Financial Conduct Authority

MS15/2.2: Annex 5

Market Study

Asset Management Market Study

Interim Report: Annex 5 – Institutional Demand Side

November 2016

Annex 5: Institutional demand side

In order for competition to work effectively in the institutional asset management sector, institutional investors need to be able to access, assess and act on useful information which allows them to identify the products and asset manager that best meets their investment objectives. Once investment decisions have been made, investors then need to be able to judge whether their investment products have delivered value for money and switch to alternative products if not.

In our analysis of the institutional demand side we found that:

Institutional investors are varied in terms of their size, experience, governance arrangements, investment objectives and resources available. Smaller investors often face similar challenges to retail investors.

The institutional demand side is fragmented, with a large number of small pension schemes with limited buyer power. This can inhibit the ability of investors to drive effective competition in institutional asset management. Many small schemes with small asset pots have limited ability to negotiate effectively with asset managers and secure value for money.

In our bi-laterals with institutional investors, we heard that they were increasingly focusing on the charges they pay for consulting and asset management products. We heard examples of institutional investors using different ways to monitor and increase their focus on costs, with some regularly identifying and reviewing the full costs associated with their investment strategy (including investment consultant, custodian, asset manager and ancillary service costs).

Institutional investors told us that asset managers do not willingly provide cost information and need to be pushed to provide, for example, transaction costs. They also rasied concerns that there are parts of the industry that are particularly opaque with regard to charges, for example, fiduciary management, the defined contribution segment of the pensions sector, hedge funds and private equity.

Investment consultants have an important role in this market, in particular for pension schemes. Pension schemes are required to obtain advice related to investment matters from qualified advisors with the appropriate knowledge and skills. To fulfill this requirement, trustees tend to seek investment consultant advice. Investment consultants are often heavily relied upon by trustees, and institutional investors in general, in making asset allocation and asset manager selection decisions. Respondents to the institutional online survey, in general, felt that they are receiving good value for money from their investment consultants. However institutional investors find it difficult to assess the quality of consultants ahead of apointing them and to evaluate the quality of their advice. The quality of the relationship between institutional investors and their consultant appears to be a key driver of whether investors switch provider.

We found that investment knowledge on oversight committees varies. The larger institutional investors appear to be well represented on their trustee boards by those with investment expertise. The academic research we commissioned found that trustees often fear looking ignorant in front of their peers and often fear dealing with complexity. These factors can have implications for the degree to which investors rely on advisors (including investment consultants), the Chair of Trustees, or those that they perceive to have more investment expertise. This can effect their willingness to challenge in meetings. Even where a lack of expertise or fear of looking stupid does not prevent trustees from challenging, it can delay decision-making, with much time being taken to get trustees up to speed and gain their agreement on a particular strategy.

Introduction

1. This annex sets out our analysis of the demand side of the institutional asset management industry, with a particular focus on pension funds. It aims to help us assess whether the demand side is working effectively in the institutional asset management sector.

2. For competition to work effectively, institutional investors need to be able to access, assess and act on useful information which allows them to identify the products and asset manager that best meet their investment objectives. Once investment decisions have been made, investors then need to be able to judge whether their investment products have delivered value for money or are likely to deliver value for money going forward and switch to alternative products if not.

3. The evidence presented in this annex is drawn from three pieces of research:
   - An online survey of 89 institutional investors (Institutional online survey)
   - Bi-laterals with 30 institutional investors
   - Academic research undertaken on our behalf

4. Taken together, these pieces of research inform our understanding of:
   - A subset of institutional investors (pension funds, insurance firms and charities) that buy asset management products and services.
   - Whether these institutional investor groups face obstacles in selecting, monitoring or switching asset management products and services or intermediary services such as investment consultants.
   - Whether there are any concerns with their ability to select, monitor and switch custodian or other ancillary services.
   - Whether there are material barriers to oversight committees making effective decisions on behalf of their underlying beneficiaries.

5. Throughout the market study, we have engaged with over 100 institutional investors through one to one meetings and online surveys. We would like to thank all of those who provided input into the study.

Online survey

6. We carried out an online survey of a subset of institutional investors, including pension funds, insurance firms and charities. The online survey sought to understand how pension schemes, insurance firms and charities:

   – are governed, including the level of investment expertise and knowledge on trustee boards; and

   – purchase, use and monitor asset management, investment consultancy and employee benefit consultancy products and services.

7. The survey also sought to understand whether institutional investors faced barriers to accessing or assessing investment information or when switching providers.

8. We aimed to give a wide range of institutional investors (pension schemes, charities, insurance firms) the opportunity to feed through their views on whether the asset management industry was working well and highlight any areas that they felt could be improved.

Survey format

9. The survey included 82, mainly multiple choice, questions. Care was taken to frame the questions in a neutral way, to ensure they did not bias responses.

10. A number of free text questions were included to understand how institutional investors think about and assess value for money as well as to get their views on areas where they felt the industry was not working well.

11. In the survey, we asked respondents whether they would be happy to be contacted by the market study team and to contribute to the study going forward. We invited those that provided their contact details to meet with us in two hour bi-laterals and to take part in academic research.

12. The survey was reviewed by four industry bodies, before it was distributed.

Sample

13. Given that pension schemes are the largest institutional investor group, this was our main focus. However, we also sought the views of insurance firms and charities so we could understand whether there were distinct issues faced by different institutional investor groups.

14. Initially, we asked three associations that separately represented pension schemes, insurance firms and charities to distribute the online survey, by email, to their members. The email was addressed to both the Chief Investment Officer and Chair of Trustees and it was requested that one or the other completed the survey. We estimate that around 2,000 institutional investors received an email via their associations. A number of reminders were sent out to this population. There was a low number of responses (23). This was in line with the Associations' expectations and experience of engaging with their members in this way.

15. Given the low response rate, we also distributed the online survey by email to:

   – 4,183 Chair of Trustees and 959 Professional Trustees of UK pension schemes. 63 pension schemes responded; and

   – 60 life insurance companies: To try to increase the coverage of insurance companies, the FCA circulated the online survey to 60 Life insurance companies.

16. In total, the online survey was emailed to over 6,000 pension schemes, insurers and charities. 93 responded. We removed four responses from our analysis as they were insufficiently complete.

17. The survey results presented in this annex are not weighted to reflect the wider population of institutional investors. This is a key limitation of this survey, and as such, the survey provides some high level insights that are intended to be interpreted alongside other evidence to understand what is working well and not so well in the asset management industry.

Survey results

18. The results of the survey are presented below and structured as follows:

a) **Profile of survey respondents:** here we describe the profile of survey respondents and make observations about the extent to which they reflect the general population of institutional investors.

b) **Profile of investments made by respondents:** this summarises the types of investment vehicles and strategies employed.

c) **Governance:** this section provides an overview of the number of members on investment oversight committees and summarises the criteria used when appointing members.

d) **External asset managers:** this covers the use of confidentiality agreements, investor views on what value for money for asset management services looks like, factors that inform manager selection, frequency and methods used to monitor and evaluate asset managers and investors' ability and willingness to switch asset manager.

e) **Role of investment consultants:** this covers views on what value for money from investment consultants looks like, frequency and methods used to monitor and evaluate consultant advice and investors' ability and willingness to switch consultant.

f) **Employee benefit consultants (EBC):** this covers views on what value for money from EBCs looks like, the frequency and methods used to monitor and evaluate EBC services.

g) A summary of what respondents said was **working well and not so well** in the asset management industry.

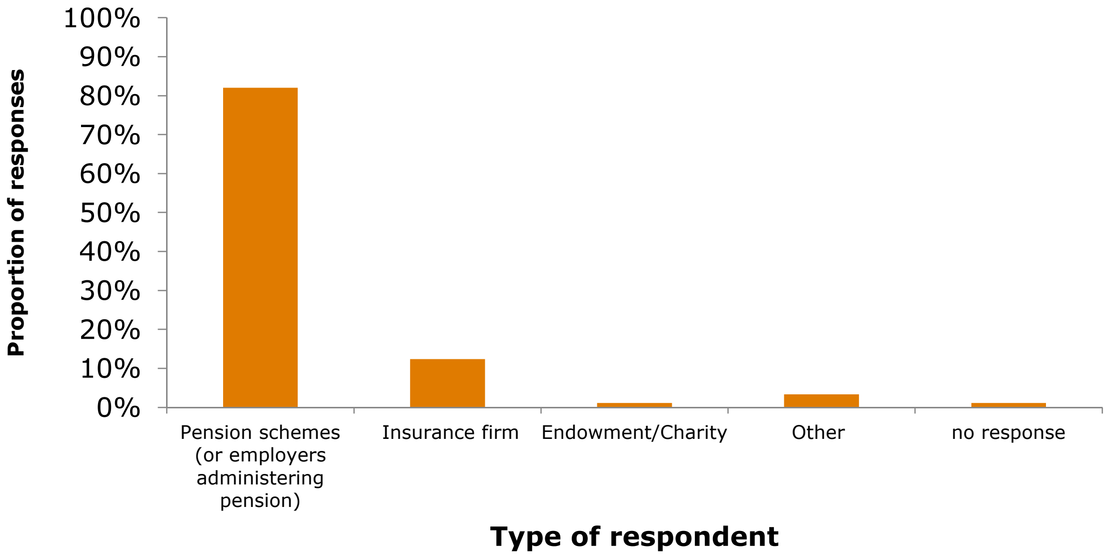
Profile of survey respondents

19. This section provides an overview of the respondents to this survey. We initially received 93 respondents to the online survey. Four of these were removed as their responses were insufficiently complete.

20. We are mindful that the profile of respondents underpinning the survey results in each section may vary. Not all institutional investors completed all of the survey sections. This may have been because they did not, for example, procure investment consultancy or employee benefit consultancy services or it could be that they submitted the survey before completing all sections[1]. Where we expect these variations are significant and could influence the findings, we have indicated this at the beginning of the section.

21. Overall, 82% of respondents were pension schemes, 12% insurance companies and 6% were other institutional investor types - including one charity.[2] We expect this broadly aligns with the general population of institutional investors, with pensions schemes representing the largest institutional investor group by number (with over 30,000 open schemes).[3] The population of insurance firms and charities are much smaller. For example, there are around 387 life insurance firms and 911 general insurance companies in the UK, many of which are authorised in the UK[4] and are likely to engage with the asset management industry. There are 12,000 endowment funds in the UK, many of which will use asset management products and services[5].

Figure 1 – Institutional investor type



Question: Type of institutional investor (please select all that apply).
Sample base: 89 respondents; unweighted

22. Of those respondents that were pension schemes, 27% represented solely DB schemes (compared with 12% in the general pension scheme population) and 40% represented solely DC (either contract or trust based) schemes (compared with 79% DC trust based schemes and 6% DC contract based schemes). 25% had both DB and DC trust based schemes (compared with around 3% in the general population). 7% indicated that they were pension schemes but did not specify what type of scheme.

[1] The survey was designed so that not all questions were compulsory, and respondents could submit the survey without completing all sections.

[2] To avoid double counting where response stated both pension scheme and insurance company; (e.g. respondent is a trustee of a pension scheme sponsored by an insurance company) the response has been classed as a pension scheme.

[3] See table 1

[4] 2014 (ABI) UK Insurance Key facts

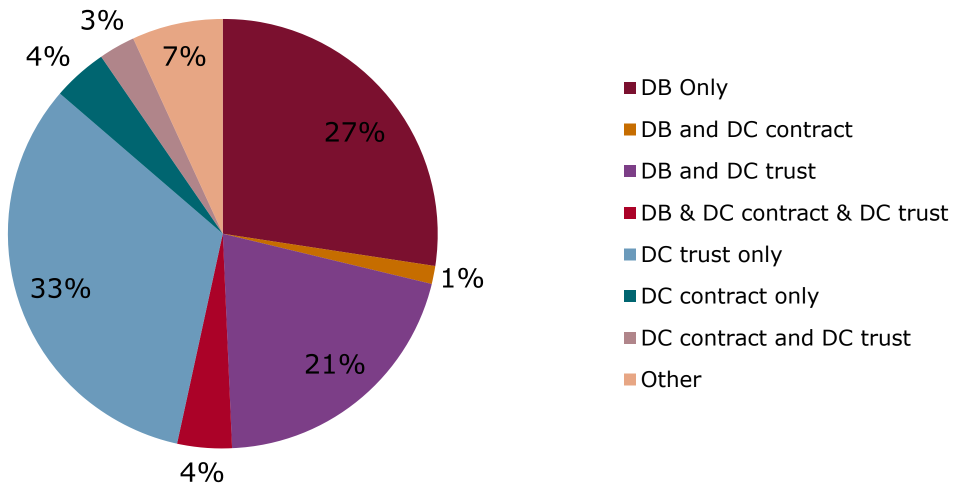
[5] ACF (2012), The Governance and Financial Management of Endowed Charitable Foundations

Table 1 - Population of workplace pension schemes in the UK

	Defined benefit	Hybrid: mixed benefit	Hybrid: dual section	Defined contribution trust based schemes	Defined contribution (workplace contract)	TOTAL
Schemes	5,240 (12%)	240 (1%)	980 (2%)	24,730 (79%)	2,500 (6%)	43,690 (100%)
Open Schemes	800 (3%)	30 (1%)	470 (2%)	27,000 (88%)	2,270 (7%)	30,570 (100%)
Active members	1,255,000 (12%)	30,000 (0.3%)	1,151,000 (11%)	3,883,000 (37%)	4,174,000 (40%)	10,493,000 (100%)

Source: The Pensions Regulator data based on scheme returns, 1 Jan 2016

Figure 2 – Type of pension schemes in the sample

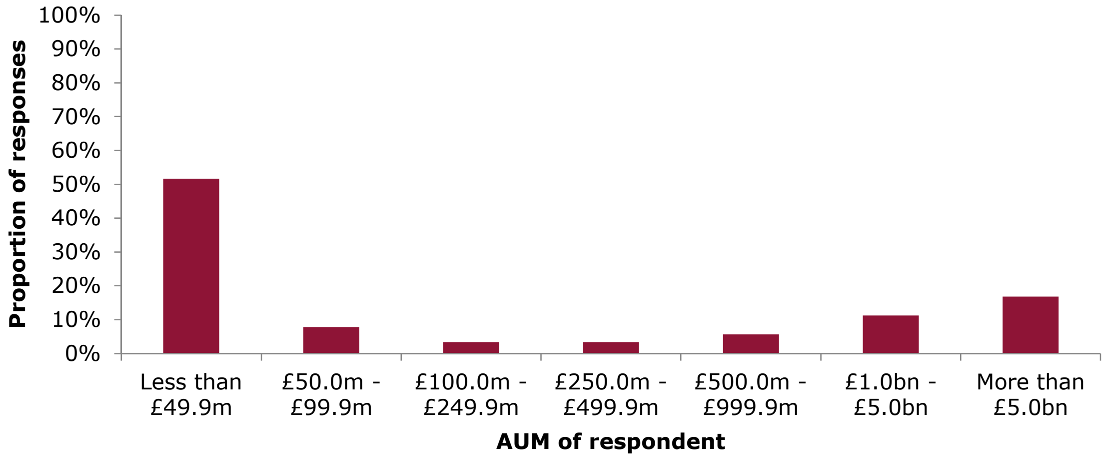


Question: Please indicate the type of pension you provide (Please select all that apply).
Sample base: 73 respondents; unweighted

23. When we refer to mixed pension schemes in this annex, we are referring to respondents which represented both DB and DC schemes.

24. The majority of responses (52%) were from institutional investors with assets of less than £50m. This reflects the general institutional investor landscape, where there are many very small pension schemes and endowment funds. In general we obtained good representation from institutional investors that fall into the different size categories (which are defined in terms of assets invested) specified in figure three below.

***Figure 3- Assets under management of respondents*[6]**

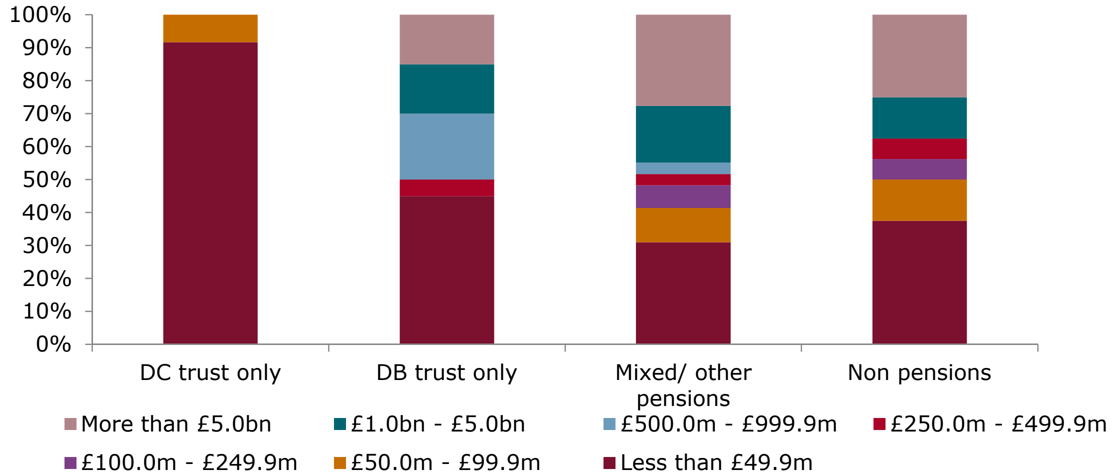


Question: Value of all scheme / fund assets at end of 2015 (this should include assets in Defined Benefit and Defined Contribution schemes, as well as non-pension investments, for example life trusts)
Sample base: 89 respondents; categories pre-defined; unweighted

25. DC schemes in our sample are small, with low levels of assets (e.g. assets less than £50mn). This is to be expected, as many of these schemes are just starting out and will not have accumulated a large volume of assets. For example, we estimate that the average DC trust scheme with over 12 members has only £20m of assets. [7]

26. In contrast, DB, mixed/other pensions and non-pension investors covered a wider spectrum of sizes, from very small institutional investors (assets less than £50mn) to very large ones (assets greater than £5bn). We estimate that the average DB or Hybrid trust scheme with over two members has around £218m of assets. [8]

Figure 4 - Comparing typical asset sizes of DC trust only, DB trust only, mixed, and non-pension responses



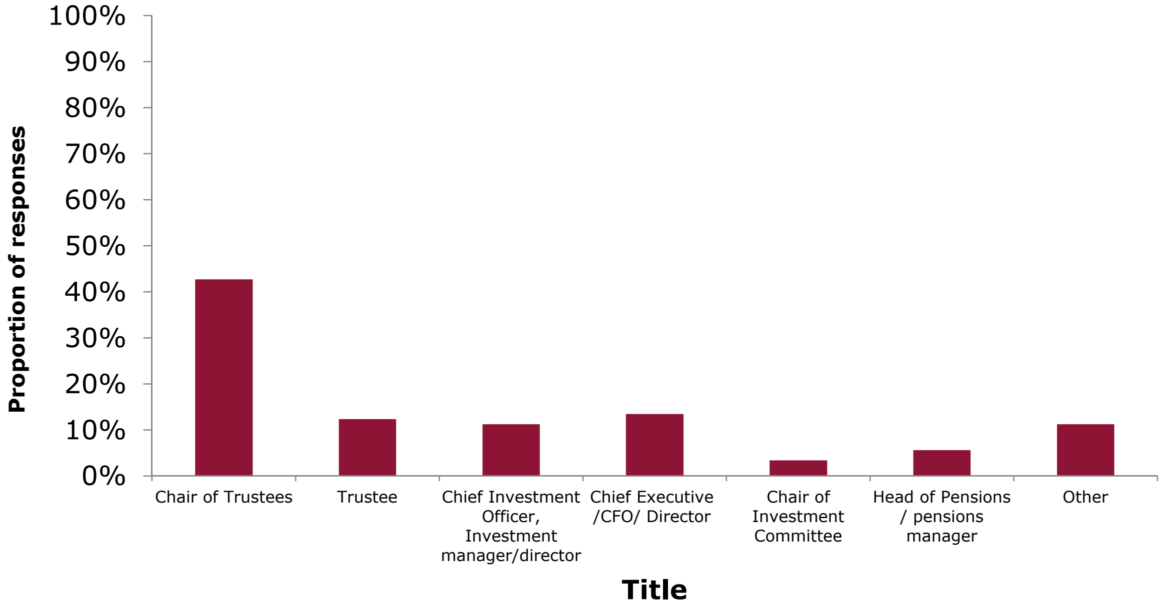
Sample base: Respondents: DC trust 24, DB trust 20, Mixed/other pensions 29 (including contract schemes and respondents who represented both DC and DB trust schemes), non-pensions 16; unweighted

[6] Note a typo in the survey meant the second size category was labelled 50 - 999.9m. We have grouped these middle asset categories in our analysis to mitigate this problem.

