

# A PRACTICAL GUIDE TO PENSION FUND INVESTMENT COSTS

TO HELP TRUSTEES AND GOVERNANCE PROFESSIONALS



CLERUS is an independent consultancy. As experienced investors we bring professional and value-added investment governance expertise directly to DB & DC pension schemes and other asset owners.

We add value to decision-makers because we are able to provide informed, independent and objective investment analysis free of any bias. This includes a full review and clarification of all investment-related costs, including transaction costs, and their impact on investment performance.

We also help investors review and improve the performance of service providers who are not being independently or appropriately assessed. Increased transparency is created which helps identify the investment activities that provide Value for Money, and those that are detracting value. As a result, costs can be reduced and investment outcomes improved, without the need to take on any more investment risk.

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4th Floor, Rex House  
4-12 Regent Street  
London SW1Y 4PE  
T: +44 20 3356 2845  
[www.clerus.co.uk](http://www.clerus.co.uk)

# FOREWORD

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The numerous explicit and implicit costs and charges that hit pension fund investments can account for one-third of the value of the fund over the life cycle of the pension fund according to some pension experts. Obviously, saving an element of this cost each year can make a big difference to pension fund values and will help secure member benefits.

The landscape for cost and charge discovery is rapidly changing for the better due to factors such as improving investor awareness, calls for increased cost transparency by industry bodies, regulatory and market initiatives and pressure to reduce pension fund deficits.

With record low interest rates and global economic uncertainty increasing, current financial market conditions would indicate that future returns could be lower than in the past and subject to significantly more risk.

Investment costs are therefore likely to have a much bigger impact on net outcomes as its proportion to actual investment returns increases. While future investment costs and charges are predictable and can be controlled by decision-makers, investment returns can not.

The onus is now on pension fund trustees and governance professionals to demand transparency on all costs and charges related to the management of retirement funds and to assess if they provide 'Value for Money'. We hope this guide will be a useful tool to assist them in this pursuit.

Full transparency is a prerequisite for fair and safe markets and for overall market efficiency. The remedies proposed by the Financial Conduct Authority (FCA) in its recent Asset Management Market Study - Interim report could have a profound impact on institutional investors and their future investment governance arrangements.

Transparency will help improve "Value for Money" for investors and intended beneficiaries and thereby provide better financial and social outcomes.

# ABOUT THE AUTHORS

This guide was written by CLERUS in collaboration with Sunil Chadda from Cairn Consulting Ltd, an experienced investment costs specialist.

CLERUS works closely with organisations whose skills complement ours.

## Henrik Pedersen

Henrik is co-founder of CLERUS. He has 30 years of applied investment management and advisory experience with leading asset management firms and investment banks. This culminated in his role as CIO for Pareto, a BNY Mellon asset management boutique. During his career he has designed, managed, analysed and improved a large number of investment strategies across a range of asset classes and environments and for substantial AUM.

Henrik has detailed knowledge of both implicit and explicit investment cost and their impact on investment performance, and is an expert in performance assessment and evaluation.

Henrik started his career in financial markets with A.P. Moller Group in Denmark, managing the group's substantial financial market exposures.

## Sunil Chadda

Sunil is a highly experienced investment costs consultant with over 30 years' experience of the UK financial Services market. During this time Sunil has built successful investment consulting practises and has worked as a business analyst and project manager on a number of front, middle and back office projects across the asset management industry. More recently Sunil has been working on identifying the total "true" cost of fund management from a DB and DC pension fund perspective. Sunil has recently developed a proprietary cost model for a large UK DB scheme as part of an extensive cost discovery project including all fund costs and charges as well as explicit and implicit transaction costs.

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# Introduction

The purpose of this guide is to assist the governance process in measuring and managing transaction costs, pooled fund costs and segregated mandate costs. This is achieved by highlighting a sub-set of the key sources of cost inherent in the management of pension fund assets. This will allow governance professionals to identify and measure a significant part of the “true cost of ownership” so that they can have a meaningful understanding of how investment performance has been impacted.

Every pension fund is different and the sources of investment costs, therefore, may be concentrated in different places. This guide aims to tackle the lowest hanging fruit first, thereby enabling a number of “easy wins” which should, in most cases, result in an immediate improvement in the ‘**Value for Money**’ that is being achieved by the pension fund or endowment. The guide is organised as follows:

**First**, we outline some of the different sources of cost that will typically be charged by asset managers to any given investment strategy.

