee structures and value propositions, citing value for money and scale. This provides strong competitive reasons – alongside the statutory and conduct rationale – for MIS Managers to review their value for money sooner rather than later if they have not already done so.