[7] TPR data

[8] TPR data

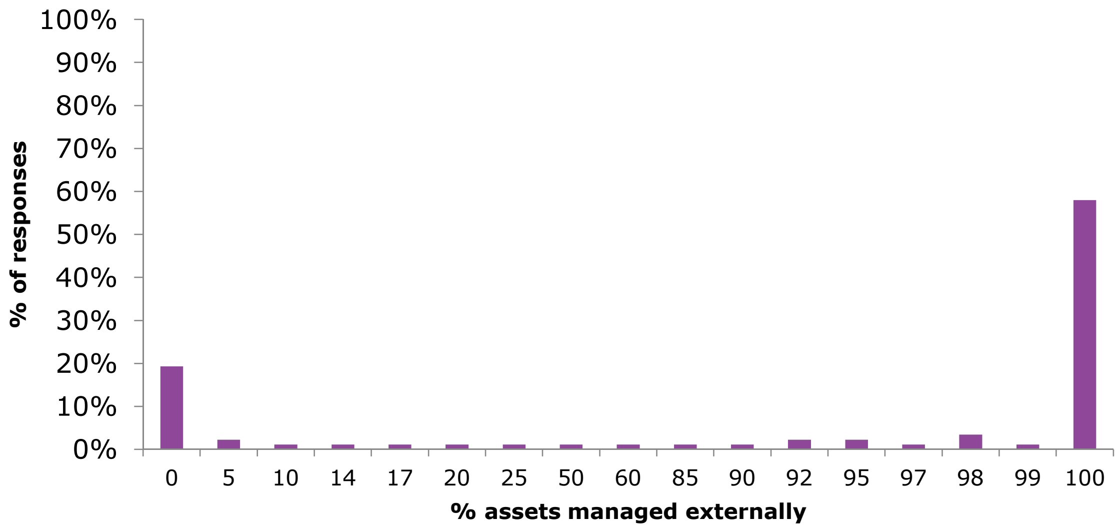
Figure 5 – Role of the survey respondents (% of responses)



Question: Job title / position (for example; the Chair of trustees or Chief Investment Officer)
Sample base: 89 – Responses were in free text, similar titles have been grouped into similar categories where possible; unweighted

27. Our responses were completed by a range of individuals. The majority of respondents were trustees, of which most were also chair of the trustee board. Other titles also given were typically corporate leadership (e.g. CEO/director etc.) or investment management roles.

Figure 6 - Proportion of assets managed externally (% of responses)



Question: Please provide information in relation to your total value of assets that are invested as of December 2015: % Assets managed by external asset manager(s)
Sample base: 88 respondents; unweighted

28. 58% of respondents used only external asset managers. In contrast, 19% used their in-house asset management arm only. The remaining 23% of respondents used a mix of in-house and external asset management.

29. Pension schemes were more likely than other investors to fully use external managers (66% vs. 38%).[9] Insurance companies often have their own internal asset management teams or subsidiaries.

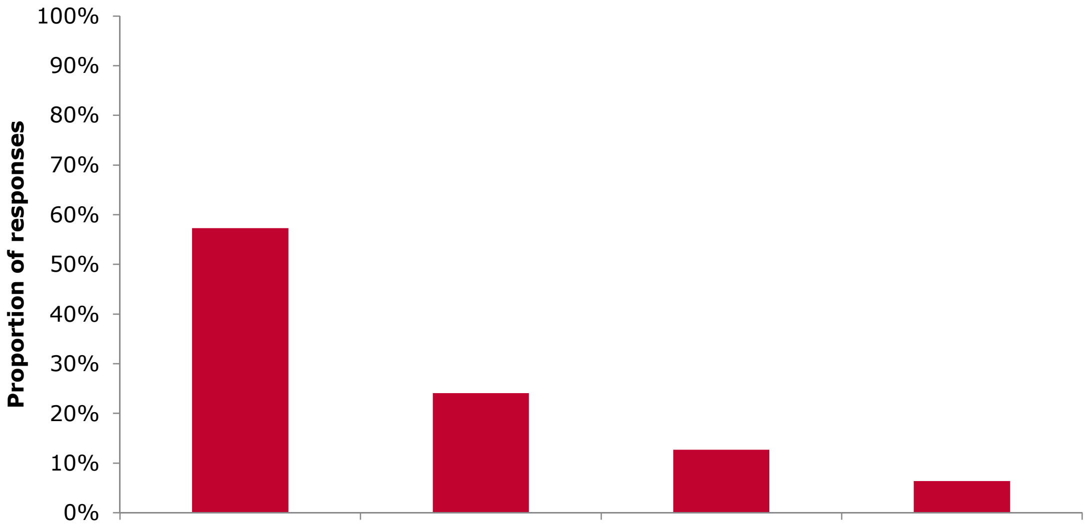
Profile of investments

30. This section provides an overview of the profile of respondents' investments.

31. The most common investment vehicle used by respondents was a mix of pooled funds and segregated funds (52%), although a substantial number (36%) used only pooled funds. We expect the significant proportion of respondents using pooled funds is the result of the larger proportion of smaller investors in our sample, which are much more likely to use this vehicle. In contrast, segregated mandates tend to be used by larger investors.

32. To test this we looked at investment vehicle by investor size and this showed that larger investors were much more likely to use segregated mandates. For example, 88% of respondents with assets over £1bn (large) used a segregated mandate. This compared with 56% of respondents with assets between £50m and £1bn[10] (medium) and 17% of respondents with assets under £50m (small).

Figure 7 – Average proportion of investments in each strategy type



Question: Please provide information in relation to your total value of assets that are invested as of December 2015: % Assets in active only, passive only, quasi-passive, other.
Sample base: 84 respondents; unweighted

33. In the survey we defined quasi-passive investments as those that fall between active management (investments that are based on analysis and not seeking to replicate any index) and passive (seeking to replicate the holdings and returns of a widely followed index).

34. On average, respondents invested 57% of their assets in active strategies, 24% in passive strategies and 13% in quasi-strategies. On average, respondents invested 6% of their assets in other investment strategies (i.e. not active, passive or quasi-passive). It is not clear what is included in the 'other' category.

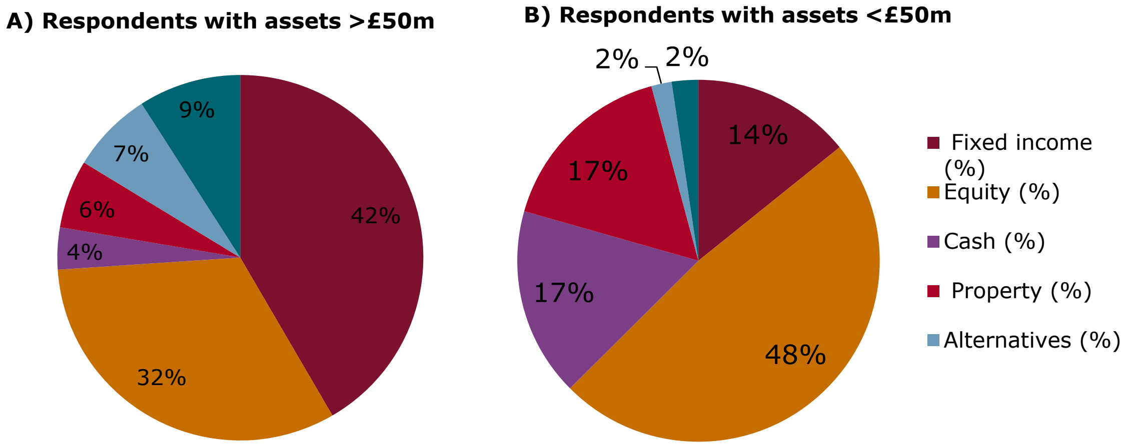
[9] Statistically significant at 95% confidence using Chi^2 and Fischer exact test

[10] Statistically significant at 95% confidence using Chi^2 and Fisher exact test

35. Interestingly, investors with low levels of assets appear to be more likely to be 100% invested in active strategies than those with higher levels: 41% of respondents with assets under £50m were invested in all active strategies compared with 27% of respondents assets between £50m and £1bn and only 12% of respondents with assets over £1bn.[11] We also found that the presence of an independent professional trustee on the governance board appeared to reduce the likelihood of investing all assets into an active strategy.[12]

36. In terms of asset classes, on average equity was the most popular asset class amongst our respondents (40%), followed by fixed income (27%). Respondents with assets over £50m were much more likely to have assets invested in fixed income than respondents with fewer assets. [13]

Figure 8 – Comparison of average asset allocation between small respondents and large respondents



Question: Please provide information in relation to your total value of assets that are invested as of December 2015: % Fixed income, Equity, Cash, Property, Alternatives, Other.
Sample base: a) 42 respondents, b) 45 respondents; unweighted

Governance

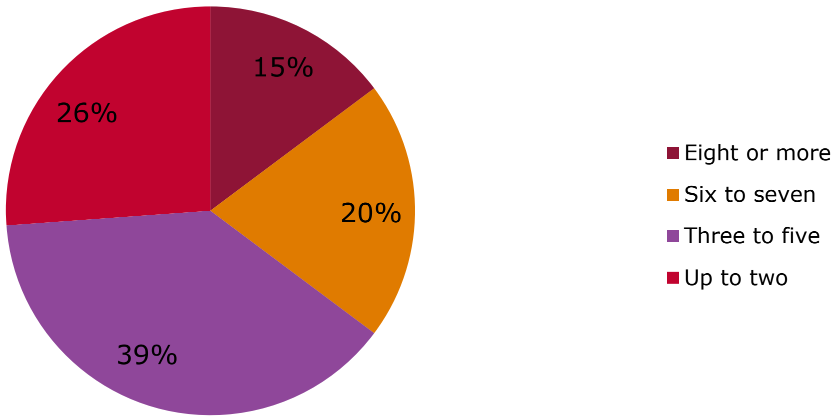
37. Around a quarter of respondents only have two people on their oversight committees, 39% have between three to five members and 35% of respondents have more than six members. We expect that the large proportion of committees with two or fewer members reflects the large proportion of smaller schemes captured by our sample. For example; 50% of respondents in our sample have less than £50m of assets. No respondents with assets over £50m have two or fewer committee members.

[11] Statistically significant at 95% confidence using Chi^2 and Fischer exact test

[12] Log-likelihood regression used to explore the factors that influenced the likelihood of a respondent investing in all active strategies. Included explanatory binary variables indicated whether the investor was: Over £50m of assets, DC, had professional trustees, procured advice from ICs, had more than five members on its oversight committee. At 95% confidence level only size and professional trustees were significant factors.

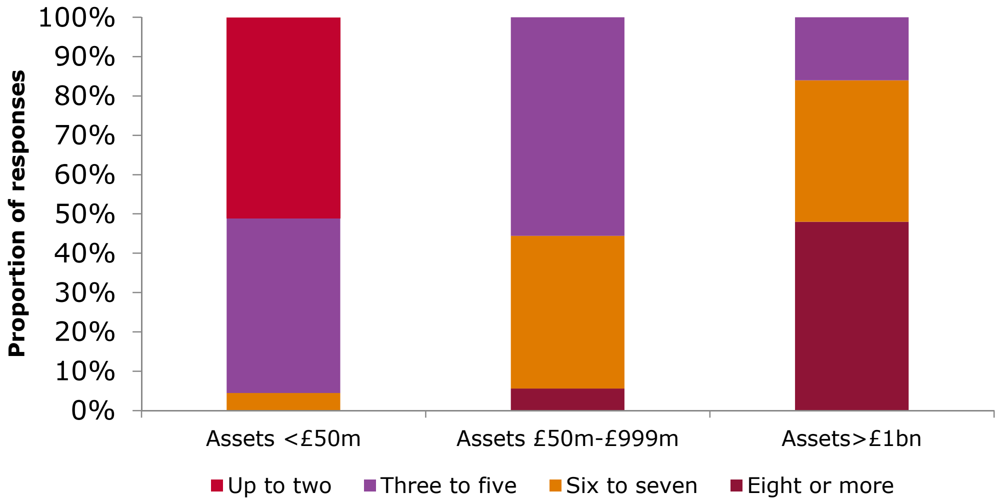
[13] Statistically significant at 95% confidence using Student T test

Figure 9 - Number of individuals on oversight committee



*Question: How many people sit on the oversight committee*14 *(e.g. for a pension scheme we are referring to the board of trustees)?*
Sample base: 88 respondents; unweighted

Figure 10 – How the number of individuals on oversight committee varies by size of investor

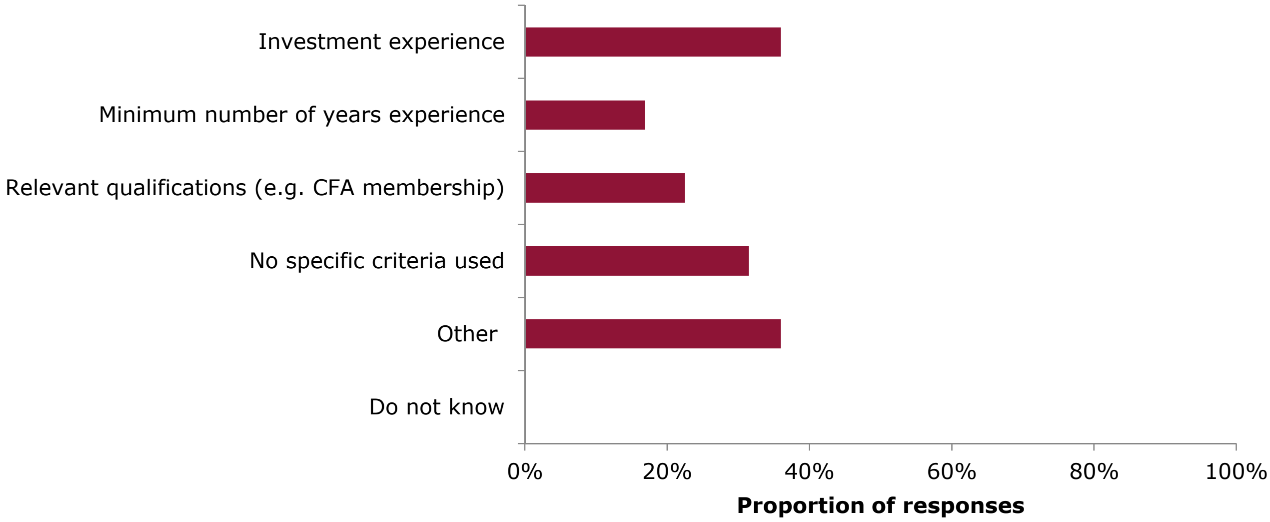


Question: How many people sit on the oversight committee (e.g. for a pension scheme we are referring to the board of trustees)?
Sample base: Assets <£50m: 45 respondents, Assets £50m-£999m: 18 respondents, Assets >£1bn: 25 respondents

38. The largest institutional investors (greater than £1bn) typically have more representatives on their oversight committee. With than 84% having six or more members on their oversight committee. For the smallest institutional investors only 2% have six or more members on their oversight committee. The remaining 98% have five or fewer.

[14] By 'Oversight committee' we mean the committee or board which oversees the investment strategy.

Figure 11 – Criteria used to appoint those that oversee investment the strategy



Question: What criteria do you use to appoint those that oversee your investment strategy?
Sample base: 89 respondents; options were not mutually exclusive; unweighted

39. A large proportion of respondents (31%) said there are no specific requirements for trustees on their board. The remaining respondents indicated that they require a combination of investment experience, minimum number of years of experience and/ or some other type of qualification before appointing a member to the trustee board.

External asset managers

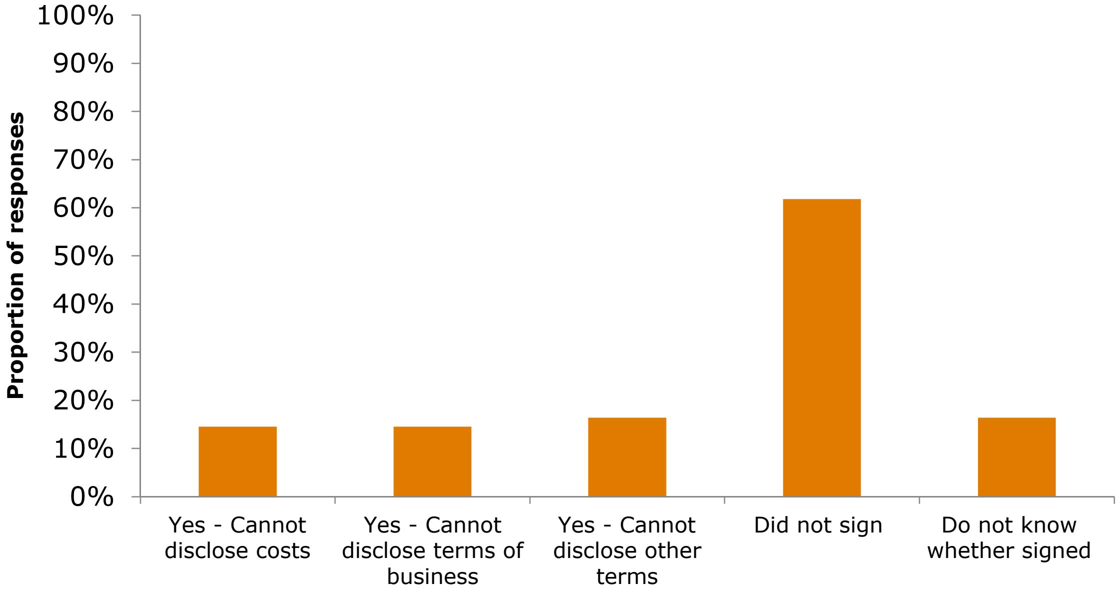
40. This section gives an indication of the extent that confidentiality agreements are used by asset managers, summarises the views of respondents on what value for money for asset management services looks like, identifies the factors that inform manager selection, outlines the frequency and methods used to monitor and evaluate asset managers and gives an overview of whether and why respondents switch asset manager.

41. A subset of all respondents answered this section (55% of all respondents). The composition of respondents are similar to those in the previous section, although there is a slightly lower proportion of pension schemes (78% of respondents in this section) and a slightly higher proportion of insurance firms (15% of respondents in this section). In addition, a slightly higher proportion of larger schemes responded to this section, with 42% of this sub-sample having assets over £1bn.

Confidentiality agreements

42. 22% of respondents were subject to confidentiality agreements with at least one of their asset managers. These were all large schemes, mostly with over £1bn of AUM.

Figure 12 - Signing of confidentiality agreement

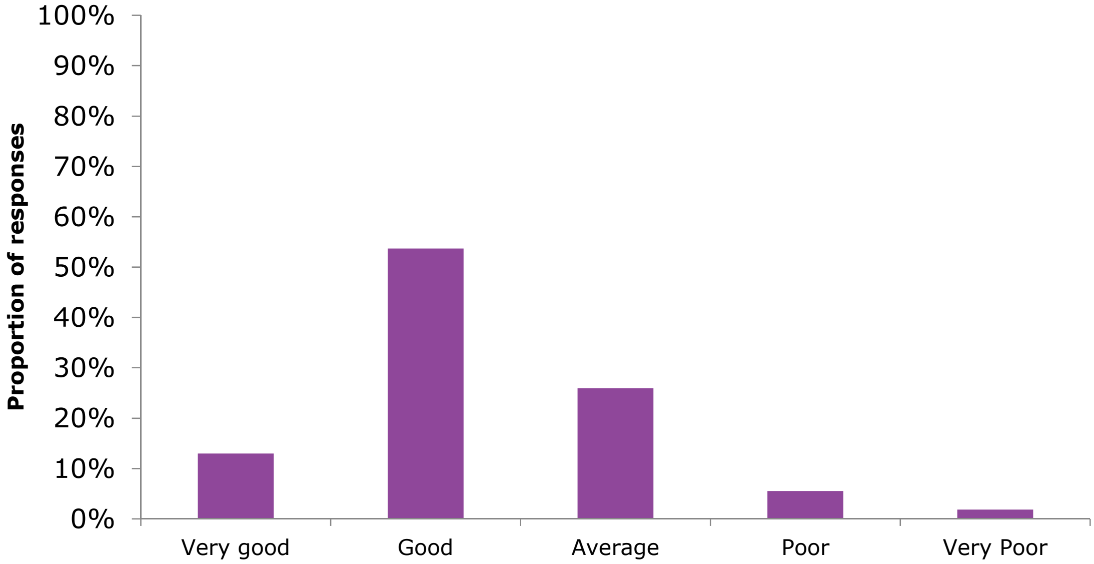


Question: Have you signed a confidentiality agreement with any of your asset manager(s) where you cannot disclose certain information?
Sample base: 55 respondents; first three options were not mutually exclusive; unweighted

Value for money from asset management products and services

43. When asked to rate their asset manager, 67% of respondents felt their asset manager was providing good or very good value for money. Just over a quarter thought they got average value for money and fewer than 10% thought they received poor or very poor value for money.

Figure 13 - Perceived value for money of asset managers (% of responses)



Questions: In your view to what extent are you receiving value for money from your asset management products and services? (1 very good value for money; 5 very poor value for money)
Sample base: 54 respondents; unweighted

44. We asked respondents to tell us what they think value for money from their asset manager looks like. Many described value for money in similar ways, stating that this would look like outperformance against a benchmark, net of all fees. A few mentioned that value for money is achieved when fees eroded less than a certain percentage of the value added (one specified 30%). Others indicated that value for money will differ depending on the product type. For example, for passive strategies they focus on ensuring the asset manager is delivering to the agreed benchmark. For active strategies they think much more about whether the risk being taken over the long term is adding sufficient value.