**Secondly**, we have provided a self-assessment Check List that can be used to gauge the potential for hidden, or excess, investment costs in your fund. A high score will indicate that there is a significant opportunity to reduce cost and improve performance.

**Thirdly**, we provide a detailed roadmap/explanation of where to

find each category of cost for any given investment, and explain why it is important to measure and manage.

For those Trustees and Governance Professionals who are just setting out on their journey of investment cost discovery the guide outlines areas where they should begin (i.e. where cost discovery is “**Easy**”) and end (i.e. where cost discovery is “**Difficult**”),

Full cost identification will require independent specialist assistance outside of the current roster of financial service providers and advisors, who may be unable or unwilling to challenge the status quo.

Finally we also provide a Glossary of the most important terms that you will encounter in the world of cost discovery.

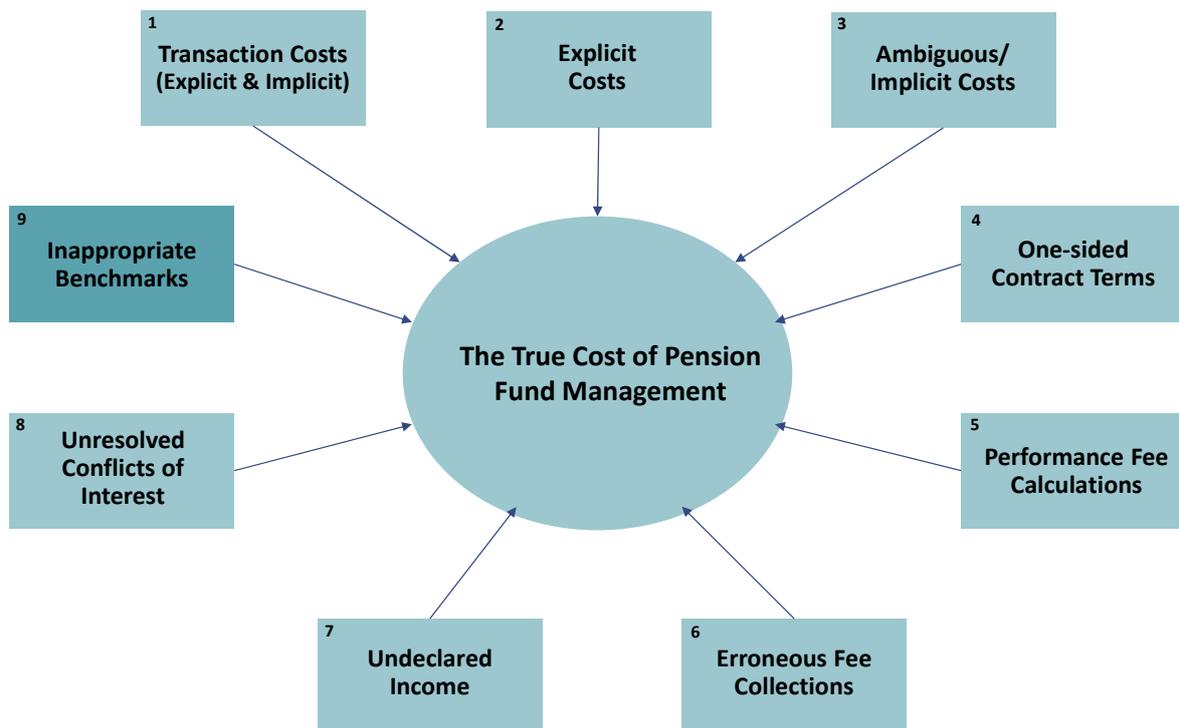
We would welcome any questions, feedback or additional examples from practitioners which will enable us to improve future versions of this guide. Good luck!

# Sources of Investment Costs for Pension Funds

Getting a full and complete picture of all the sources of investment costs for an individual pension fund is not straightforward. Investment costs can reside in multiple and unexpected areas. A full cost discovery will often require forensic analysis combined with an in-depth understanding of how the various sources of cost are being charged and their potential impact.

At a basic level the sources of cost depend on factors such as the asset class and geography (i.e. the strategy), financial instrument type, the full Portfolio Turnover Rate (PTR) etc and whether your investments reside in pooled funds or segregated mandates. Examples of a subset of the multiple sources of investment costs typical for pension funds are illustrated in Figure 1.