45. A couple of respondents highlighted the importance of compliance with the mandate (investment agreement). Others focused on the quality of communications, reporting, and the transparency of, and access to, data. They felt it was important that asset managers were flexible in meeting their needs. In addition innovation from their asset manager was valued highly, as was access to their manager.

46. One respondent did not think that asset managers could deliver value for money given their fee structure. They suggested that the ad valorem fee structure results in the absolute amount of fees and charges to rise disproportionately to the associated cost of managing more assets.

Selecting asset manager(s)

47. We asked respondents to rate, in terms of importance, factors they consider when selecting a manager. On average, the level of management fees was rated as most important, followed by the asset manager reputation.[15] Past performance remains an important feature, with all investor sizes signalling that this is an important consideration when choosing an asset manager. For the smallest investors past performance is rated, on average, higher than management fees. 53% of respondents with assets under £50m ranked past performance as more important than management fees compared to only 13% of respondents with assets greater than £50m.[16]

48. Neither the 'rating of funds' nor 'investment consultant recommendation' ranked as particularly important considerations on average across all respondents. However as expected for the sub-sample of investors who had received advice the importance of consultant recommendations was ranked higher and was in the top five factors they considered as important.[17]

49. It seemed to be more important for those that took advice and had more assets (greater than £50m).[18] Here investment consultant recommendations were in the top three factors investors considered as important. The 'rating of funds', did not feature as particularly important in any of these groupings.

[15] Scale was from 1-5. 1 - Very important and 5 – not at all important.
[16] Statistically significant at 95% confidence using Chi^2 and Fischer exact test
[17] Based on 31 respondents who had used investment consultant advice
[18] 24 respondents who had used investment consultant advice and had more than £50m in assets

Figure 14 - Average relative importance of factors that are considered when selecting an asset manager

Average score (1 – very important; 5 – not very important)

Values	
Management fee	1.82
Reputation of fund manager	1.90
Past performance of manager	2.00
Specialisation in your area of interest	2.17
Terms and conditions	2.29
Range of funds available	2.57
Other fees	2.64
Investment consultant recommendation	2.72
Rating of funds	2.73
Size of funds	2.79
Fund / investment documentations	2.87
Performance fee	3.05
Brand	3.08
Marketing pitch	3.67
Marketing materials	3.90

Very important

Not important

Question: What factors / information did you consider when appointing an asset manager? Please rate in terms of importance. (1 very important; 5 not at all important)
Sample base: 50 respondents; unweighted

Figure 15 - Average relative importance of factors that are considered when selecting an asset manager, split by investor size.

Average score (1 – very important; 5 – not very important)

Investor AUM less than £50m	
Past performance of manager	1.59
Reputation of fund manager	1.65
Range of funds available	1.88
Rating of funds	2.06
Management fee	2.12
Terms and conditions	2.56
Size of funds	2.71
Brand	2.94
Investment consultant recommendation	3.06
Specialisation in your area of interest	3.06
Other fees	3.18
Fund / investment documentations	3.31
Performance fee	3.50
Marketing materials	4.00
Marketing pitch	4.20

Very important

Not important

Sample base: 17 respondents

Investor AUM greater than £50m	
Management fee	1.68
Specialisation in your area of interest	1.72
Reputation of fund manager	2.03
Terms and conditions	2.16
Past performance of manager	2.23
Other fees	2.33
Investment consultant recommendation	2.55
Fund / investment documentations	2.63
Performance fee	2.79
Size of funds	2.84
Range of funds available	2.94
Rating of funds	3.09
Brand	3.15
Marketing pitch	3.40
Marketing materials	3.84

Very important

Not important

Question: What factors / information did you consider when appointing an asset manager? Please rate in terms of importance. (1 very important; 5 not at all important)
Sample base: 33 respondents; unweighted

Investors that used advice from an investment consultant	
Management fee	1.91
Reputation of fund manager	2.19
Specialisation in your area of interest	2.19
Past performance of manager	2.23
Investment consultant recommendation	2.25
Terms and conditions	2.37
Other fees	2.39
Range of funds available	2.66
Rating of funds	2.68
Size of funds	2.71
Fund / investment documentations	2.74
Performance fee	3.00
Brand	3.47
Marketing pitch	3.53
Marketing materials	3.87

Very important

Not important

Question: What factors / information did you consider when appointing an asset manager? Please rate in terms of importance. (1 very important; 5 not at all important)
Sample Base: 31 respondent; unweighted

50. The majority of respondents said that they could easily source the information that they needed to inform their choice of asset manager. In addition, they found the information easy to understand. Respondents suggested that most of the information they needed could be sourced from the investment management agreement (IMA). However, a couple of areas were identified as difficult to source.

- Transaction information was highlighted as an area where investors found it difficult to get information. The likely volume of transactions and associated costs were not clear.

- Cost information, generally, was identified as an area for improvement. Although most institutional investors found that this information was available if it was requested, asset managers did not always willingly volunteer it.

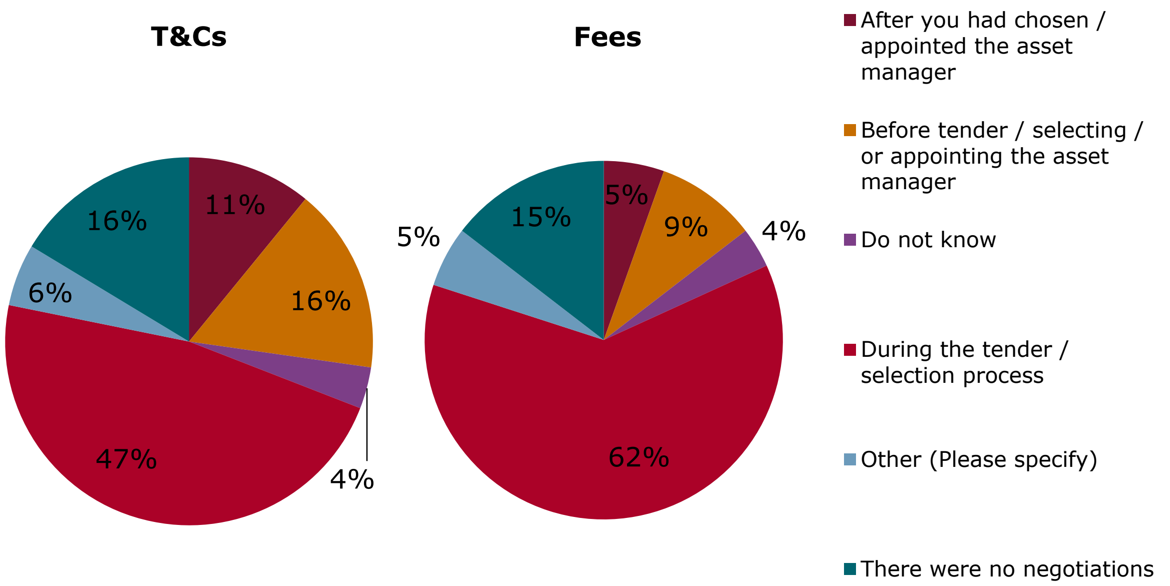
51. Although management fees and fees generally were rated as important factors, 27 investors (39%) responded that they did not know the AMC fee level or management fee for their largest strategy.

Ability to negotiate with asset managers

52. Most negotiations (59%) were undertaken directly by institutional investors. 24% were undertaken by their investment consultant. For 15% of respondents, no negotiations took place; these were all schemes with less than £50m of assets.

53. The majority of negotiations on fees and terms and conditions took place during the selection process. In line with the above finding, for around 15%, there were no negotiations on either fees or terms and conditions.

Figure 16 - When negotiations happen on T&Cs



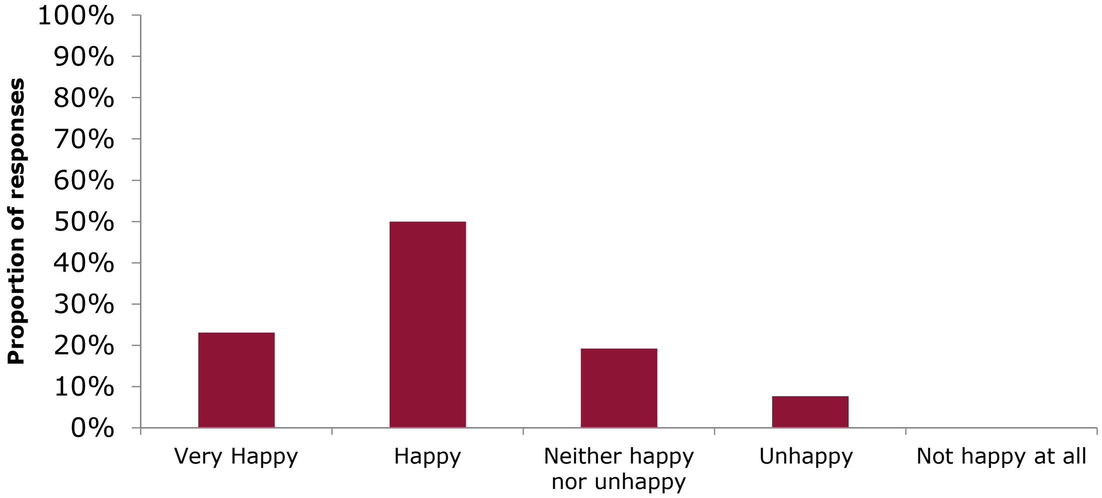
Question: When you last selected an external asset manager, at what stage of the process did negotiations happen on; Terms and conditions? Fees?
Sample base: 55 respondents; unweighted

54. We find that the scale of investor assets are likely to be important in securing better fees from asset managers. We found that there is an inverse relation between the level of fees paid and the size of assets in the institutional investor's largest mandate or fund. [19]

55. Most respondents to the survey were happy with the terms and conditions received. However, 8% of respondents indicated they weren't happy.

[19] OLS regression of fees against log of AUM for largest strategy, coefficient = -0.59, P value= 0.02.

Figure 17 – How happy respondents were with T&Cs



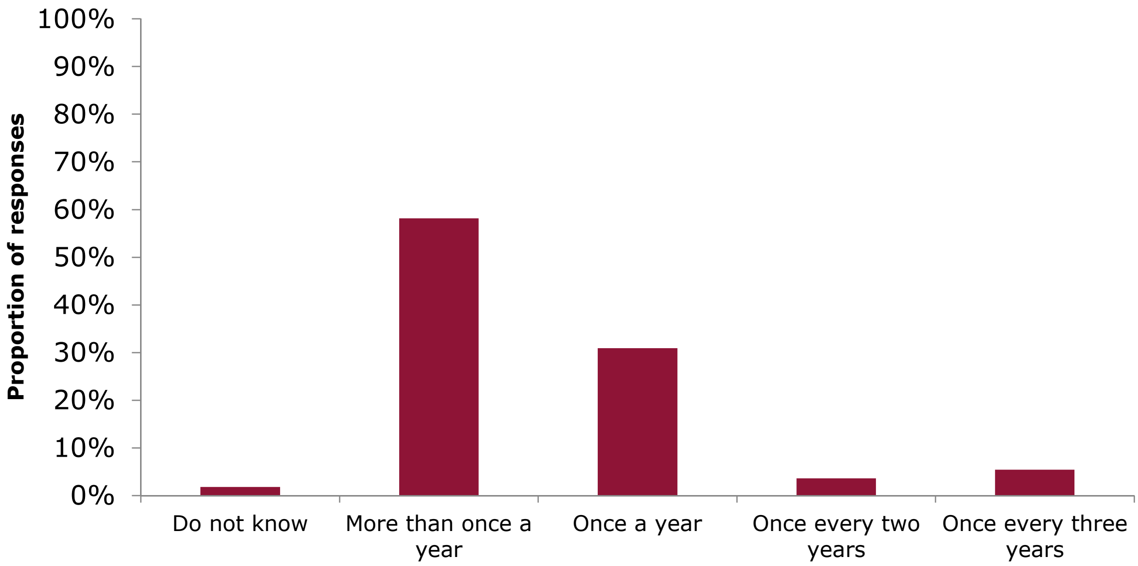
Question: Still thinking about the external asset manager that you last selected, how happy or unhappy were you with the specific terms and conditions? (1 very happy; 5 not happy at all)
Sample base: 55 respondents; unweighted

56. For those that were not happy, most respondents were able to get areas of concerns with specific terms and conditions amended. However, 21% said they were unable to do so.[20]

Manager performance

57. Evaluations tended to happen quite frequently, with around 60% of institutional investors saying that they evaluated asset managers more than once a year. Around 30% evaluated them once a year and 10% evaluated them less frequently.

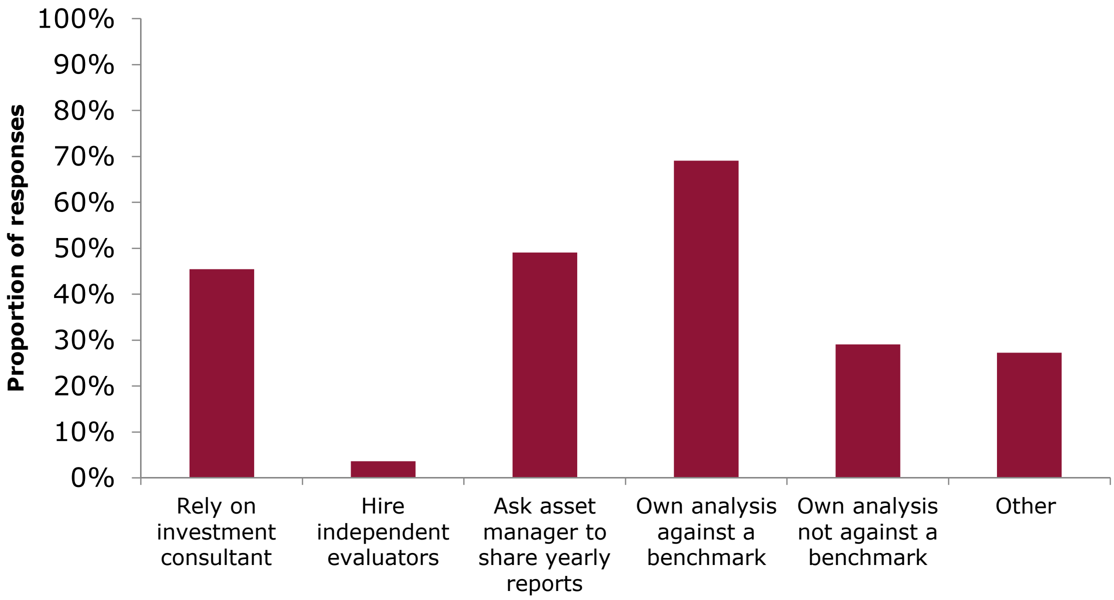
Figure 18 - Frequency of evaluating asset managers



Question: How frequently do you (or an external evaluator such as investment consultant) usually evaluate the performance of your asset manager(s)?
Sample base: 55 respondents; unweighted

[20] Sample 34, excluding those who answered N/A

Figure 19 - Ways respondents carry out asset manager evaluations



Question: How do you evaluate the performance of your asset manager? (Please select all that apply)
Sample base: 54 respondents; options were not mutually exclusive; unweighted

58. The typical approach to assessing asset manager performance for our respondents was for the institutional investor to carry out the analysis themselves against a benchmark. Many relied on investment consultants in carrying out evaluations as well as reviewing annual reports by their asset managers. Hiring an independent evaluator was less common.

59. On average, the measure rated as most important when evaluating asset manager products and services was relative net performance. This was the case across size categories. However we found that the importance of net performance was rated higher for smaller institutional investors (less than £50mn) than for larger investors (greater than £50mn). For larger investors, managing the fund to the documentation (such as ensuring asset managers comply with the mandate)[21] was rated as more important than was the case for smaller investors. Charges and fees were an important consideration across all size categories.

Figure 20 - Average relative importance of factors used when monitoring managers

Average score (1 – very important; 5 – not very important)

ALL		
Relative net performance	1.19	Very important
Managing fund mandate according to documentation	1.90	
Charges and fees	1.90	
Quality of service	2.02	
Relative gross performance	2.06	
Staff access	2.38	
Funding levels	3.28	Not important

Question: What information / factors do you consider when evaluating asset manager products and services? Please rate in terms of importance. (1 very important; 5 not at all important)
Sample base: 52 respondents; unweighted

[21] Refers to the asset manager following the approach set out in the fund documentation

Figure 21 - Average relative importance of factors used when monitoring managers, split by size of investors

Average score (1 – very important; 5 – not very important)

Investor AUM - Less than £50m	
Relative net performance	1.00
Relative gross performance	1.94
Charges and fees	2.05
Quality of service	2.17
Managing fund mandate according to documentation	2.41
Staff access	2.50
Funding levels	3.38

Very important

Not important

Sample base: 18 respondents; unweighted

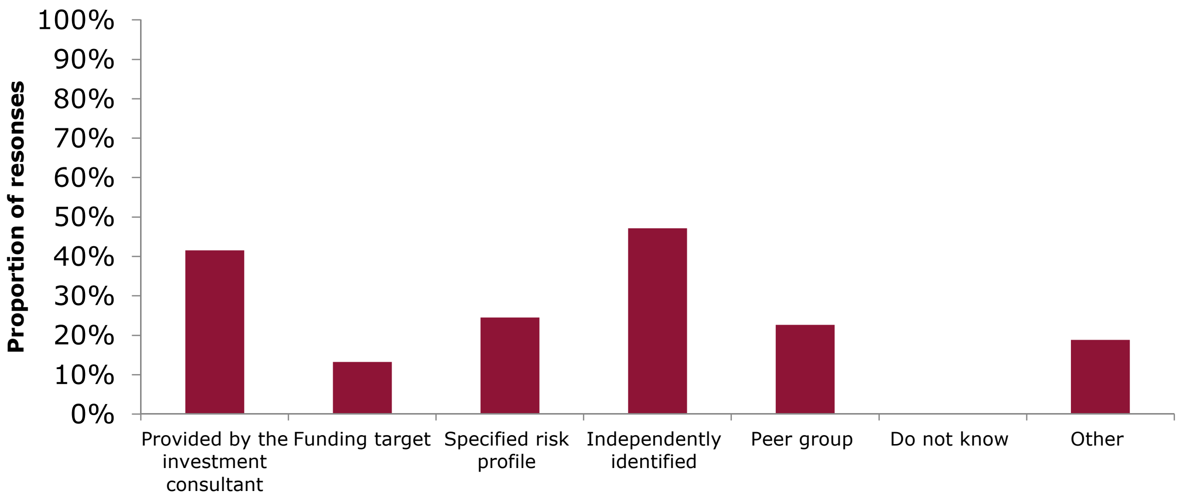
Investor AUM - Greater than £50m	
Relative net performance	1.30
Managing fund mandate according to documentation	1.64
Charges and fees	1.82
Relative gross performance	1.94
Quality of service	2.13
Staff access	2.31
Funding levels	3.23

Very important

Not important

Question: What information / factors do you consider when evaluating asset manager products and services? Please rate in terms of importance. (1 very important; 5 not at all important)
Sample base: 32 respondents; unweighted

Figure 22 – Benchmarks used when assessing performance



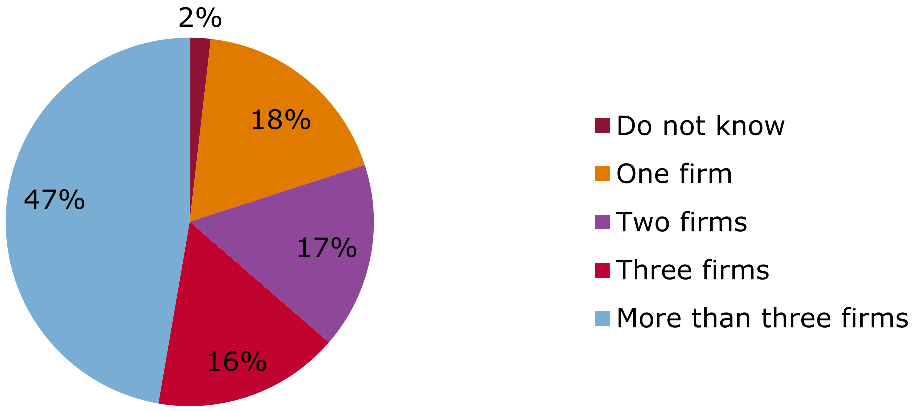
Question: Where you have indicated that net or gross performance of funds / mandates is an important or very important factor (i.e. selected 1 or 2 in the above question), please indicate which benchmarks or targets you compare performance. (Please select all that apply)
Sample base: 53 respondents; options were not mutually exclusive; unweighted

60. It was common for institutional investors when assessing performance to use benchmarks recommended by the investment consultant and benchmarks they had independently identified. Peer group benchmarks and specifying a risk profile are also popular tools for assessing performance against.

Switching asset manager

61. The majority of respondents used more than one asset manager (80% of respondents). 18% used only one. Of those that used only one, 80% of these were small investors (i.e. less than £50mn in assets).

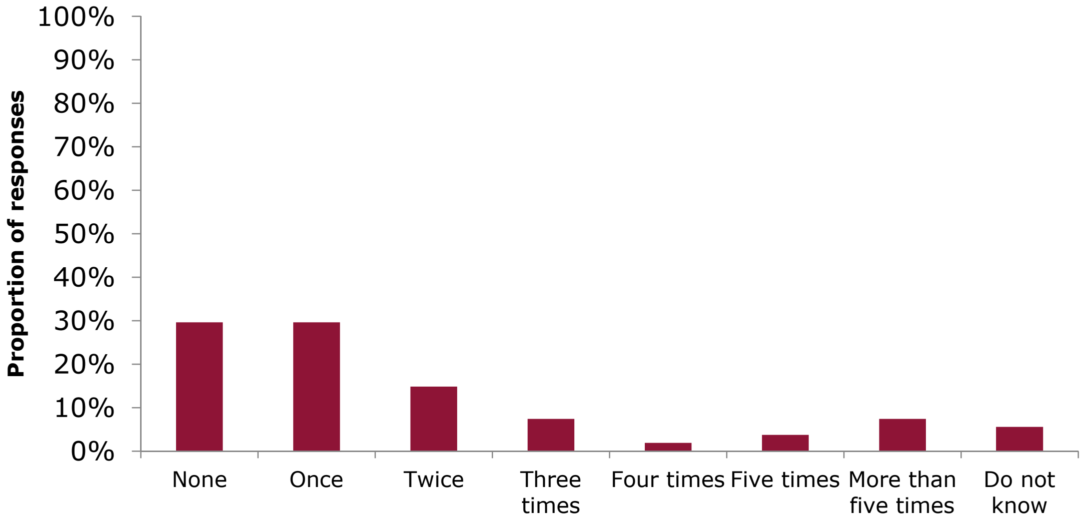
Figure 23 - Number of asset managers used by respondents



Question: How many external asset management firms do you procure products and services from?
Sample base: 55 respondents; unweighted

62. 30% of respondents had not changed asset manager within the same investment category e.g. UK equity manager, over the last five years; and another 30% had changed asset manager only once. This lower level of switching was more common amongst small investors (80% of small investors, i.e. less than £50m in assets, had switched once or less in the past five years) than larger investors (more than £50m in assets) where only 47% had switched once or less in the last five years.[22]

Figure 24 - Level of switching in last five years (% of responses)

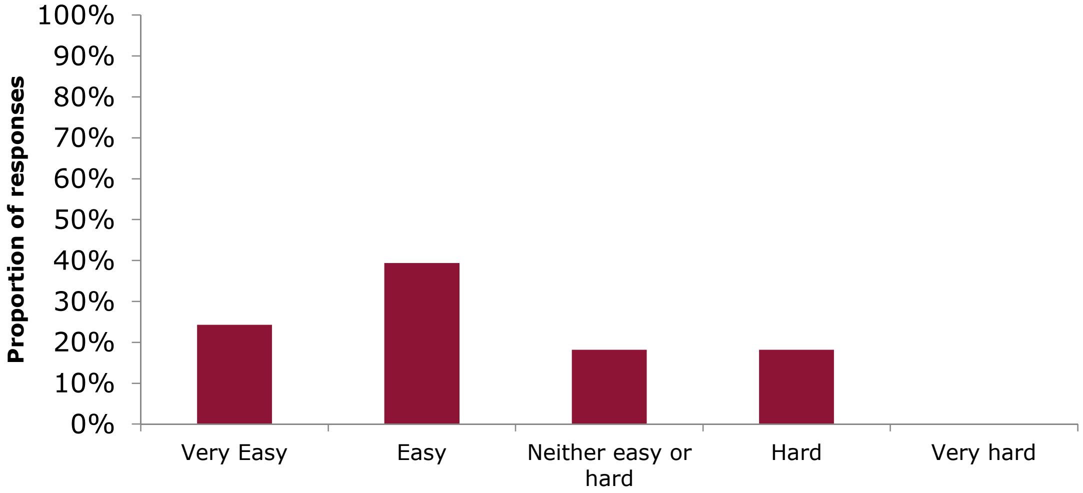


Question: How many times in the past five years have you changed manager within the same investment category? (For example, changing asset manager within a UK equities investment category)?
Sample base: 54 respondents; unweighted

[22] Statistically significant at 95% confidence level using Chi^2 and Fischer exact test

63. Of the 65% of respondents who switched in the last 5 years, most ranked switching asset manager as easy or very easy (65%), around 20% of respondents found it hard.

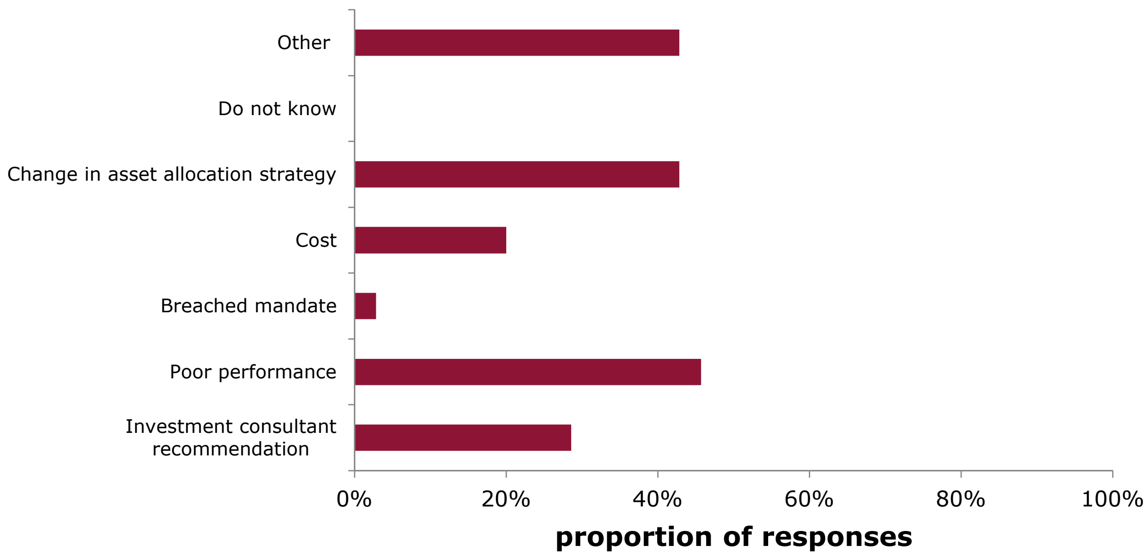
Figure 25 - Difficulty switching asset manager (% of responses)



Question: Overall, how easy or difficult was it for you to switch asset manager? (1 very easy; 5 very difficult)
Sample base: 33 respondents; unweighted

64. The respondents to the survey that had switched asset managers did so for a number of reasons. The main reason was poor performance or a change in strategy. Investment consultant recommendations also appear to be a strong driver of switching. Some additional reasons they provided for switching included: they lost faith in the asset manager's ability to deliver due to under-performance; it reflected their current investment strategies and they expected the pace of switching will slow down in subsequent years; change of personnel; poor reporting; deviation from strategy (rather than a strict breach); the manager withdrew from the market; and questionable competence of the asset manager.

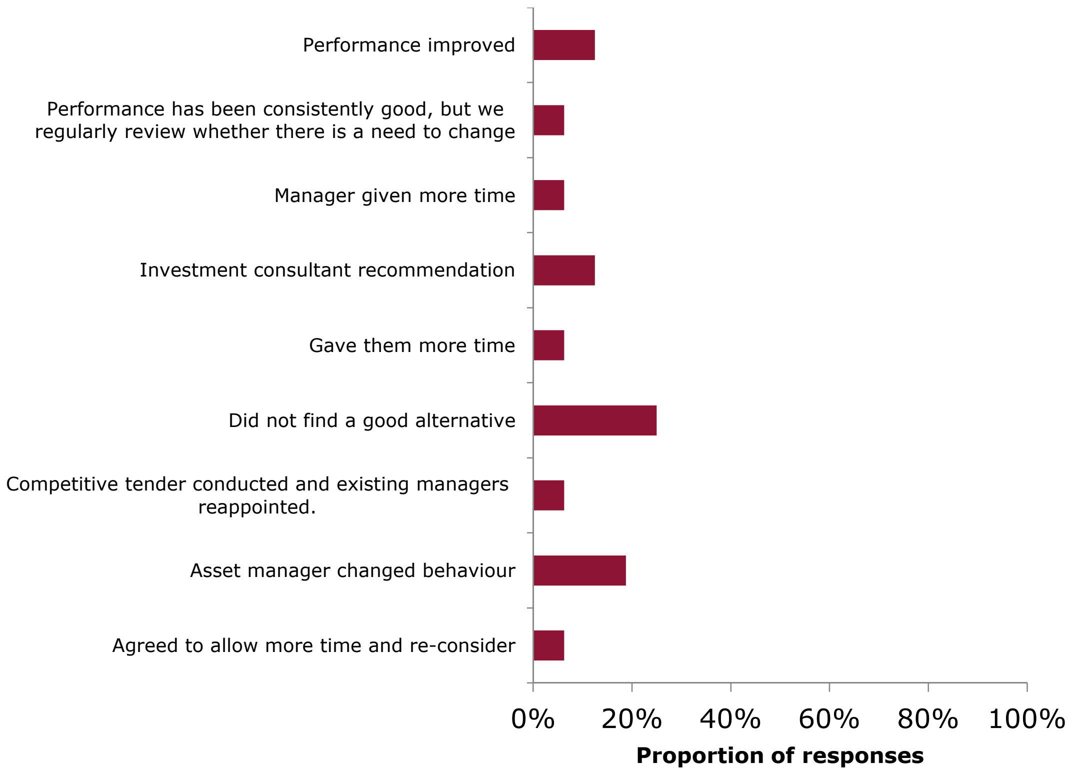
Figure 26 - Driver for switching asset manager



Question: What tended to be the main triggers for changing asset manager? (Please select all that apply)
Sample base: 35 respondents; responses were not mutually exclusive; unweighted

65. 30% of respondents said that they had considered switching but then did not. The most frequent reason given for why they did not switch was that they could not find a good alternative. Others were for positive reasons, for example, the asset manager changed behaviour and/or performance improved.

Figure 27 - Reason for not switching after considering it



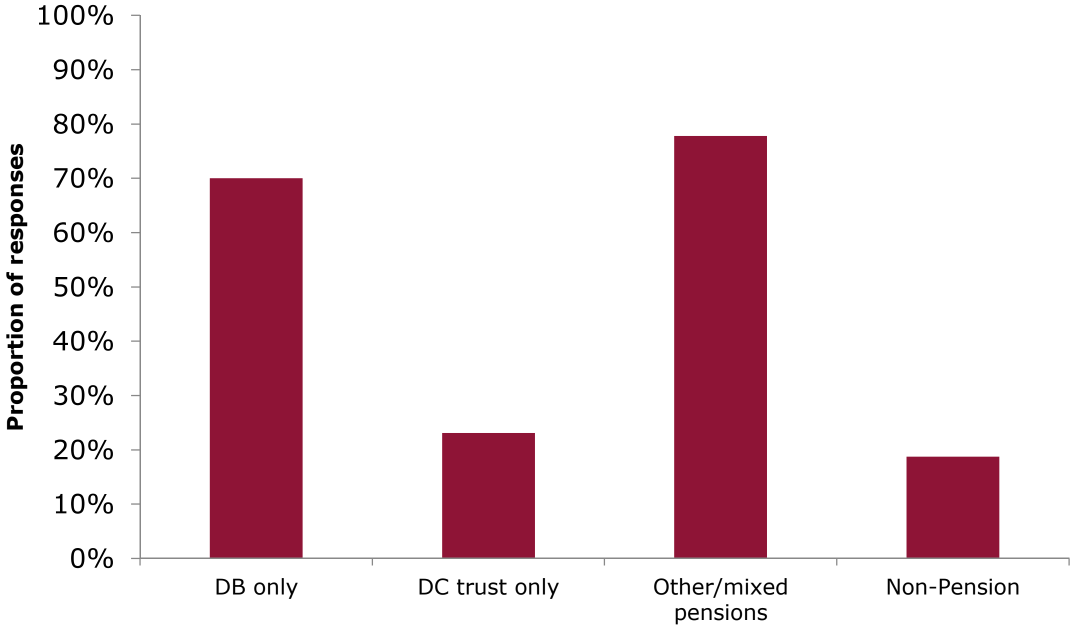
Question: Have you in the past five years, considered switching asset manager but did not?
Sample base: 16 respondents; responses were mutually exclusive; unweighted

Role of investment consultants

66. This section sets out the survey results related to the role of investment consultants. It provides an overview of the types of services procured from investment consultants, as well as the perceptions of respondents on what value for money from investment consultancy services looks like, and their views on whether they are receiving good quality advice from investment consultants. It also explores the ability of investors to effectively monitor and switch between consultants.

67. A subset of all respondents answered this section i.e. the 49% of respondents that had said that they had procured services from an investment consultant. The respondents are mainly DB pension schemes (75% of respondents in this section) and pension schemes with more than £50mn in assets (68% of respondents in this section). It also captures some DC trust, contract based and non-pension investors.

Figure 28 - Proportion of respondents which procured services from investment consultant by type of investor



Question: Do you procure services from an investment consultant?
Sample base: DB trust based schemes only- 20 respondents; DC trust based schemes only – 26 respondents; mixed pensions – 27 respondents; and non-Pension – 16 respondents.

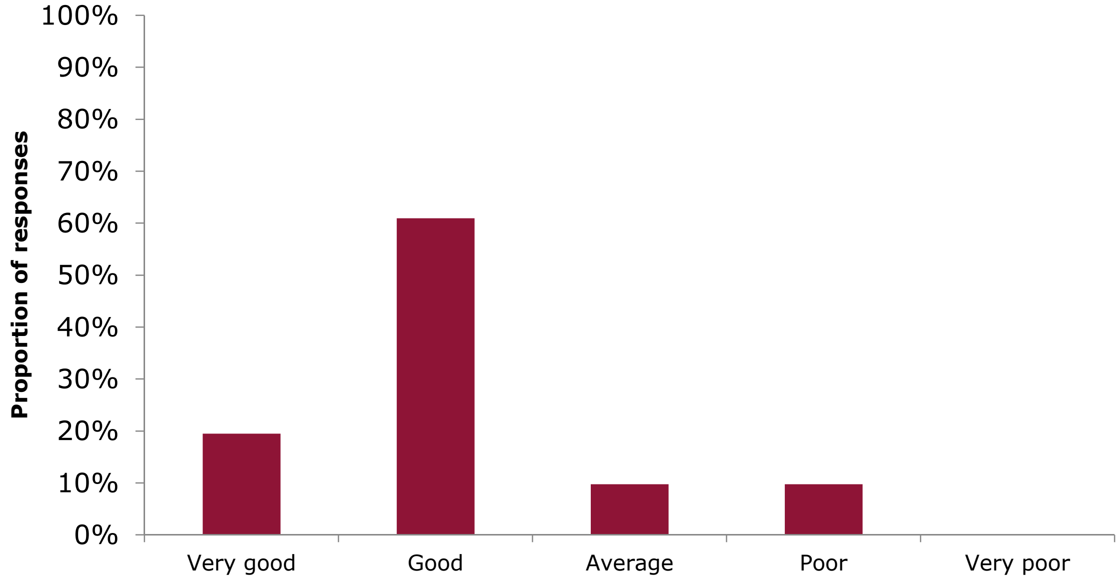
68. A high proportion of other/mixed pension schemes (78%) and DB schemes (70%) use investment consultancy services. The proportion of DC trust based schemes and non-pension schemes that draw on investment consultancy services are much lower (around 20%). From our information request to investment consultants, we know that many investment consultants provide services to non-pension scheme investors, such as charities and insurance firms.

Quality of advice received from investment consultants

69. Respondents, in general, feel that they are receiving good quality advice from their investment consultants. 81% thought they were getting good or very good quality of advice from their investment consultant. Around 10% felt that they were getting poor advice.

70. Of those respondents that said they had received poor quality advice from their investment consultant, the majority worked with the consultant to improve the quality of advice. A small proportion sought recourse, stopped using their investment consultant and/or switched to another provider.

Figure 29 - Views on quality of investment consultant advice (% of responses)



Question: How do you describe the quality of the advice you usually receive (1 very good quality; 5 very poor quality)
Sample base: 41 respondents; unweighted

71. We asked respondents what value for money from investment consultants services looked like to them. They highlighted a number of factors. Including:

- **Evidence that advice leads to good performance outcomes:** Advice has to clearly lead to good decisions and outcomes. The outcomes the investment consultant must achieve vary depending on the individual investor objectives. For example, some suggested that advice needed to lead positive investment returns (net money weighted returns for consistency with liability measurement) and exceed actuarial funding requirements by a margin over a three year period.
- The track record of the consultant was also important for some. The consultant needed to demonstrate five to ten year evidence that their advice on strategy, fund type and asset manager recommendations, had been effective.
- The consistency with which high quality advice was provided was highlighted as particularly important.
- **Able to demonstrate strong understanding of client needs:** It was important that trustee and company views were listened to and taken into account. For DC schemes, there was also an emphasis on the consultant having a strong understanding of the membership base, and this actively shaping their recommendations.
- **Clear presentation of recommendations, backed by evidence:** advice which is well presented, pragmatic and clear was highlighted as important. Targeted answers to questions were also highlighted as valuable, as well as proposed strategies being clearly underpinned by the evidence.
- **Provides cost effective solutions:** Here respondents highlighted the importance of not getting 'fee surprises' and that fees were competitive. Implementation of strategies needed to be taken forward in a cost effective manner.

- **Strong research capability:** This was an area that institutional investors valued.
- **Ability to generate innovative solutions:** Respondents placed value on consultants being good at idea generation and see this as a significant area where they can add value.

72. A couple of the larger institutional investors (greater than £1bn in assets, one managed a DB scheme, the other managed both a DB and DC trust based scheme), mentioned in their response that they were moving away from using investment consultants in the traditional way, in order to achieve value for money. For example, traditionally schemes have used a single investment consultant. They are now using a range of consultants and tendering for consultants to deliver bespoke projects.

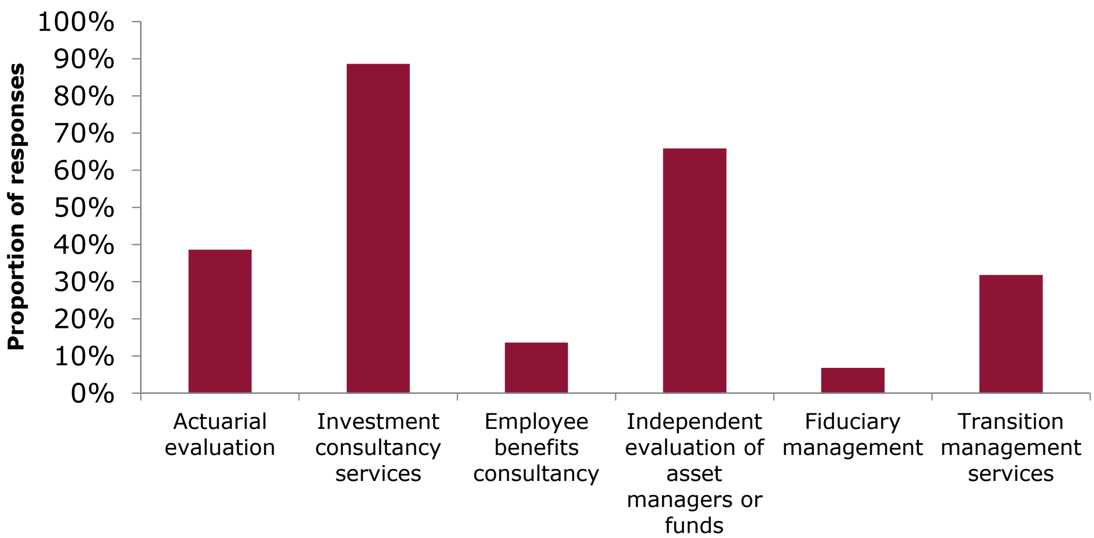
73. One respondent raised a concern that investment consultants did not add value, yet they were required by legislation to use them. In addition, concern was raised about investment consultants moving into the provision of fiduciary management services as well as other asset management products and services.

Services institutional investors procure from investment consultants

74. Respondents mainly used investment consultants for their investment consultancy services. However, respondents also used other services from investment consultants including their independent evaluation services (usually to review asset manager performance) as well as their actuarial evaluation services. To a lesser degree, they use investment consultant employee benefit consultancy, fiduciary management and transition management services.

75. 21% of all 89 respondents indicated that they had assets which were managed by an investment consultant in a fiduciary management arrangement. All of these schemes had less than £50mn assets and they tended to have the majority of their assets in these arrangements. In this section only 8% of respondents suggest they have such an arrangement in place. This appears to be the result of many respondents not completing the full survey.