**FIGURE 1.** Typical Sources of Investment Costs for Pension Funds



Source CLERUS LLP

Getting to a point where the sources of all investment costs are clearly understood may take a number of iterations. Each iteration will identify questions, probably involving asking for more transparency, that will need to be answered in order to move on to the next iteration. These questions can be directed towards your asset manager or fund management service provider.

# Inappropriate Benchmarks

Without a correct benchmark a 'fair and proper' assessment of 'Value for Money' cannot be undertaken. Asset managers and fund selectors have a vested interest to provide benchmarks that make their performance look as attractive as possible.

Benchmarks are the standard against which the performance of an asset manager or investment strategy can be measured. The use of inappropriate benchmarks can therefore lead to **a loss of performance** as the service provider is not being held properly to account.

For example, by setting performance benchmarks that are easy to beat, relative outperformance may be reported which is not real. In addition the negative performance impact of excessive transaction costs and other charges can be hidden.

The response to past underperformance is often to lower the bar against which performance is being assessed.

The Financial Conduct Authority (FCA) in its recent Interim Asset Management Market Study report<sup>1</sup> stated that *"In some cases we found the benchmarks for targeted absolute return funds are not representative of the risk taken on or are misleading, and the threshold for performance fees was lower than the return targeted"*.

Failure to independently establish and validate a fair and measurable metric against which past and future performance can be correctly assessed, may therefore mean holding investments that *appear* to provide Value for Money but in reality do no such thing.

In some cases, validating the proposed benchmark can be straightforward. For example, a very high proportion of the performance variation in a FTSE Tracker Fund will be explained by the return of the applicable FTSE Index itself. However, for other investment types this may not be as straightforward.

A **Red Flag** is typically raised if the benchmark suggested by the promoter, does not explain at least 90% of the performance variation in a given fund. This benchmark attribute is typically measured by a statistic called R-squared (see the Glossary for a more detailed description).

# Performance Evaluation

“Performance evaluation cannot be conducted in a vacuum. By its nature, performance evaluation is a relative concept. Even so-called “absolute return” managers should provide some sense of how alternative uses of their clients’ money would have performed if exposed to similar risks.” - CFA UK

According to the CFA UK a valid benchmark must always be investible, measurable and appropriate<sup>2</sup>.

Trustees and governance professionals should therefore always reject the use of aspirational or so called ‘target return’ benchmarks, which are not suitable for measuring how an investment strategy or asset manager performs relative to the return opportunity provided by the relevant assets for any given period of time.

In our experience it is often very easy to construct a low cost passive and investible benchmark which accurately reflects the investment strategy of the majority of the multi-asset or multi-manager funds that are currently being offered by the market. This will facilitate the Value for Money assessment.

The use and promotion of inappropriate ‘target return’ benchmarks can be a particular problem within Fiduciary Mandates, Implemented Consulting, Absolute Return, Private Equity, Hedge Funds, Multi-Strategy and DGF’s, Private Equity and Infrastructure.

Sometimes even the use of standard FTSE-100 benchmarks may not be an appropriate reflection of an investment strategy. For example, where the asset manager has a persistent allocation to smaller (and riskier) companies. In this case the asset manager expects to earn a higher return via the exposure to riskier assets and the relevant performance benchmark should reflect this.

Be particularly alert if incentive fee calculations are based on this kind of performance metric. It will almost always result in excess fees being paid by the investor.

# How to Evaluate 'Value for Money'

In simple terms 'Value for Money' is optimised when you have purchased a service or product at the lowest available cost for what you can reasonably expect to receive in return.

There is currently some confusion as to what the term 'Value for Money' really means for investors and it is prone to misuse or misunderstanding.

As part of its research for Interim Asset Management Market Study report<sup>1</sup>, the FCA found broad agreement that 'Value for Money' for asset management products is seen as a combination of the:

- return achieved
- price paid
- risk taken
- quality of any additional services provided by the asset manager

However, just as it applies to past performance, past 'Value for Money' is no guide to the future.

The main challenge therefore, when evaluating 'Value for Money' is that it is not always possible to validate the perceived 'Value' term upfront as future investment returns from risky assets or active management cannot be predicted.

However, Arbitrage Pricing Theory<sup>3</sup> suggests that in the long run assets with similar risk attributes can be expected to produce similar returns, as there can be no 'free lunch' in financial markets.