Figure 30 - Services being procured from investment consultants (% of respondents who procured services)



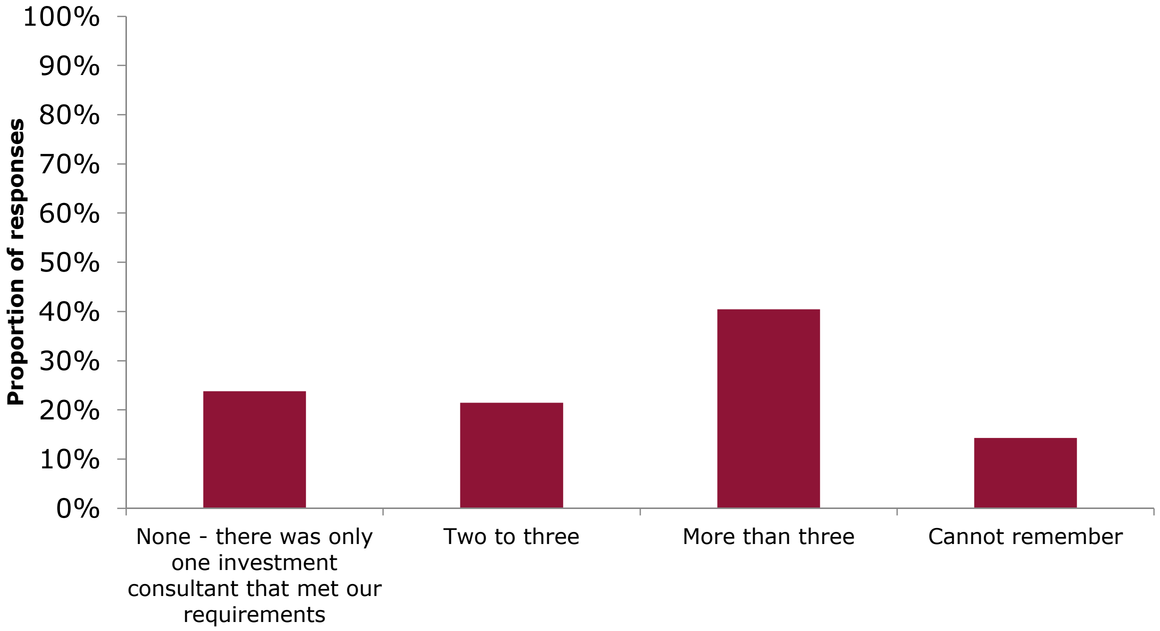
Question: Which of the following services do you procure from investment consultants? (Please select all that apply)
Sample base: 44 respondents; unweighted

76. Of the investors procuring services from an investment consultant, 77% used only one provider, 16% used two or three consultants and 7% used four providers. Those using multiple providers all had assets greater than £50m.

Choosing an investment consultant

77. When selecting an investment consultant, almost a quarter of respondents said only one investment consultant could meet their requirements and 40% said that more than three consultants could meet their requirements. Smaller respondents perceived a greater lack of choice than larger respondents. 8%[23] of respondents with assets lower than £50m indicated they had a choice of more than three investment consultants that could meet their requirements compared with 53%[24] of respondents with assets over £50m.[25]

Figure 31 – Number of investment consultants available to choose from (% of responses)



Question: Given your requirements, how much choice did you have when appointing your last investment consultant?
Sample base: 42 respondents; unweighted

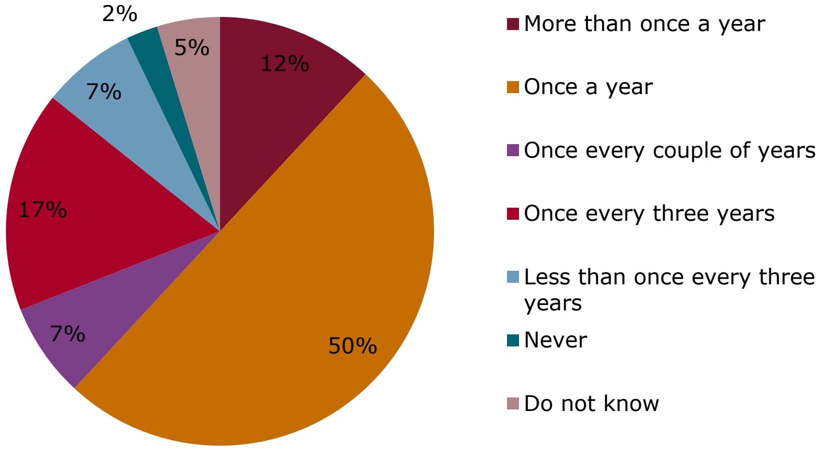
Monitoring investment consultants

78. Generally advice is monitored frequently. 50% of respondents said they reviewed advice once a year and 12% reviewed advice more frequently than this. 7% said they reviewed advice less than every three years

79. When reviewing advice, 79% considered the advice they had received over a horizon covering three to five years.[26] 21% said they reviewed advice over a period shorter than three years. None used a longer timeframe.

[23] Sample is only from 12 responses
[24] Sample of 30 responses
[25] Statistically significant at 95% confidence level using Chi^2 and Fischer exact test
[26] Sample of 38 responses

Figure 32 - How frequently advice is reviewed



Question: How frequently do you evaluate the quality of advice provided by your investment consultant(s)?
Sample base: 42 respondents; unweighted

80. We asked respondents how they reviewed investment consultant advice. Many respondents told us how they reviewed and evaluated investment consultant services more generally. These methods included:

- **Competitively tendering** for investment consultancy services was the main way institutional investors tested whether their current investment consultant was delivering value for money.
- **Industry surveys and surveys of trustee experiences**: this included surveys to seek trustee views on aspects of service provided by the investment consultant, but also sometimes included industry surveys on fees which helped trustees benchmark the cost of their consultancy service.
- **Professional trustees** can also play an important role. Their experience from sitting on other trustee boards and seeing how other investment consultants work and operate, allows comparisons to be made on whether the current consultant is appropriate.

81. In terms of the types of factors that are evaluated, respondents typically:

- Compared investment outcomes as a result of investment consultant advice and checked whether they achieved the stated objectives.
- Benchmarked costs across the sector.
- Evaluated the quality of the service received, reviewing a range of softer factors such as how quickly consultants responded to queries, the quality of the training they provide, and clarity of papers and communications.

82. Usually the evaluation of investment consultant advice and services is carried out by the trustee board. However, in other cases the in-house investment team (where applicable) may complete the review and in some cases an external evaluator is asked to review the advice and service provided to trustees.

Challenging investment consultants

83. One third of respondents said they rarely challenged investment consultants, and two thirds responded that they regularly challenged consultants.[27]

[27] Sample of 42 responses

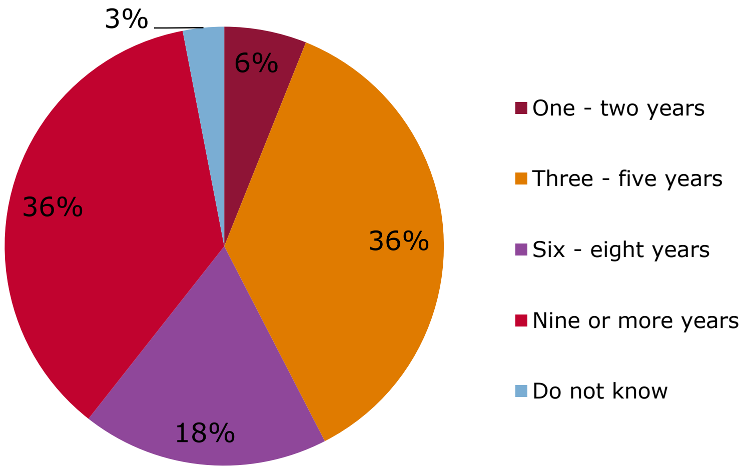
Fiduciary management

84. Insufficient respondents[28] answered these questions to draw conclusions.

Switching investment consultant

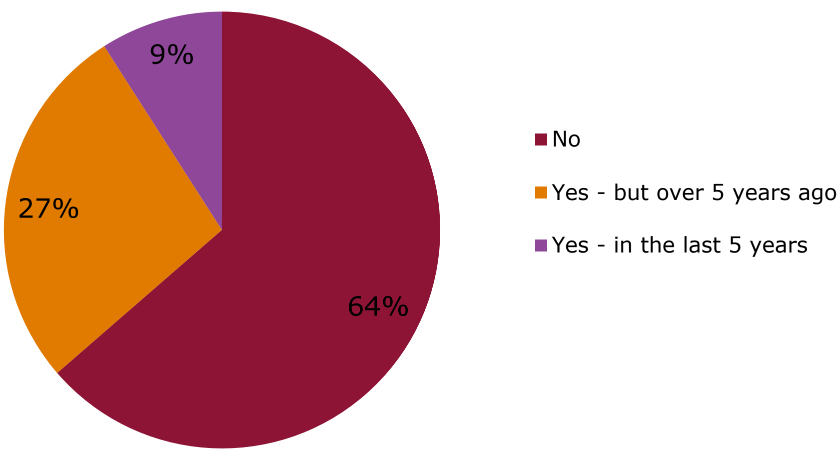
85. Institutional investors stay with their investment consultant for long periods of times. 36% of respondents had been with the consultant that they do the majority of their business with for over nine years. A significant proportion had been with their current consultant for six to eight years (18%), with the remaining 42% having been with their consultant for five or less years.

Figure 33 - Length of time with investment consultant they did the majority of their business



Question: How long have you been with your current investment consultant provider? Where you procure more than one investment consultant, please answer this question in relation to the investment consultant you use for the majority of your business.
Sample base: 33 respondents; unweighted

Figure 34 – Switched investment consultant provider



Question: Have you ever switched investment consultant provider?
Sample base: 33 respondents; unweighted

[28] Only three respondents completed this section

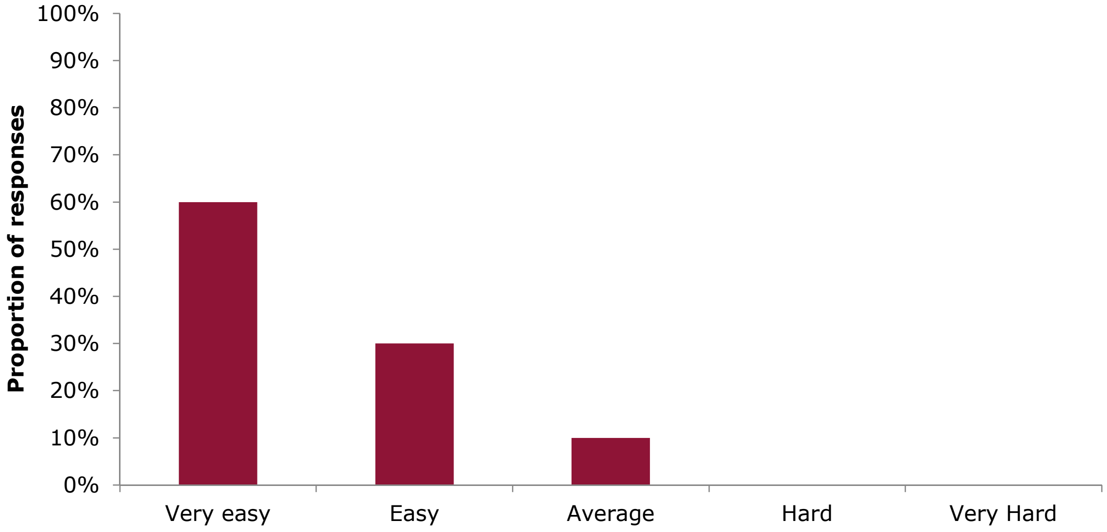
86. 64% of respondents had never switched investment consultant in the last five years. 27% had switched but not in the last five years. Only 9% of respondents to our survey said they had switched investment consultant in the last five years.

87. For those that switched investment consultant provider, a range of reasons were provided:

- Poor advice and, in some cases the poor communication of advice,
- High cost of investment consultant advice,
- Disillusionment with level of service provided and time taken to implement strategic change,
- Consultants' poor knowledge
- Consultant's not being pro-active enough,
- Another consultant demonstrated ability to provide a better value added service as demonstrated through tender process, and
- Dissatisfaction with performance.

88. Those investors who had switched investment consultant[29] typically found it easy. 90% of respondents who had switched found it was easy or very easy.

Figure 35 – Ease of switching (% of those who have switched)



Question: Thinking about the most recent time you switched investment consultant provider, please provide an indication of how easy or difficult you found it to switch? (1 very easy; 5 very difficult)
Sample base: 10 respondents; unweighted

89. 30% of respondents said that they had considered switching in the past five years but had not switched[30]. Of those that did not switch, the main reason given was that they could not find a good alternative provider. The second most frequent reason was that the process of switching was too resource intensive. It was noted that in some cases they didn't switch because either as performance improved or the investment consultant behaviour changed.

[29] Sample of 10 respondents
[30] Sample of 33 respondents

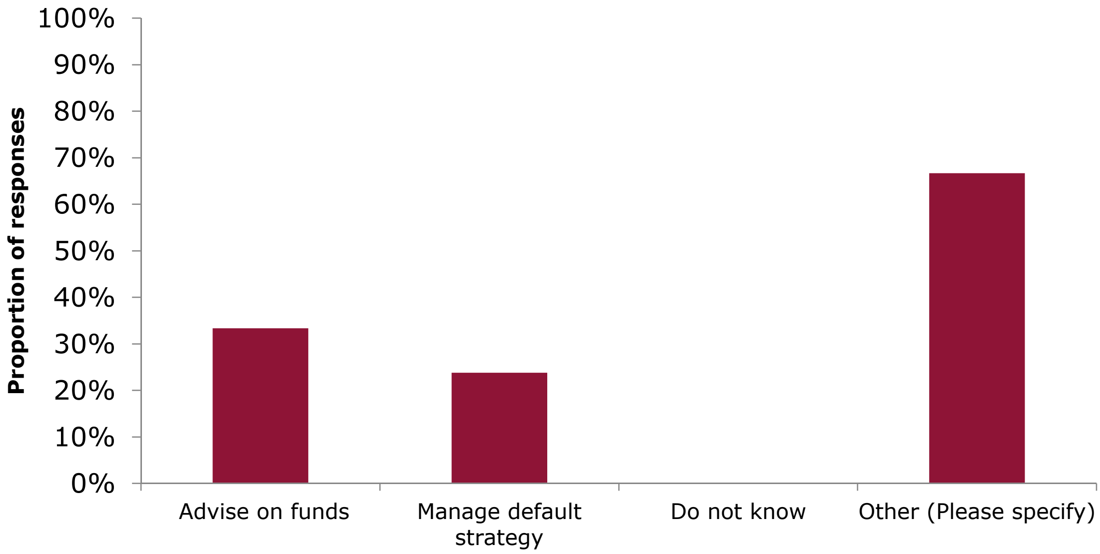
Role of employee benefit consultants

90. For this survey employee benefit consultants (EBC) refers to providers of advisory and administrative services in relation to pension schemes by providers that are not investment consultants.

91. 24% of all respondents answered this section. As expected the majority of respondents to this section are DC contract and trust based schemes (62% of respondents to this section). However, almost a quarter that responded to this section had a DB only scheme. The remaining respondents were non-pension scheme investors. In terms of size, 43% of respondents had assets of less than £50mn. Almost a quarter had assets of £1bn or more.

92. Of the respondents that procured services from an EBC, a third procured advice on funds and 24% used an EBC them help to manage the default strategy. [31] Other services investors told us they used included monitoring scheme design and scheme administration. Some respondents also listed actuarial services. Those institutional investors were not DC contract or trust based schemes tended to procure EBC services in the 'other' category and no other type of EBC service. These institutional investors did not procure advice on funds or services to help them manage their default strategy.

Figure 36 - Services EBC clients procure



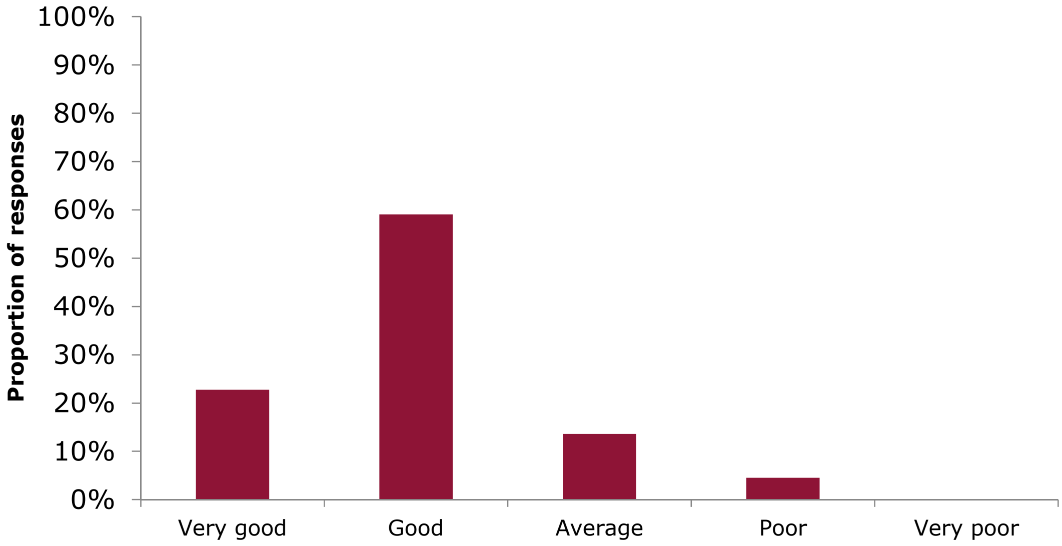
Question: What do they [EBC provider] advise on? (Please select all that apply)
Sample base: 21 respondents; unweighted

93. Of those respondents that procured some kind of service from an EBC, 23% were not procured as part of a competitive tender.

94. As with investment consulting, most respondents (around 80%) viewed the service provision as being good or very good value for money. Fewer than 5% said they had received poor value for money.

[31] Sample of 21 respondents

Figure 37 - EBC quality (of services) score (% of responses)



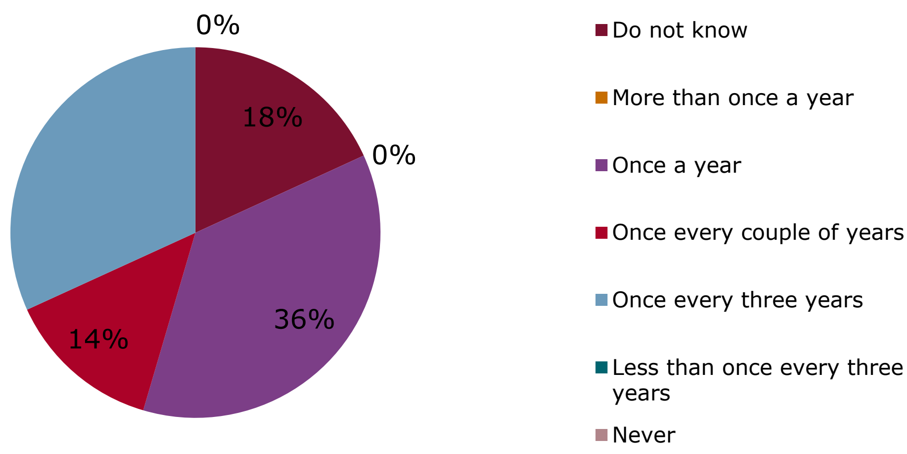
Question: How do you describe the quality of EBC services you receive? (1 very good quality, 5 very poor quality)
Sample base: 21 respondents; unweighted

95. Of those that received poor quality services from their EBC, the majority worked with the EBC to improve quality (78%) and only 11% switched provider.

Evaluating/ monitoring EBCs

96. Most institutional investors monitored EBC services at least every three years, with 36% monitoring them annually. None reviewed less than every three years.

Figure 38 - Frequency of evaluating EBC services[32]



Question: How frequently do you evaluate the quality of these EBC services?
Sample base: 22 respondents; unweighted

97. In addition to the frequency of evaluating EBC services we also asked for the time horizon over which investors evaluated their services. The response was usually over three to four years (56% of respondents).[33] 11% evaluated over more than a

[32] Categories "more than once a year" and "less than once every three years" received no responses.
[33] Sample of 18 respondents

four year period. 17% evaluated their service over a year and 17% over two years.

98. Respondents told us that they evaluate EBCs in different ways. The approaches tended to fall into the following categories:

- **Competitive tender, to test the market:** This again, is a key way used to test whether they are achieving sufficient value for money from their existing provider, compared to other providers.
- **Formal surveys of trustees, employees and the employer:** In some cases they sought the views of a range of stakeholders on their experiences of the EBC, in particular the EBC's responsiveness to queries and timeliness of responses.
- **Review effectiveness of recommendations and outcomes:** in some cases they may consider whether the EBC fulfilled the mandate given to them and within the service agreement timelines, against benchmarks. Reviewing performance against defined Key Performance Indicators (KPI) was another way this was evaluated.
- **Review of information provided to trustees:** some mentioned that they would review the quality of work/ information provided at board meetings as well as the quality of the consultant/ trustee relationship.
- **Seek professional trustee views:** Guidance from professional trustees was important for one respondent.
- **Benchmarking costs:** again, one respondent said they considered whether costs are set at the right level by carrying out peer fee analysis.

Overall views on satisfaction with the asset management industry

99. A quarter of respondents said they were unhappy with specific parts of the asset management or investment consulting services they procured. When asked what elements they were not happy with and how the industry could be improved, the responses fell under the following categories.

Fee levels and fee structures

100. Many suggested fee levels were too high. This was in relation to both investment consultant and asset management products and services. One respondent mentioned that investing in certain asset classes is restricted, due to the high asset management fees. They did not specify which areas.

101. Fees for private market exposures were identified as very high. In addition, concern was raised that performance fees are asymmetric and should be more equitable.

102. Fee structures for both investment consultants and asset managers were flagged as concerning. Investment consultants' tendency to charge per hour was identified as incentivising providers to recommend more complex strategies. In addition, concern was raised that consultants face no penalty (financially) if their recommendations do not perform well. One respondent suggested that this was not satisfactory.

103. The industry practice of asset managers charging ad valorem fees was seen as problematic. It was felt that charging as a % of assets invested meant that the price rose much quicker as assets invested increased, than the cost of servicing those assets.

Cost transparency and comparability

104. In general, it was identified as difficult to get meaningful cost comparison information between asset managers. A couple of areas where it is particularly difficult were identified:

- One respondent mentioned that it was difficult to obtain gilt and other bond prices and historical returns.
- Defined contribution was an area where it was identified as particularly in need of more transparency.

Poor quality of reporting/unnecessary complexity and jargon

105. Many flagged that there is too much industry jargon used in communications with trustees.

106. One respondent said they would like to see asset managers with more expertise on life insurance company requirements (in relation to Solvency II), as well as the management of inflation and interest rate risk.

Inflexible and unresponsive to client needs

107. Some respondents noted that investment consultants are particularly inflexible and unresponsive to client needs. Here the concern is that consultants give too much focus to the larger managers and strategies that they can then add to their buy list and promote across their client base. This makes it harder for smaller schemes to access smaller funds or ideas.

108. In addition, timing was raised as an issue. Consultants were seen as taking too long to research managers and strategies and can be slow to react to a worsening position, because of the time it takes to research and review managers.

109. Institutional investors also felt they could not negotiate to change the terms of pooled funds, or influence the instruments used, for example, influence use of derivatives and the range of permissible instruments. One noted that they had to either accept the package as proposed or walk away.

Conflicts of Interest

110. A large number of respondents highlighted the conflicts inherent in investment consultants offering their own fiduciary management arrangement to their clients.

Herding

111. Respondents told us that they found little variation between investment consultants offerings. It was also noted that they can be unwilling to give unpopular advice.

112. Related to the point above about being inflexible, they may only consider adopting a new strategy if they can sell it across their client base. This can result in many of a consultant’s clients adopting the same types of solutions.

Reliance of investment consultant

113. One respondent flagged that there can be real difficulties where Trustee Boards prefer one option, but their investment consultant does not agree. Often in such circumstances trustees will go with their investment consultant’s recommendation as it is seen as the ‘safe option’. It was also flagged (and as is seen by the survey

responses above) that most schemes rely on one consultant for their advice and the 'consultant has probably been in place for many years.'

Improvements

114. In terms of suggestions on how things could be improved, the following were identified:

- Require costs and performance to be reported in a standardised way.
- Require greater separation between the provision of fiduciary management services and investment consultant advisory services to pension schemes, for example, require they are procured from different providers.
- Encourage trustees to seek advice from a range of consultants.

Bi-laterals with institutional investors

115. To explore some of the themes we identified in the online survey in more detail, we met with over 30 trustees/ chief investment officers of primarily pension schemes, but also charities and some insurance firms. We are mindful that the sample of institutional investors that we spoke with did not reflect the wider population. Larger pension schemes, in particular, are over-represented. As such, we take care not to generalise our findings across the whole population of institutional investors.

116. We explored different themes with each institutional investor we met, covering those themes that were most relevant to them. The main themes mirrored the online survey and included:

- Governance
- Asset manager selection
- Monitoring of fund performance, fees and charges
- Investment consultants: their role in the market, investor views on investment consultants moving into the provision of products traditionally provided by asset managers (multi-asset products, fund of fund products, fiduciary management) and the steps taken to evaluate investment consultant advice
- The role of institutional platforms, focusing on DC platforms
- Value for money along the value chain (including custodian and other ancillary services)
- Other issues raised by institutional investors (demand side fragmentation, Liability Driven Investments (LDI), and the impact of the regulatory landscape)

Sample of investors

117. In order to capture the views of different institutional investor groups, we approached pension schemes (which are the largest group of institutional investors), charities and insurance firms and invited them to meet with us. This approach allowed us to explore whether any issues or concerns identified were pertinent across all or only a subset of institutional investors.

118. Within each investor group, we tried to include within our sample, investors of different sizes (in terms of assets invested), governance and organisational structures. We also tried to include representation from institutional investors that procured different types of products and services from investment consultants and asset managers. In particular, we were keen to speak with those that had used an LDI strategy, given concerns about concentration in this sector. We also wanted to speak with those that had used a fiduciary management arrangement with their investment consultant; those that used an institutional platform provider; and those that had managed at least part of their investment portfolio in-house.

119. There were three main mechanisms we used to achieve our sample:

- Those that had indicated in our institutional online survey that they would be willing to meet with us to support the study (50% of institutional investors we met with);
- Trade associations, who put us in contact with their members;
- Those we met through our wider programme of stakeholder engagement.

120. In total we spoke with 30 institutional investors. The majority were pension schemes (24), but we also captured a number of charities and a couple of insurance firms (mainly in the context of them procuring products and services from asset managers in their provision of institutional platforms).

121. The below table provides a summary of the profile of investors in our sample.

Type of institutional investor/ size (in terms of assets)	<£50mn	£50mn-£500mn	£500mn-£1bn	£1bn - £5bn	£5bn-£20bn	Greater than £20bn	TOTAL INTERVIEWED (TOTAL POPULATION)
DB scheme only	1	0	1	0	1	4	**7**
DC trust based	1	0	0	0	0	1	**1**
DC contract based	0	0	0	0	1	0	**1**
Master trusts	0	0	0	2	0	0	**2**
Hybrid schemes (e.g. operate both a DC and DB schemes)	0	1	1	3	6	2	**13**
Insurers	0	0	0	0	0	2	**2**
Charities/ endowment funds	2	1	1	0	0	0	**4**
TOTAL	**4**	**2**	**3**	**5**	**8**	**8**	**30**

122. In terms of the 24 pension schemes and funds we met with, most were larger schemes (19 had assets of more than £1bn). Only five had total assets of less than £1bn. As such, we acknowledge, that the findings presented in this section may overstate the views of larger pension schemes.

123. Within the sample, we spoke with three investors that had fiduciary arrangements in place with their investment consultants and ten that had an LDI solution in place. Three of the pension schemes had an in-house asset management arm.

124. We also spoke to a number of hybrid schemes – where trustees oversee both the DC and DB schemes. In some cases, the schemes were governed separately. We captured a range of these in our sample.

Governance

125. Below we provide an outline of how each of the categories of investors (Pension funds: trust based and contract based schemes; charities and insurance firms) are governed and provide a summary of the nature of their engagement with the asset management industry.

Pension funds: trust based schemes

126. Trust based workplace schemes are generally run and managed by an employer through a board of trustees. The board of trustees has a general duty to act and exercise its powers in the best interests of the scheme members (pension holders).

127. Both defined contribution and defined benefit schemes can be set up as trust based schemes. In January 2016, there were 5,240 defined benefit trust schemes (12% of all pension schemes) with 1.2m active members. There were 24,730 defined contribution trust based schemes (79%) with 4.2 m active members. There are also 980 (2%) hybrid, dual section schemes – the scheme has two sections (one offering DC benefits and the other DB benefits) with 1.2m members.[34]

128. We spoke with a range of trust based schemes, including DB and DC schemes of varying sizes (for example, we spoke with a self-sponsored administration scheme, with less than £50m in assets; and very large schemes, with more than £20bn assets).

129. In many cases employers had both DB and DC schemes (or multiple DB and DC schemes where the employer had been merged with, or acquired by, another firm). Often the DB schemes had been closed to new members. For employers that had both schemes, many were governed by the same trustee board (often referred to as hybrid schemes). The remainder were governed by separate boards.

130. Trust-based schemes can be single-employer schemes or can cover multiple employers that are in some way related (for example, because the employers belong to a parent company) or that are not related in any way (master trust schemes). Our series of bi-laterals included two master trusts.

131. The Pensions Regulator regulates trust based occupational pension schemes, and in particular focuses on the effectiveness of trustees.

The role and composition of trustee boards

132. Trustees set the investment strategy for the scheme (including setting the risk appetite). We found, from our discussions, that trustee boards vary in size. For example some were small (around four members) others were much larger (around twelve members). This is broadly consistent with our survey findings. Trustee boards also vary in structure, with some having a range of committees such as a risk and audit committee, investment committee, policy committee, and/or member communications committees. The composition of board members also varies, with varying combinations of employee nominated members, member-nominated members, employer nominated members, independent or professional trustees. In some cases trustee boards co-opted members onto the board, due to their investment or other expertise.

133. In many cases the size and composition of the board were determined by the complexity and size of the scheme. For example, more complex schemes tended to have a separate investment committee. In these cases, the day to day investment decisions – such as asset allocation and/or manager selection - were delegated to this committee. This was commonly the case for DB schemes that tended to employ more complex strategies and complex investment decisions than DC schemes.

134. In many cases the trustee board or investment committee sought advice from an investment consultant (to fulfil a legal requirement). In some cases, they delegated all or part of their investment decisions to their investment consultant or in some cases an asset manager (in some form of fiduciary management arrangement).

[34] The Pensions Regulator data based on scheme returns, 1 Jan 2016.

135. For large and complex schemes, some trustee boards have set up a subsidiary investment management company. These investment companies can be large, for example, some employed more than 20 staff. The investment company tended to manage the relationships with a range of third party suppliers (custodians, ancillary services, asset managers, investment consultants). In some cases they provided the investment advice and often provided implementation services to the trustees (i.e. implementing the investment strategy set by the trustees). The investment company may have an in-house asset management arm which manages all or some of the pension schemes assets.

136. In other cases, we found the sponsor employer provided resource to support the pension scheme and trustees. This usually took the form of a small investment team comprised of around two to five people – typically this included administration staff, a chief investment officer and chief executive officer of the scheme. They carry out similar services to the investment company, but will solely rely on external asset managers.

137. Usually, many of the smaller pension schemes will not have sufficient resources for an internal investment management team or have sufficient scale to justify setting up a subsidiary investment company. As such, smaller schemes tend to rely much more heavily on investment consultant advice and support. In some cases, it is the investment consultant that leads on managing the relationships with external suppliers. Some smaller schemes will delegate investment decisions related to all or part of their portfolio to investment consultants (in a fiduciary arrangement). This appears to be more common for defined benefit, rather than defined contribution schemes and can allow smaller schemes to gain exposure to certain asset classes that they otherwise would not be able to, given governance constraints. This is the case where they do not have the time, resource or expertise to monitor complex investment strategies that exposure to certain asset classes may require.

Defined contribution schemes versus defined benefit schemes

138. Pension fund trustees of DC and DB schemes focus on different factors. For DB schemes, trustees' focus on reducing any deficit and ensuring they were able to meet their liabilities. The employer has a much greater role, given the pension scheme is reflected on the employer's balance sheet and they face substantial risks if things go wrong, including reputational risk. As such, they are incentivised to get involved in overseeing the pension scheme and are much more willing to put resource into its governance and oversight.

139. In DC schemes, scheme members bear the investment risk and are responsible for deciding how to use their pension savings to provide for retirement. The focus of trustees here tends to be on finding the right products. There is much more work done on understanding the employees and understanding what value for money means to individual pension members – for example, for some this will be access to an internet tool to monitor their own pensions, for others it might be having a wide selection of funds to choose from. The main focus for trustees is ensuring the right 'default' and lifestyle strategy for their members is chosen – given this is where most of their members will end up (more than 90% in most cases). Where trustees oversee both DB and DC schemes a number of investors we spoke with said that the DC scheme can be overlooked. One reason given for this was that the sponsor had no financial stake in DC schemes. To mitigate this, some trustees set up a DC sub-committee or govern the schemes separately (with separate trustee boards).

Pension funds: contract based schemes

140. Contract based schemes are solely defined contribution schemes and involve a contract between each individual member and a product provider (such as an insurance company). There is no direct contractual relationship between the employer and the product provider regarding the pension itself. The pension provider is typically the scheme administrator and there are no trustees.

141. As outlined in table 1 above, there were 2,500 (6% of all pension schemes) defined contribution workplace contract based schemes with 4.2 million members (40%) in January 2016. Although this is significantly less than trust based schemes (there were 24,730 DC trust based schemes), they represent more active members (i.e. 4.2 million active contract based scheme members compared with 3.9 million scheme members in trust based defined contribution schemes).

142. We were told that employers may choose to set up a contract based, rather than a trust based, scheme for a number of reasons:

- Limited time or resource to manage the occupational pension scheme themselves (more likely for smaller firms and schemes) and to dedicate to governance. Instead they outsource this task to a pension provider.
- the scheme employs a simple investment strategy and does not require much governance
- the pension scheme is not a large or important part of the employees' total remuneration, nor a core part of their strategy for attracting and retaining staff.

143. Investment Governance Committees (IGCs) were set up in 2015 to improve the governance of workplace personal pensions, such as group personal pensions (GPPs) and group self-invested personal pensions (group SIPPs). The role of IGCs is to represent the interests of scheme members in assessing the value for money of pension schemes, challenging providers to make changes where necessary.

144. The FCA is responsible for regulating the conduct (and, in some cases, the financial stability) of providers of contract-based schemes.

Charities

145. There were about 12,000 grant making foundations in the UK in 2012. Around 900 generate an income of greater than £500,000 annually and 90% are dependent on investments to fund their activities.[35] In 2012, these 900 endowment funds represented less than one percent of registered charities in England and Wales and in 2012 they had accounted for just over £48.5bn in assets (more than half of total voluntary sector assets in the UK). [36]

146. In 2013/14, five of the largest charities (in terms of assets owned) held almost a third of the sector's net assets (including the Welcome Trust, Garfield Weston Foundation, The Children's Investment Fund Foundation, The Leverhulme Trust, and The National Trust for Places of Historic Interest and National Beauty).[37]

147. For charities, investments are overseen by a board of trustees. Trustees' remit is wider than for pension schemes, with trustees overseeing both how assets are invested and how revenue is spent. Those charities we spoke with suggested that

[35] ACF (2012), The Governance and Financial Management of Endowed Charitable Foundations

[36] ACF (2012), The Governance and Financial Management of Endowed Charitable Foundations

[37] The National Council for Voluntary Organisations (NCVO) (2016), Assets and Reserves https://data.ncvo.org.uk/a/almanac16/assets-and-reserves/

there can be a conflict between time spent by trustees on the investment side versus that spent on deciding what charitable causes should be supported. The latter can at times gain more of the trustees focus.

148. Charities tend to have much more scope when making investment decisions than, for example, pension schemes. An ACF report (2012) notes that 'foundations, unlike pension funds, are not legally obliged to frame their investment objectives to meet the liabilities of known beneficiaries'.[38] As a result, the charities we spoke with noted they can often take on much more risk than pension schemes and have a wider range of options available to them – including those less liquid assets such as infrastructure and property. However, we heard that often, charity trustees do not always take advantage of this scope, as they tend to be risk averse. Some mentioned this is due to the lack of investment expertise.

149. The investment objectives of charities can be broadly similar across all charities – usually involving capital preservation above inflation and income for charitable expenditure. The ones we spoke with had set an absolute return target of a specific percentage above inflation. One also ensured that the percentage was sufficient to cover all costs associated with their investment approach (including costs associated with using advisors and ancillary services).

150. The larger charities that we spoke with had a small team (two people) to support and advise the trustee board. These individuals had investment and financial backgrounds. They tended to work closely with advisors (in both cases investment consultants) to support and advise trustees and work with external suppliers to implement their investment strategy. This aligns with an ACF report (2012) which found that larger and medium sized foundations were likely to have staff, with some of the largest employing their own investment experts. The report also suggests that smaller foundations may have executive and administrative staff to support the trustee body and deliver grant-making and other functions, whereas the smallest foundations may be run entirely by trustees without any paid staff. [39]

151. We heard that smaller charities often have their investment needs looked after by private banks or wealth managers. In addition, smaller charities (less than £50,000) are likely to invest in common investment funds (CIFs), rather than operate segregated mandates, for example[40]. According to one charity trustee we spoke to there are around 32 of these available. These funds receive tax benefits and have specialist managers.

Insurers

152. Those insurers that we spoke with engage regularly with the asset management industry and are providers as well as customers of asset management solutions.

153. Insurers may provide administration and investment management services to DC occupational pension schemes and may operate Group Personal Pension Schemes used by employers and provide individual personal pension schemes. Insurers may operate pension schemes and are often providers of pensions and investment platforms to institutional investors. As part of this, they procure external asset

[38] ACF (2012), The Governance and Financial Management of Endowed Charitable Foundations

[39] ACF (2012), The Governance and Financial Management of Endowed Charitable Foundations

[40] CIFs are registered charities and offer other charities of all sizes a vehicle for the investment of their funds. CIFs are collective investment schemes, and as such provide a way for those entitled to invest in them to diversify their investments in order to spread investment risk. For more information see https://www.gov.uk/government/publications/common-investment-funds-and-common-deposit-funds/common-investment-funds-and-common-deposit-funds-a-basic-guide-to-their-regulation

management services and can, at times, use the expertise of investment consultants.

154. Insurers may also invest premiums. Like pension funds, their strategy has to take into account their need to meet their liabilities (for example, ensuring they can meet insurance claims as they fall due).

155. Insurers typically have a lot of investment experience often within an in-house or subsidiary asset management arm. The scale of their assets (particularly the case for life insurance firms) and their expertise makes them well placed to effectively negotiate and secure value for money from asset managers.

Investment knowledge on oversight committees varies

156. The larger pension schemes we spoke with had a broad range of investment experience on their trustee boards and usually had an investment team with investment experience to support the trustees. All of the trust-based institutional investors we spoke with had at least one individual with investment experience or significant financial experience, represented on their trustee board.

157. It also seemed common to have professional trustees represented on trustee boards and in some cases taking a leadership role, such as chairing. The input of professional trustees was valued across many investors we spoke with. They valued their investment knowledge, and the experience they bring from sitting on other boards. They also valued their independence (especially if the interests of the employer and pension members were not aligned).

158. Many of the investors (small and large) that we spoke with felt that smaller schemes and charities with limited resources were likely to find it difficult to attract and retain individuals with the right level of investment experience. It was also highlighted that there were likely to be regional disparities, with trustee boards of charities and pension schemes in London being more able to secure individuals with the relevant expertise. They expected that outside of London this would be much more difficult. In fact one trustee noted that the fragmentation of the demand side, with many small trust based pension schemes, means that it is not possible for all trustee board members to have investment expertise – even if all individuals with investment experience were willing to be trustees.

159. A number of trustees mentioned that the variation in investment expertise on a given trustee board or investment committee can be a constraint on the quality of discussions. Pitching the information at the right level to ensure engagement from those with different levels of investment experience and to ensure a productive conversation can be challenging. It also can have implications for making decisions in a timely manner. Much time can be taken with those more experienced bringing those with less experience up to speed with the key concepts.

160. One investor noted that they believed the lack of investment expertise can lead boards to be more risk averse.

Beliefs of trustees may go unchallenged

161. Trustees tend to have a range of beliefs about the effectiveness of particular investment strategies. For example, some believed strongly in the ability of active strategies to outperform the market and that the higher costs for active strategies (versus passive strategies) are justified. Other beliefs held by trustees included things like: higher fees will result in higher returns, or illiquid assets add value

and you get a better risk adjusted return. It was suggested that investment consultants may not have an incentive to challenge such beliefs even when they are inhibiting good investor outcomes. This may be the case where it allows the consultant to sell more complex products, which in turn allows them to charge more for their services (through accumulating more billable hours).

162. Trustees with in-house investment teams or a subsidiary investment company told us that the incentives between these parties were more aligned. We heard examples of in-house investment teams challenging trustee investment beliefs. For example, a couple of investment teams presented information on the outcomes of active and passive strategies so that trustees could assess whether their belief in active strategies was warranted.

163. A chief investment officer mentioned that helping trustees explore their beliefs can be time consuming. Finding the right benchmark tools and exploring alternate strategies takes time. Part of the reason for this is due to information being reported differently.

Trustee short termism and disproportionate reactions to poor performance

164. Some institutional investors that we spoke with highlighted that trustee boards can be sensitive to short term performance.

165. A charity said that there is a risk that trustees focus too much on the performance achieved over their term. This can cause them to over-react to underperformance, by switching asset manager. For example, the strategy set by the trustee board may be the right strategy in the long run, but the economic environment or other shocks over a short period may cause a particular fund to under-perform.

166. A number of the chief investment officers and trustees we spoke with said that trustees can be quick to fire a asset manager due to poor short run performance, even when they are meeting their mandate and delivering performance within the specified volatility ranges. Another investor mentioned that they felt there was a trend for trustees to act off the back of macro-economic conditions, retaining asset managers in good market conditions and firing them in bad.

167. One investor mentioned that the first two years of performance for a new asset manager can be the most important. If they performed badly in their first two years, they were more likely to be fired than if they perform well for two years and then poorly subsequently. They felt that reporting quarterly figures can exacerbate this problem.