Comparing the price you pay for each unit of risk that is being taken is therefore a good proxy on which to compare future expected costs and therefore 'Value for Money'.

This is why an investible benchmark is required which enables the investor to assess and compare the real risk of an investment versus all future costs.

The recent debate on closet tracking, where active fees are charged for passive mandates, is a good example of where 'Value for Money' is not being delivered.

This also means that simple peer group comparisons of cost can be misleading as investment strategies may differ.

In some sectors (such as private equity) investors might now be collectively overpaying for the average investment returns received per unit of risk, as vintage returns since 2006 have not outperformed public markets, according to a recent research report covering over 2000 funds<sup>4</sup>. A peer group comparison will therefore not provide a valid guide as to whether 'Value For Money' is being achieved for this asset class.

# CLERUS Self-Assessment Check List

Outlined below is a Check List that will help you begin to understand the potential for cost savings in your pension fund.

*For each Question simply circle your score in the designated column, i.e. if the answer to question 1 is a “No” circle 1, if you “Don’t know” circle 4 and if “Yes” circle 5. ‘X’ denotes an invalid answer. Each question has its own scoring key indicated within the question. In question 2 all six sub-questions should be answered individually.*

#	Question	Your Score				
		1	2	3	4	5
1	Do you use a Fiduciary Manager? (No=1, Don't Know=4, Yes=5)	1	X	X	4	5
2	Do you invest directly in investment strategies, and/or have an investment strategy or asset allocation, that involve any or all of the following?					
2.1	Uses numerous asset managers, segregated mandates and/or pooled funds? (1-2 managers=1, 3-5 managers=2, 5-8=3, 8-15=4, more than 15 managers=5)	1	2	3	4	5
2.2	Invests directly in hedge funds and/or absolute return products? (No=1, Don't Know=4, Yes=5)	1	X	X	4	5
2.3	Invests in funds of funds, diversified growth funds, multi-strategy funds and target return funds? (No=1, Don't Know=4, Yes=5)	1	X	X	4	5
2.4	Invests in private equity or infrastructure? (No=1, Don't Know=4, Yes=5)	1	X	X	4	5
2.5	Uses a hybrid life/fund structure? (No=1, Don't Know=4, Yes=5)	1	X	X	4	5
2.6	Invest in pooled funds which charge performance fees? (No=1, Don't Know=4, Yes=5)	1	X	X	4	5
3	If you know your total annual portfolio turnover including, but not limited to, the buying and selling activities of your asset managers, changes made to asset managers and/or changes to asset allocation – please indicate here: (0-10%=1, 10-25%=2, 25-50%=3, 50-100%=4, more than 100%=5. if you Don't Know=4)	1	2	3	4	5
4	Do you know how much you are paying for any chargeable extras (such as soft commissions, ticket charges or marketing related costs) with any of your asset managers (or funds)? (Yes, I don't pay=1, Yes, I pay some=3, Don't Know=5)	1	X	3	X	5
5	Do you predominantly rely on the performance assessment/reporting provided by the person or company who recommended the investment strategy/manager to you (i.e. asset managers, investment consultants and fiduciary managers)? (No=1, Somewhat=3, Don't Know=4, Yes predominantly=5)	1	X	3	4	5
6	Do any of your pooled funds or asset managers make use of unconstrained, peer group or aspirational target return benchmarks (such as cash, or cash plus, RPI or CPI plus, gilt or liabilities plus) to assess investment performance? (No=1, Don't Know=4, Yes, some or all =5)	1	X	X	4	5
7	Do you have a process in place to shadow, map and compare the actual charges paid versus contracted charges agreed? (Yes=1, Don't Know=4, No=5)	1	X	X	4	5
8	Have you reviewed your IMA(s) and/or pooled fund documentation and mapped out any potentially unfavourable charges or asymmetric contract terms (i.e. hidden charges)? (Yes=1, Don't Know=4, No=5)	1	X	X	4	5
9	Are all transaction and investment costs and benchmark & performance data readily available to you to access? (Yes=1, Mostly=3, Don't Know=4, No difficult=5)	1	X	3	4	5
10	Do you regularly monitor and compare the costs of your financial services providers and renegotiate the price paid, if appropriate? (Yes=1, Ad hoc=3, Don't Know=4, No=5)	1	X	3	4	5

# How Well Did I Do?

To obtain your overall score simply add together your scores relating to each question in the self-assessment Check List.