Investment consultant training may encourage over reliance of trustees on advisors

168. The trustees of the larger pension schemes that we spoke with received a wealth of training from a range of sources – internal training delivered from their investment team, training from investment consultants and/ or asset managers. The content of this training covered industry updates or focused on specialist investment products.

169. The majority of investors we spoke with mentioned that they received training, and this usually took place before embarking on a new investment strategy or product. The training was used to ensure trustees fully understood what they were being asked to approve.

170. However, some institutional investors felt that, at times, training by investment consultants or other industry providers played on trustee fears. For example, in

some cases the training highlighted the risks to trustees of getting it wrong. This can result in trustees being less willing to challenge or go against their advisors' advice and could encourage them to be much more risk averse than they otherwise would be.

Trustees rely on investment consultants to varying degrees

171. A smaller pension scheme and a charity told us that they used to rely much more heavily on their investment consultant. The consultants set the agenda of meetings, took the minutes, chose the benchmark, made and reported decisions and actions taken back to the oversight committees. One of the charities felt that this did not give trustees any levers with which to challenge, and as a result, with the advent of a new Chair the first action was to tender for a new investment consultant. It may be the case that some smaller investors remain in these kinds of arrangements.

172. A number of investors highlighted the implications of the legal requirement to take advice. A pension scheme told us that the requirement meant that where there are differences of opinions between the trustee board and the consultant, the investment consultant opinion will always win out. A couple of investors suggested that over-reliance on investment consultants is driven by fear, with trustees afraid that they will be liable if they go against their consultant's advice. This was not the case across all investors we spoke with. A mid-sized and larger pension scheme mentioned that they were happy to go against their investment consultant's advice. However, one investor noted that in these cases, they needed to get the investment consultant to approve their approach in writing and this had cost implications.

Asset manager selection

173. The institutional investors we spoke to had very different approaches. Some appointed a very wide range of asset managers, in order to diversify risk. We heard an example of a smaller institutional investor using a large number of asset managers, which appeared disproportionate given their small pot of assets. Others preferred to choose a few managers and work closely with them (one or three).

174. A few trustees suggested that manager selection was a part of their role that they enjoyed. Almost all trustees we spoke with got involved in asset manager selection. However, a small number delegated this completely to their internal investment management team or the investment consultants.

The selection process

175. Investment consultants were almost always involved in manager selection, alongside the trustees. In general the selection process includes some of the following steps – although not always in this order. The degree of input from the investment consultants will vary.

- Selecting a new asset manager is usually the result of the trustee board deciding to employ a new investment strategy or replacing a poor performing a manager.
- The need for investing with a new asset manager will be agreed by the trustee board or if investment decisions have been delegated, to the relevant committee (often the investment committee).
- The investment strategy will help inform the universe of asset managers that will be considered. The universe of asset managers is often identified by the

investment consultant. Trustees will direct investment consultants on their requirements. This may include things like: volatility range, asset classes, number of asset managers they want to appoint.

- If the investment strategy is complex or novel, trustees will receive training, normally by the investment consultant. This is to ensure that trustees understand the full implications of the strategy.
- Investment consultants tend to provide a list of asset managers from which trustees can choose and decide who to invite for tender.
- Trustees will review the tender proposals of interested asset managers – with input from the investment consultant. They typically work together to produce a short list.
- Often those asset managers that have been short listed will be invited in to present to the trustee board/ investment committee (a process commonly referred to as a 'beauty parade'). Here trustees may challenge on costs/ other parts of the tender document and factors that are important to them (stability of the asset management team, for example).
- In some cases, the trustee board may ask the investment consultant to make the final decision rather than holding a beauty parade.
- Where there was a beauty parade, the board/committee will decide which asset manager(s) to appoint.
- The investment consultant will undertake due diligence on these asset managers, and if they are satisfactory, they will be selected and appointed.
- The timing of negotiations on fees and the terms and conditions varies depending on the institutional client, but typically take place throughout the asset manager selection process.

176. A couple of investors expressed their concern with this process, in particular that beauty parades were not a good way of selecting an asset manager. A number of institutional investors provided examples of trustees making their decision based on factors (such as the best presenter, or the first or last presenter) that are not necessarily correlated with good 'future' fund performance.

177. Some investors had taken steps to mitigate concerns with beauty parades, by using other selection processes. For example, some required the investment consultant to make the final recommendation.

178. Others raised concern that trustees do not have the expertise or time to choose an asset manager and this sits best with investment consultants – especially given that the process is resource intensive and an on-going issue. Some noted that asset manager selection is a distraction for trustees, and they should focus on strategy (seeing manager selection as an operational issue). Others felt that having a wide range of asset managers recommended by the investment consultant allowed consultants to hide a possible lack of skill. One charity we spoke with took steps to force their consultant to make a firm recommendation underpinned by the evidence. They felt this allowed them to hold the consultant to account.

179. Many noted that the cost of the selection process to both trustees (time, investment consultant fees) and asset managers is high. Others flagged that some investment consultant business models charged the cost of search to the 'selected' asset manager, who may pass this cost onto the institutional investor. We did not hear concerns from investors about this fee model. We discuss this further in Chapter 8.

180. Many suggested that throughout the manager selection process, they were able to bring up and negotiate on costs – except in instances where there were capacity constraints – e.g. for certain asset classes or managers. Smaller schemes/ investors noted that they have limited capacity to negotiate with asset managers on fees and charges due to their limited assets, but also because they do not have the time and resource required to negotiate. Investment consultants can play a positive role here – using their bulk of client assets to secure good deals for their smaller clients.

181. We heard examples of larger institutional investors securing discounts. There were many trigger points for negotiations, for example, when the fund is not doing well and/ or when there have been changes to the asset management team.

182. A couple of the investors challenged how investment consultants decided their short list. Some indicated this process was opaque and they found it difficult to assess whether it was appropriate for them. Two of the larger pension schemes we spoke with told us that when their investment team reviewed the short lists provided by consultants they felt that the consultants had not done sufficient due diligence. In these cases, the in-house team used the consultant to provide a long list and the in-house team did the rest to narrow down the options.

183. There was a concern that where investment consultants include those funds that are performing well in their short list, they were recommending funds that were nearing capacity. Investors suggested that this makes it much more difficult for them to negotiate on price. One of the charities noted that they avoid such funds.

184. There was one example of institutional investors competitively tendering for non-investment consultants and investment consultants, to carry out 'due diligence work'. They found the quality of non-investment consultants to be better in this area.

Factors that inform manager selection

185. Those we spoke with mentioned a number of factors that they consider when selecting or switching an asset manager. The key ones mentioned include:

- A stable asset management team and a senior and experienced person on the team.
- Having a long and established relationship with the manager was important for some.
- Ability to demonstrate that they have experience of managing operational risks.
- Investment consultant recommendations.
- Asset management costs and charges.

Restricted choice of asset managers

186. One of the larger pension schemes noted that with investment consultants it is hard to know that you have seen everything – as they tend to rate a subset of asset managers that submit data to their databases. When asset managers underperform, they may stop submitting this data to the consultants.

187. A larger pension scheme felt that investment consultants had agreements already in place with their asset managers and this influenced what asset managers were brought to their attention. As a result, they do manager selection within their internal investment team.

188. Larger pension schemes noted that because of their scale they often have a restricted choice of asset managers, as some managers don't have the necessary capacity.

189. In some cases, trustees told us that they had identified asset managers that they wanted to use, but these asset managers had not appeared on the investment consultant short lists. One trustee told us they had asked their investment consultant to include an asset manager in their short list. Before doing this, the investment consultant had to complete their due diligence on the asset manager. To appoint the asset manager, trustees had to get approval in writing from their investment consultant. The cost of these activities fell to the trustees.

Monitoring and evaluating fund performance

Frequency of, and metrics used when, monitoring performance

190. The investors we spoke to usually monitored performance quarterly. They considered performance over the last quarter, three and five years. They aimed to review performance over the longest period that they could.

191. Some got their investment consultant to report on performance quarterly at trustee meetings. A couple used external evaluators to report on performance/ investment consultant advice. However, it was noted that care needed to be taken when choosing an evaluator i.e. they needed to ensure it was not another investment consultant that was in competition with their current investment consultant, as this compromised their independence as they could have an incentive to produce a less positive evaluation.

192. Most of the investors we spoke with emphasized the importance of the quality of reporting to trustees, and that it needed to be in a digestible format and pitched at a level that trustees could reasonably understand and engage with.

193. A number of investors we spoke to felt that the quality of reporting to trustees has improved and in a couple of cases was very good.

194. It was also emphasized that when assessing asset managers, it is not just about identifying poor performance. One trustee mentioned that they would be equally concerned about an asset manager that was delivering on performance but that this was due to an unexpected environment, rather than the effectiveness of their strategy/ approach.

195. Investors we spoke with evaluated performance at different levels – the fund or mandate level, asset manager level, asset class level, and portfolio level. In general, they found it much more difficult to evaluate performance at the portfolio level (mainly the difficulty was around finding an appropriate comparator) to assess whether they were achieving value for money.

196. The kinds of metrics that trustees/investors monitored include some of the following:

- net performance against a benchmark,
- fees and charges,
- key risks, including risk tolerances and volatility,
- operational processes,
- concentration in particular funds,
- changes in the asset management team or changes in philosophy,

- valuation policies, and
- compliance with the mandate and regulations.

197. In addition, quite a few of the investors we spoke with said that they do periodic deep dives into specific issues, for example, into the performance of a particular asset class.

Benchmarks

198. Some institutional investors noted that certain benchmarks were not suitable for their needs. Fixed income benchmarks were identified as a poor comparator, in terms of how they are composed. For example, it was raised that market capitalisation weighting was not sensible from an investment perspective.

199. It was noted that peer group analysis and benchmarking is an iterative process, and trustees and their investment teams need to invest time into doing this right. Investors told us that looking at peer groups can be informative, but clearly there are lots of variables and although it is not always appropriate to replicate what others have done, learnings and observations can be used to improve their own strategy. A number of investors asked whether there was anything the FCA could do to make this process easier.

More help needed to support institutional investors to evaluate value for money

200. One of the larger pension funds and a charity mentioned that they would find the publication of investment performance really helpful (for example, similar to what is done with financial accounts). This would help with benchmarking and assessing value for money from asset managers and particular funds.

201. There are benchmarking firms already out there, but trustees felt that these do not provide sufficiently granular information or metrics. Some metrics that investors felt would be useful to disclose include total expense ratio[41] (TER) at asset manager and class level, risk adjusted returns net of fees over the longest time frame available, gross returns above the relevant benchmark and net funding position. The information would need to cover a number of different time periods. They felt that this information would allow schemes to think more carefully about whether they were achieving value for money, whether they should act, by moving to passive, switching to another asset manager and/or moving out of asset classes.

Fees and charges

202. Many of the investors we spoke with said they looked at fees and charges, some considered them periodically. A couple mentioned that this has not always been the case, but increasingly trustees have become more and more aware of the implications of costs and ensuring they understand the full cost of their investment strategy. One charity noted that trustees are chipping away at the fees and requesting ‘all in fee’ quotes.

203. One investor had consolidated funds and mandates across different schemes and had found that these different schemes were paying management fees that were materially different, for similar funds and products.

[41] This is a measure of the total costs associated with managing and operating an investment fund. Typically includes the management fee as well as additional expenses such as trading and legal fees.

204. There was a general view that when trustees viewed their investment management costs in absolute terms, the costs seemed much too high. However, they weren't clear what an appropriate cost would be.

205. Some suggested having all costs reflected in a single fee would be helpful.

Transparency of fees and charges is poor in certain areas

206. Many of the investors we spoke with asked their asset manager for fee and cost information. They noted that this information was not always readily reported to them, but if they were persistent at requesting this information from asset managers they tended to be able to get it. Many of the larger pension funds said that the smaller pension schemes/ investors, may find it much more difficult to push asset managers to provide them with fee information.

207. A number of the investors we spoke with noted that, even when they get reported cost information, they find it difficult to understand whether it is too high. Others did benchmark costs using industry surveys. There are benchmarking tools available (e.g. CEM) in the pension fund world and to a lesser extent in the charity space (ARC), but we heard that they are limited and that these tools would benefit from being more granular, allowing for the ability to better identify peer groups and include data from non-pension investors. This could be a useful tool to support institutional investors in assessing whether they are 'paying too much'. We heard that Greenwich Associates produces a table which allows investors to benchmark trading costs. Many institutional investors can struggle to get hold of comparable trading cost data directly from asset managers ahead of selecting them. A small number of institutional investors told us they use industry surveys to sense check that any trading costs presented to them by asset managers are in line with the broader industry.

208. Another issue that was raised regarding fees was the way in which they were reported. There was concern that terminology is not consistent, with different items appearing in the AMC. This made benchmarking difficult and time consuming.

209. In addition, investors highlighted to us a number of areas were they felt that costs were particularly opaque or high:

- Hedge fund fees are high: we heard that high hedge fund fees tended to be because of demand and capacity constraints. Many investors said they stopped using hedge funds, when negotiating on fees hasn't worked. In addition, there was concern about fee structures in this area, in particular asymmetric performance fees, and that they do not incentivise good manager behaviour. Performance fees are discussed in more detail in para 225. Private equity is also an area where fees are thought to be particularly opaque.
- Poor transparency on the DC side: There were some indications that transparency (of fees) on the DC side is particularly poor. The reasons given for this included the additional players in the value chain (platforms) and the fact that the trustees do not own the assets as they do on the DB side (less incentives to push for the right information). It was also noted that more intermediation on the DC side (with the involvement of platforms), can make it more difficult to get management information on the underlying funds, e.g. getting information on transaction costs was cited as particularly difficult.

- Pooled fund costs (in particular transaction costs) can be hard to get hold of, compared to mandates where the institutional investor is often involved in the detailed negotiation of the IMA.
- Transaction costs are hard to get hold of: Dealing spreads are not always clear, although they should eventually show up in the performance record (net performance). Institutional investors have to push asset managers to provide this information.

210. A couple of the investors we spoke with highlighted that they felt there were hidden costs both on the asset management side, but also for custodian services. They flagged that many pension schemes may not realise how much they are paying, if they are not asking the right questions – especially in an environment where asset managers are not forthcoming with this information. Smaller schemes may also be much more heavily reliant on investment consultants to negotiate and manage costs.

211. A couple of larger pension schemes indicated that they had reviewed the costs associated with their investment strategy and as a result, made significant savings. In one case, they used their scale to re-negotiate with asset managers. They were able to make significant savings despite having a higher weighting to private assets. In the other, they looked at the absolute amount they were paying for their strategy and worked hard to bring these costs down by streamlining the supply chain (stripping out some investment managers) and negotiating hard. Again, they made significant cost savings..

Negotiations on fees and charges is easier for larger investors

212. Many institutional investors we spoke to said that the size of the assets matters, and can help you secure better deals with asset managers.

213. Larger pension schemes felt that smaller schemes could benefit from consolidating their assets: supporting their ability to negotiate and secure better fees from asset managers as well as providing them with more choice. One investor we spoke with said that they were able to achieve significant fee savings from pooling the assets of multiple schemes together. One way smaller employers could do this for DC schemes is by using master trusts, for DB schemes they could consider using fiduciary management.

214. Across all institutional investors, negotiating fees was described as an on-going process. It does not just happen at the outset of appointing an asset manager. There are trigger points which are used as leverage to negotiate better deals, such as if there is turnover in the asset manager team, or if there is poor performance.

215. However, in some cases investors have to push the asset manager quite hard to get discounts. One investor said that when they pushed back on costs, the asset manager re-packaged them, rather than reduce them. They had to go back and challenge the fees a further few times before they were successful.

216. There will be instances where there is no scope for the institutional investor to negotiate on fees, for example, where the fund is nearing capacity.

Mixed views on the impact of Most Favoured Nation clauses and confidentiality agreements

217. Not all investors we spoke with had signed MFNs or confidentiality agreements/ Non-disclosure agreements (NDAs). Those confidentiality agreements that existed tended to be between the asset manager and institutional investor. The

agreement captured the key elements of their terms and conditions and prevented them from sharing this information, especially where the institutional investor has been given preferential terms.

218. The larger investors felt able to refuse to sign these agreements. One investor noted that factors captured by confidentiality agreements are commercially sensitive anyway, and that they would not want to share this information. They felt that they could talk openly with other investors about their experiences of specific asset managers – on things like governance and structures.

219. Another investor suspected that NDAs allowed asset managers to re-sell the same proposition to multiple institutional investors – and position it as bespoke. The same investor said an asset manager asking them to sign an NDA was a sign to them that the culture within the asset manager was not quite right.

220. Most favoured nation clauses were often requested by the institutional investor. These required the asset manager to notify the institutional investor if they offer the same products to other clients, but on preferential terms. One investor told us that they felt MFNs were common in the industry and worked to restrict negotiations, contributing to price opacity. Others felt that signing MFNs improved transparency.

Views on performance fees

221. Many of the institutional investors that we spoke with said that they tried to avoid paying performance fees, where they could. They expect that performance fees do not incentivise asset managers to do better than they otherwise would.

222. The key reasons why investors tried to avoid performance fees are twofold. If an institutional investor has a range of asset managers that use performance fees, a case can arise where at the portfolio level the performance is neutral (or there has been no outperformance), yet performance fees will be incurred because at the asset manager level some will have outperformed. In addition, the same can be true over time. Over a five year period, performance of an asset manager may be neutral or negative, yet the investor may incur performance fees if within this period the asset manager outperformed for a year or so.

223. Institutional investors we spoke with suggested that where they cannot avoid performance fees, investors try to introduce some constraints. For example, they will try to negotiate a hurdle rate (so performance fees are only paid when performance is material), negotiate a lower AMC, and/ or require that they only pay on performance fees at the point performance is realised (at point of sale, rather than as an annual cost).

Good practice examples of managing fees

224. Institutional investors we spoke to were aware of the impact of costs on their returns, and often actively monitored costs. Some of the ways they did this are summarised in the box below.

Reporting of total fee burden
An oversight committee requested that their consultant provide an estimate for the total fee burden associated with their investment strategy, and report this figure in quarterly meetings. The fee burden information actively informs their choice of asset manager. This information is also used to challenge investment consultant recommendations, asking them to demonstrate why more costly strategies will add value. Although it was acknowledged that some fees were difficult to estimate in advance of incurring them (for example, transaction fees), the expectation is that by closely monitoring them over time (and comparing estimates with actuals), estimations will become much more accurate.

Setting a fee cap
We heard an example of an institutional investors setting a total fee cap. This cap included all costs associated with the investment strategy (including custodian and advisory services). It is expressed as a percentage of assets invested (x% of assets invested). This cap was used as a way to direct investment consultant advice – ensuring proposed strategies were not unduly expensive and introducing cost discipline.

Reporting performance, net of all fees (including advisory)
Requesting that overall (portfolio) performance is expressed net of all fees associated with the investment strategy (again, including advisory fees).

Capping the proportion of alpha paid out in fees
Setting a cap on the proportion of the alpha that they expect to pay out in fees (e.g. around 30%). They review this periodically and if it is exceeded, this would trigger a discussion on whether to switch asset manager.

Role of investment consultants

225. Some investors we spoke with highlighted the fact that the investment consultant market was concentrated. These investors said that they did not have many investment consultants to choose from, as a result.

226. A charity and local authority pension scheme noted that the options available to them are restricted further, with a few niche providers specialising in services that cater to their needs.

227. Most investors we spoke with valued the input of their investment consultants, however, one did note that they would not use them if it was not for the legal requirement to obtain advice related to investment matters from qualified advisors with the knowledge and appropriate knowledge and skills.

Investment consultant selection and switching

228. Those that we spoke to tended to use a competitive tender every three years. In some cases the recruitment process for a new investment consultant mirrors that used for asset managers – with beauty parades being used. There were also a couple of advisory firms that supported trustees in selecting their investment consultants as well as supporting them with wider governance issues.

229. One investor we spoke with suggested that the tendency to competitively tender for investment consultant services does not mean that the sector is competitive and working well. There is a tendency for investment consultants to come in and suggest the previous consultant had done a terrible job and suggest an overhaul of the investment strategy – with a cost. Then the process happens again at the next tender round.

230. One institutional investor said that they would find it helpful, when selecting an investment consultant, for investment consultants to provide information about: the level of funding rate improvements (for DB schemes); acceptance rates of their advice; and their flexibility and thought leadership.

231. When selecting an investment consultant, there are a number of areas that institutional investors told us informed their decision:

- **Consultant trustee relationship is important:** The quality of the relationship between the trustee board and the individual consultant was considered very important: Examples were given of changes in the staffing of teams on the client and/ or consultant side causing trustees to switch consultants because the 'chemistry' didn't work.
- The **investment consultants' wider relationships can be a major factor**: one pension scheme noted that their sponsor employer used the investment consultant for other business, and this was the main reason why they were selected. Another suggested that the good working relationship between the investment consultant and their actuary was a priority when choosing whether to stay with their current consultant.
- The **quality of investment consultant communications is important:** In particular the quality of their reporting and the clarity of their recommendations and communications. They must be able to explain complex ideas in a way that trustees understand and their recommendations must be underpinned with evidence.
- **Brand is important:** Institutional investors told us that smaller niche providers are not always considered as substitutes to the larger investment consultants. Some said they were less willing to consider these relatively unknown brands. However, a couple noted that the larger investment consultant providers do not have a flexible approach to serving their customers and as a result they are now considering the smaller market providers.
- **Idea generation:** Forward looking, prepared to go against the herd, as well as being good at idea generation was seen as one way consultants would add value.