Overall Score	Potential for cost savings
0-25	<b>Limited.</b> You appear to have a relatively simple and cost effective investment strategy in place, which combined with a robust investment costs governance process enables you to measure and manage investment costs effectively. However you may still benefit from an independent review.
25-50	<b>Significant.</b> You have a number of areas where further investigation is required. Some relatively simple steps could be taken that would likely improve your investment costs governance process. Potential cost savings may be large.
50-75	<b>Very High.</b> You have significant scope for improving your investment costs governance process. An independent cost-benefit review of your current investment cost-base would almost certainly highlight key areas of 'low hanging fruit' where costs could be reduced, and the Value for Money received could be significantly improved.

The scoring methodology used in this Check List is based on known indicators which can be used to gauge the potential for hidden or excess investment cost in a pension fund. The questions seek to evaluate whether certain types of cost apply to you as well as the strength of processes in place to monitor and control these costs relative to the value you can expect to receive in return.

In our experience these patterns provide a very good indication of costs, but we recognise that individual circumstances may differ. In designing the Check List, we have assigned a relatively high score for answers that are "Don't Know". The rationale for this is that if you don't know, then you are more likely than not to be paying more than you should.

Finally, please note that reporting on transaction costs items is currently a regulatory requirement for some types of DC pension funds<sup>5</sup>.

# Where Do I Find Costs & Charges?

The Cost Table on the next few pages has been split into 4 columns as follows:

1. **Source of Cost:** Where the cost item is located
2. **Description:** A description and/or a definition of the cost item
3. **Why Important?:** Why the cost item is important to understand and what the drivers are for reviewing it
4. **Key Examples:** Examples of the cost item itself and/or how to measure, manage or reduce that level of cost.

In the 'Source of Cost' column we also indicate the type of investment that it relates to using the following key in {} brackets:

**EQ** = Equities      **FI** = Fixed Income  
**C** = Cash            **AI** = Alternative Investments

And where the cost item is typically found, whether in Segregated Mandates or Pooled Funds:

**SEG** = Segregated Mandates      **P** = Pooled Funds

Finally, in the 'Key Examples' column, we indicate in () brackets, in our opinion, whether or not we believe the cost is "Easy" to find, "Could Be Difficult" to find or "Difficult" to identify and establish":

**E** = Easy      **CBD** = Could Be Difficult      **D** = Difficult

# Cost Table

Source of Cost	Description	Why Important?	Key Examples
<b>1. Transaction Costs (Explicit &amp; Implicit)</b> {EQ, FI, C, AI} {SEG & P}	<p>Transaction costs are incurred when asset managers and agents buy and sell assets including individual stocks, funds, currencies and derivatives etc. Transaction costs can be split into implicit and explicit costs.</p> <p>Total transaction costs are directly linked to the portfolio turnover/activity of your asset manager/agent. It is therefore a variable cost. The higher the portfolio turnover (and the bigger the fund) the higher the expected cost.</p> <p>See the Glossary section for a definition of Implicit and Explicit transaction costs.</p>	<p>For some types of pension funds it is a regulatory requirement<sup>5</sup> to understand transaction costs and if they represent “Value for Money”.</p> <p>Excessive portfolio turnover and transaction-related cost can be a significant deduction to investment performance.</p> <p>The value added or deducted from this activity can be assessed against an investible benchmark. However, asset managers will often use artificially low or inappropriate benchmarks to hide the impact of their investment activities, in particular when this is negative.</p> <p>The FCA has recently issued a consultation paper on transaction cost disclosure in workplace pensions<sup>6</sup>.</p>	<p>Ensure that the stated Portfolio Turnover Rate (PTR) is a true reflection of ALL transactions in your pooled funds &amp; segregated mandates. Sometimes artificially low PTR numbers are indicated that understate total costs. <b>(CBD)</b></p> <p>Custody per ticket fees count as explicit transaction costs and should be attributed as such. <b>(E)</b></p> <p>Understand the costs of your initial investment (i.e. the bid/offer spread on fund units). <b>(E)</b></p> <p>Understand all Implicit and Explicit transaction costs. The majority of funds that we have analysed provide only explicit costs such as commissions and direct broker fees; however these items may be only a fraction of the overall cost of a trade (i.e. market impact or bid-offer spread may not be reported). The higher the assets under management in a given strategy the higher the expected implicit costs. <b>(CBD)</b></p> <p>Implicit transaction costs may have to be estimated, but can normally be established with reasonable accuracy. <b>(CBD)</b></p>