232. A number of pension schemes and charities we spoke with had switched their investment consultant provider. A couple mentioned this was because the investment consultant was recommending complex strategies and one of these mentioned that cost was also a factor (they perceived costs were much too high). Another said that a new Chair had come in and felt that the trustee board were relying too heavily on the investment consultant (e.g. the investment consultant was setting the agenda).

233. Quite a few of the investors we spoke with had been with their investment consultant for some time, one going back as far as 30 plus years. Part of the reason for this was they were concerned that going out to tender would put strain on the good relationship that they had with their current consultant.

Evaluating investment consultant advice is difficult

234. Many of the institutional investors that we spoke with attempted to evaluate the advice of their consultant. In most cases, they did this by using the competitive tender process to benchmark costs and investment approaches across investment consultants.

235. There were some concerns raised across institutional investors of varying sizes about testing the market. Some were concerned about de-stabilising their good working relationship with their current consultant. Otheres mentioned that the process was time consuming, especially for the trustees and for those bidding. It was also mentioned that to encourage bids, you need to be able to give some certainty of revenue over a certain time frame – otherwise the cost of bidding may not be worth it for some consultants.

236. In some cases institutional investors have also considered using an external evaluator to monitor the investment consultant, but usually this was when they had a fiduciary arrangement with the investment consultant (typically the mid-sized charities and smaller pension schemes).

237. Many investors said that they found it difficult to assess the advice of investment consultants. They tended to focus on evaluating asset manager performance and/or the quality of the service provision by their investment consultant, for example:

- timeliness of their advice,
- appropriateness of their advice (one investor said they would specifically consider whether they recommended strategies that would lead to churn with no real monetary benefit),
- pro-activeness, ability to generate ideas,
- cost-effectiveness – often this was done by benchmarking costs against other providers using industry surveys (it was noted these were not always helpful as often these headline prices are negotiated down),
- implementation speed,
- clarity of communications and readability of papers,
- flexibility and adaptability to trustee needs,
- interpersonal skills of the consultant, and
- whether they are ethical.

238. A couple of the investors we spoke with suggested that it would be helpful to have some guidance on how to assess investment consultant advice. Many highlighted that there was no standard way to assess advice, which can make comparisons across investment consultants challenging.

Larger pension schemes and some charities took steps to ensure interests of investment consultants are aligned, but conflicts remain

239. The larger pension schemes we spoke with seemed to be moving away from relying on any one investment consultant. In some cases they used a panel of consultants that they call on for advice, either consulting a couple or choosing the one they judge as being best placed to advise. Other models include using investment consultants for bespoke projects (for example, when setting up an investment strategy that the consultant specialises in or selecting a manager in a particular asset class).

240. There was concern that investment consultants do not have a fiduciary duty and they do not have any of their own capital at risk. Their charging structure was also raised as a concern. It was suggested that billing by the hour provided consultants with incentives to recommend more complex strategies. It allowed investment consultants to charge for more hours work and as a result generate more revenue.

241. We heard a couple of interesting initiatives being taken forward by a charity to try and better align the advisor incentives with the scheme/charity objectives. For example:

- Setting an overall fee cap, which limits the charges the consultant can generate (the cap included advisor fees/asset manager fees/ custodian fees and other fees); and
- limiting the number of asset managers the advisor can recommend. This puts the onus on the advisor to ensure they have done the due diligence and are confident in the asset managers they recommend/ select.

Larger investment consultants are not seen as flexible in meeting client needs and tend to provide similar advice across their client base

242. A number of the smaller pension schemes and charities raised concern that the larger investment consultants are not flexible at meeting their needs. Often smaller schemes are allocated more junior consultants. Investment consultants are only interested in taking forward 'novel' ideas if they can market them to their full client base.

243. A smaller charity provided us with an example of this. They found it very difficult to secure an advisor that would work with them to provide reporting on performance that met the needs of their trustees.

244. A number of investors mentioned that the smaller investment consultants are able to provide a more bespoke service and are much more flexible. However, one mid-sized pension scheme said that they were (and other pension schemes would be) reticent to use these 'unknown' consultants and viewed switching to them as 'risky'.

245. A few of the institutional investors we spoke with raised concern that investment consultants provide similar advice to all their clients (herding). There was concern that advising their clients to take the same action and at the same time can have 'market impacts'. One institutional investor speculated that the movement in February in the relative value of gilts and swaps was an example of this.

Quality of investment consulting reporting of fund performance varies

246. A number of investors we spoke with mentioned the poor quality of some of the reporting from investment consultants. One investor described it as 'impenetrable'. Many said they had to work closely with their advisors to ensure that the information is appropriately pitched for trustees. Some mentioned that smaller schemes may not have the resource to work with consultants in this way.

247. Some were positive about the information reported to them. One charity noted that they were able to work closely with their investment consultant to improve reporting. They now feel that the quality of reporting is very good. A pension scheme with an in-house investment team, focused on ensuring trustees had the right information and presented in a way that was digestible.

248. We heard that in some cases institutional investors use custodians to provide objective reporting. This was used to address the concern that investment consultants may not have incentives to report poor performance, where it is the result of their advice.

Asset management products offered by investment consultants

249. Investment consultants are now offering products and services that are in competition with asset managers. These include fund of fund and multi-asset products. They are also increasingly moving into the provision of fiduciary management services.

250. Institutional investors we spoke with raised a number of concerns specifically about using a fiduciary management arrangement from the investment consultant that they use for advice, mainly in relation to the conflicts of interest which many felt were insurmountable. Many felt conflicts could not be resolved, and as such would avoid these types of relationships.

251. Some raised concern that investment consultants would be incentivised to encourage their clients to move into fiduciary arrangements (or their own branded asset management products), even when it may not be in their best interests. There was also concern that the route from advice to a fiduciary arrangement may not be clearly set out to clients. For example, a trustee board may be led into a fiduciary arrangement without realising this is the route they were taking. One trustee we spoke with called for much more clarity about the process a client goes through to get from an advisory to fiduciary arrangement.

252. A range of concerns about fiduciary management were raised. These included:

- Advice may be influenced by the fiduciary investment arm of the business – therefore they may be incentivised to make recommendations to clients that benefit their fiduciary activity, rather than the client. One investor raised concern about whether it was feasible to get impartial advice in this market.
- It may result in some asset managers being unwilling to disclose certain information if a consultant with a fiduciary management arm is present.
- There was also concern over whether investment consultants have the robust systems in place to effectively deliver on their fiduciary management arrangements (they considered asset managers are much better placed to do this).
- An example was provided where the investor had found out that their investment consultant had negotiated a better deal with an asset manager for its own fiduciary manager than the 'best deal' it was offering its clients.

253. Many institutional investors recognised that fiduciary management could deliver value for some investors, for example, pension schemes with less than £1bn. In particular, it was noted that fiduciary management works well where the trustee board cannot act quickly and the members are not very sophisticated, but would like exposure to certain asset classes that require stronger governance than they have in place.

254. We spoke to a couple of investors that used a fiduciary arrangement with their investment consultant. These arrangements varied, with some which had fully delegated investment decisions to all or part of their portfolio, to others that delegated some investment decisions but required final approval by the Board.

255. One charity we spoke with, felt that they had sufficient oversight of their fiduciary management arrangement, ensuring that it was meeting their needs. They required the consultant to report to the trustees, and before making a decision (on asset allocation / manager selection) to set out the rationale for final approval by the board. They heavily constrained their mandate, requiring all discussions to go by trustees/ finance director – and took care not to give full discretion to the consultants.

256. Another relatively large pension scheme had used a fiduciary arrangement in the past. They found that there was significant poor performance yet the investment consultant reporting showed good progress under each of the performance measures they reported. They stopped using the fiduciary management arrangement.

A number of additional concerns regarding investment consultants that were raised

257. The institutional investors raised a number of concerns about the approach of investment consultants, which can mean investors pay more for little additional benefit:

- They encourage churn, which ends up becoming expensive for the investor
- They encourage complexity in product design, which needs active monitoring
- They focus on trustee fears, which can result in trustees using unnecessary services/ or taking costly investment approaches
- They nudge their clients into the investment consultant's own fiduciary arrangements or asset management products (discussed above).

The role of institutional platforms, focusing on DC platforms

258. Platforms are the main route for distributing funds to pension members for defined contribution schemes. Platforms are common in both contract and trust based DC schemes. Trustees (or the employers) work with advisors and platform providers to agree the funds that should be available to their members through the online platform and decide on the default fund (where the majority of members end up investing -institutional investors told us this typically was over 90%).

259. We were told that there are three main institutional platforms, mainly run by providers set up as life insurance propositions. In addition to these main providers, there are some banks that provide institutional platforms and a couple of investment consultants that provide their own branded platform.

260. When selecting a platform provider, trustees/ investment teams can choose either bundled or unbundled platform propositions. A bundled proposition is where the platform provider runs both the administration and the investment side. This option is often preferred, especially by smaller schemes. It is much simpler and easier to operate, as trustees/ investment teams do not have to monitor whether the admin and investment side are co-ordinating their activities effectively. A couple of trustees of defined contribution schemes told us that the bundled option is not necessarily cheaper and there are benefits to using an unbundled proposition. For example, it allows trustees to select the best in class for admin and the best in class for investment.

261. Platform costs tend to be on top of admin and investment costs. These costs tend to be borne by the members and should fall within the 75bp cap on investment costs of the default fund. All other costs are often borne by the sponsor employer. However, the split of costs borne by the member versus the employer tends to vary, depending on how important the pension scheme is as part of the attraction and retention of employees.

262. When choosing a platform provider, institutional investors mainly consider the operational robustness of the platform and the range of managers. There is a lot of due diligence carried out by the institutional investor (smaller investors may have to outsource this work). For example, before choosing a platform they will assess the technical ability of the whole team, specifically assessing the dealing team; review the technology in place; operational robustness; and the way the platform is structured (e.g. is it properly backed). Some noted that they did use investment consultants to advise them when choosing a platform provider. Some institutional consultants also provide their own labelled platform. In one case they used a beauty parade process when selecting a platform, a process similar to that typically being used to select asset managers.

263. No one raised concerns with gaining access to their preferred funds represented on a new platform. This was particularly easy for larger pension schemes that were able to use their scale of assets to negotiate and guarantee fund flows. Most investors that used platforms said that even where this is not possible there will always be a range of similar alternatives (for example, many of these platforms host hundreds of funds).

264. White label funds are often used on platforms. This is where the company/trustees/ investment team name the fund using the company name. They may also incorporate in the name the type of fund it is e.g. 'global fund'. This is a way to communicate to members what the fund does and aids their decision making. Trustees told us that the benefit of naming funds to reflect what they do is that members can understand what they do without having to do further research. It also allows the sponsor firm to change the underlying asset manager (or use blended funds where multiple funds underlie the white label in line with proportions agreed by the trustees) without causing confusion to the member.

265. We also spoke with trustees who said that they used an institutional platform that both manufactured and distributed funds. They did not use any of the platform's own funds and did not feel pushed to do so.

266. The large pension schemes we spoke with told us that switching platform providers is relatively easy but may be more difficult for smaller schemes. Some of the smaller schemes mentioned that it would be time consuming and moving assets from one platform to another can be administratively problematic.

Ability to assess value for money across the value chain

267. Across all the investors we spoke with, none identified material issues with ancillary services. In general, they felt that costs of ancillary services, including custodian services are already low. In fact, some mentioned that they were so low that the costs involved in switching would not make it worthwhile.

268. In relation to custodian services, it was mentioned that switching can be costly, in particular for the smaller schemes. It was felt that custodians often use different

processes and systems, and investors have to amend their processes in turn if they switch custodian providers. There may also be costs associated with the necessary advisory support, governance and consultant fees.

269. Some mentioned that the quality of custodian services had in the past been poor, but had been improving. Poor quality custody services can include things like recording assets under the wrong name, poor valuation of assets/securities, and administration errors in transitions.

Other issues

Fragmentation of the demand side is alleged to work against securing good investor outcomes

270. A number of institutional investors we spoke with were concerned about the fragmentation of the demand side of the asset management industry, and difficulties this presents. In particular, in terms of 1) having sufficient assets to negotiate effectively with asset managers to secure discounts, but also to work with them to develop solutions to meet their needs; and 2) attracting sufficient individuals with investment experience to the trustee board.

271. A couple of investors felt that many of the issues, in terms of lack of transparency, were in part due to clients not asking the right questions and pushing for more transparency and negotiating fees down. Part of this was due to the large number of smaller schemes that have limited buyer power. Some investors suggested more consolidation on the demand side would help.

272. A number of obstacles to merging smaller schemes were identified. Firstly it is difficult to consolidate DB schemes where funding levels and objectives are very different. Consolidating funds would likely be costly for employers, which can deter consolidation. We spoke to an organisation that was in the process of consolidating the assets of multiple schemes, demonstrating that consolidation is possible. They are finding that they are able, as a result, to secure significant cost savings from asset managers, but also across the value chain.

273. Consolidating DC schemes may be easier. In fact, master trusts were given as an example of funds trying to consolidate and reduce governance costs. New legislation in the form of the Pensions Schemes Bill 2016 will include additional protection for consumers saving into master trusts. Other market solutions are working to rectify the fragmentation of the demand side, for example, fiduciary management was seen as a way to consolidate assets to achieve costs savings for clients. Concerns with fiduciary management are discussed in more detail in chapter 8.

Liability Driven Investments (LDI)

274. We spoke to a range of pension schemes that used an LDI strategy. Many of them felt that they were getting a good deal. They did not raise concerns with this segment of the market.

Regulatory landscape

275. The constantly changing regulatory landscape was raised as a particular concern for trustees, with much time being spent on ensuring compliance.

276. Another obstacle raised regarding the current regulations was the perceived ambiguity in the rules over what constitutes regulated advice. Some firms have

suggested that this has prevented them from engaging with pension holders as much as they otherwise might have, being afraid that their guidance might inadvertently constitute advice and as such would be subject to the relevant regulations. This mirrors concerns previously raised as part of The Financial Advice Market Review (FAMR), where stakeholder responses highlighted the reluctance on the part of some firms to offer support to consumers in the form of helpful guidance, for fear of straying into the provision of regulated advice. Recommendations to support greater clarity on the advice boundary were set out in the FAMR report published in March 2016.[42]

[42] HMT and FCA (2016), Financial Advice Market Review: Final Report. https://www.fca.org.uk/publication/corporate/famr-final-report.pdf

Academic work on effectiveness of oversight committees

277. The FCA commissioned some exploratory academic work to inform their understanding of the dynamics of, and obstacles to, effective investment decision making by oversight committees. This academic work was carried out by Baddeley, Liao and Tilba[43] and included a review of the academic literature on behavioural biases and governance; an online survey of 71 institutional investors (insurers, charities and pension funds); and 22 interview responses by pension fund trustees.

278. Specifically this academic work sought to understand investment decision-making in the asset management industry; exploring the impact of behavioural biases and herding/group-think on decision making and investor outcomes and considering the role played by asymmetric information and principal agent problems in exacerbating some of these problems. It also sought to understand the extent to which qualifications and education help trustees make better decisions and/or better understand fees and documentation; and assess the quality/standard of discussions at oversight committee meetings.

279. The findings from this work provide some insights into the kinds of obstacles oversight committees face and the potential implications for the quality of decision-making and investor outcomes.

Summary of themes

280. Oversight committees make a range of investment decisions. They decide on the investment strategy and objectives, asset allocations, types of strategies employed (mix of active versus passive) and choice of asset managers. The strategies employed vary depending on the type of institutional investor. For example, defined benefit (DB) schemes focus on improving funding levels and meeting liabilities as they fall due. Charities tend to have much more flexibility and as a result can take a longer-term view with their asset management strategies.

281. In some instances oversight committees take advice from a number of advisors – actuaries, investment consultants, legal advisors and others. Some oversight committees delegate investment decisions to a sub-committee (often referred to as the investment committee). Others may delegate investment decisions to investment consultants or asset managers, in what is often referred to as a fiduciary management arrangement. [44]

282. Since the publication of the Myners Report in 2001, the level of investment knowledge and experience on oversight committees has been improving. However, there is still room for improvement with some committees still having limited and/or varied investment expertise represented. This can increase the likelihood of herding behaviours, result in a lack of challenge from committee members, and encourage over-reliance on investment consultants and excessive deference to the Chair of Trustees.

283. Herding behaviours (the tendency for individuals to mimic the actions of a larger group) may distort effective decision making by oversight committees. Herding is

[43] See Tilba, Baddeley & Liao (2016) research report on the effectiveness of oversight committees.

[44] We define Fiduciary Management as managing investors' assets through activities such as manager selection and the provision of asset management products (such as fund of fund, multi-manager products, master trusts, or directly managed funds, etc.)

more likely in the context of committees made up of individuals with limited or varied investment experience and knowledge. Those members with limited investment experience are more likely to rely on other committee members or external advisors whom they perceive to have more expertise (for example the Chair of Trustees or an Investment Consultant). This is also more likely to be the case in instances where members do not feel they have fully understood the information presented to them at meetings. Reliance on external experts, such as investment consultants, can also be driven by the long-standing relationship trustees have with their consultant. In addition, the brand and reputation of the investment consultant can also play a part in giving the consultant 'credibility'. In the in-depth interviews with pension schemes, trustees said they often fear complexity and looking ignorant in front of their peers. This can contribute to trustees not speaking out when they do not understand information presented to them and so prevents them from actively challenging.

284. Over-relying on, and not effectively challenging, other committee members or advisors, as well as Chairs can significantly constrain a committee's ability to ensure they consider a full list of alternative courses of action ahead of a decision. Sometimes it means that decisions are made even when trustees do not understand the full implications. To illustrate, one interviewee highlighted that by not challenging, trustees can buy 'something without knowing what they are buying'.

285. In-depth interviews provided examples of how investment consultants can lead trustees into particular strategies, using peer pressure and reverting to norms, either because 'everyone else is doing it' or because 'the regulator is expecting it'. Trustee fears may also impede effective decision-making e.g. if trustees fear being sued, or are misled by apparently sophisticated but ultimately specious evidence that supports 'pseudo-scientific quantitative strategies'.

286. The volume and quality of information provided to oversight committees is identified as a particular constraint on effective investment decision-making. Certain data was identified as opaque, especially information in the area of costs where this is not freely provided by asset-managers unless requested, and where requests have to be made repeatedly before the information is released.

287. The complexity of cost information (for example, complex layers of different costs from different providers – the asset manager, custodian, investment consultant, other advisors) was highlighted as an area where pension fund trustees felt ill-equipped to challenge and fully understand. Fear of complexity was identified in the interviews as one reason for trustees' reluctance to challenge costs and charges.

288. Selection of asset managers is another area associated with limits on effective decision-making. The interviews provided examples of how trustees choose between asset managers on the basis of pre-selected short-lists, often provided by the investment consultants. Asset managers are presented to committees via 'beauty parades' and information about the relative merits of asset managers is provided selectively in this case. Responses to the interview questions suggested that emotion had a large role in informing trustees' choice of asset manager. For example, one interviewee suggested an asset manager was chosen because they had referred, in their presentation, to their investment portfolio including the funding of a local project. Another noted that although the asset manager had delivered the worse presentation, he was selected as he had managed to impart to the trustees that he hated losing money.

289. Investment oversight committees can over-focus on short-term returns. The literature review on pension funds has highlighted an investment herding behaviour among pension funds, which is also geared towards generating short-term investment returns (Haldane, 2010; Haldane and Davies, 2011). This study finds that pension funds seem to be 'herding' into investment strategies and buying investment products that may not necessarily reflect the specific needs of individual funds and their long-term investment time horizons. In addition, when committees expect reports from advisors too frequently, this can encourage an excessive focus just on short-term performance, e.g. the last quarter's performance figures. Investment decisions will be made off the back of these short-term metrics when a longer-term view would be more desirable. All these influences can lead to unbalanced portfolios, with poorer returns than might otherwise have been generated.

290. Investment consultants may not always be incentivized to achieve the best for their institutional clients. For example, they may have incentives to recommend changes to a pension fund strategy, advise on new asset allocation, offer new products and recommend different asset managers as a way to generate more revenue – rather than because these are in the underlying investors' best interests. Asymmetric information between the consultant and trustees may allow consultants to continue providing advice that is against an investor's best interests.

291. Interviewees raised concern about "fiduciary management". [45] It was noted that this term is used inconsistently across the industry, meaning different things to different providers and investors. In addition, interviewees raised concerns about value for money (both in relation to not having sufficient information to judge value for money as well as not getting value for money) and lack of accountability of fiduciary managers (for example, they are not liable for poor outcomes as a result of poor investment decisions).

292. The role of legal advisors also arose as an issue. A couple of interviews raised the concern that there is little understanding by legal advisors of investment complexity and this can inhibit their ability to effectively to review contractual documents. It was also highlighted that investment consultants encourage legal advisors to carry out 'light touch' reviews of contractual terms and conditions, with the threat of losing business if they do not comply.

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