# Cost Table

Source of Cost	Description	Why Important?	Key Examples
<b>2. Explicit Costs</b> {EQ, FI, C, AI} {SEG & P}	<p>All segregated mandates and pooled funds pay an Annual Management Charge (AMC) which is the stated annual fee that the asset manager charges for managing the mandate. However the AMC does not include all costs and charges paid for by the investor.</p> <p>Some types of pooled funds usually publish an Ongoing Charges Figure (OCF) on their Factsheets. The OCF provides investors with an estimated annual cost of holding the pooled fund investment and includes the AMC.</p>	<p>The AMC may not be the only cost that is being charged. Other costs &amp; charges may add up to a significant amount.</p> <p>There are many shortcomings involved with using the Ongoing Charges Figure (OCF). The cost items included in the OCF are “disclosable” costs only. They do not include, for example, cost items relating to trading and one-off cost items. They also don’t include performance fees.</p> <p>Higher costs reduce expected returns.</p>	<p>The true annual cost of holding the pooled fund investment or running a segregated mandate is likely to be appreciably higher than you think. <b>(E)</b></p> <p>The introduction of the OCF by the regulator was an attempt to capture the cost paid by investors in a pooled vehicle. The true cost can typically be established by subtracting net performance from gross performance; however a separate validation of the ‘true’ gross performance figures might be required. <b>(CBD)</b></p> <p>The stated OCF for funds of funds products often does not include the OCF of the underlying funds. This results in actual ongoing costs that are much higher than those stated. <b>(CBD)</b></p>
<b>3. Ambiguous / Implicit Costs (chargeable extras)</b> {EQ, FI, C, AI} {SEG & P}	<p>These are items that are charged for over and above the AMC but it may not be clear how much they amount to upfront.</p> <p>Cost items included in this category typically include Directors Fees, Custody, Administration, Legal Fees etc. But more questionable charges such as marketing, travel or the CIO’s pension are sometimes charged. For pooled funds, some, but not all of these extras are included in the OCF.</p> <p>For segregated mandates the costs of many of these chargeable extras are incurred directly by the asset owner.</p>	<p>Some chargeable items can easily lead to excessive extra costs thereby unexpectedly reducing investment returns.</p> <p>Some of the costs charged to pooled funds or investment trusts such as research, marketing or fund distribution are arguably part of the asset manager’s cost of doing business and should therefore be covered by the AMC.</p>	<p>Asset managers of some pooled fund defined contribution solutions may charge for extras such as a “ticket” or “execution” fee per executed transaction. <b>(E)</b></p> <p>Multi-manager and fund of fund type investment strategies typically have several layers of cost that are not always reported fully or in a transparent manner. <b>(CBD)</b></p> <p>In segregated mandates, no Soft Commission items, such as investment research costs or execution services (that relate to an asset manager’s cost of doing business), should be charged to your portfolio (E) or bundled into the price of transactions. <b>(CBD)</b></p>

# Cost Table

Source of Cost	Description	Why Important?	Key Examples
<b>4. One-sided Contract Terms</b>  {EQ, FI, C, AI}	<p>The terms of your contract (per the IMA or Fund Documentation) set out how your asset management service provider is paid and what you receive in return.</p> <p>The use of 'standard' documentation provided by asset managers can often include one-sided terms that transfer the risk of unexpected losses and associated costs to the investor - the cost of which will not be evident up front.</p>	<p>The actual costs of these one-sided terms may only be evident when something untoward happens and you are hit with unexpected costs. These costs can be material and are designed to protect the asset manager.</p> <p>A forward-looking analysis and risk assessment are, therefore, required prior to signing contracts. In some cases, investors are better off walking away if terms are not negotiable or are unfavourable to them.</p>	<p>Contractual terms covering events such as a disaster impacting your asset manager might find you waiting a while to take control of your investments – typically these events occur in a falling market. <b>(D)</b></p> <p>There have also been a number of examples of court cases where asset owners have lost, despite the asset manager having caused a loss to the investor by deviating from the investment mandate due to these clauses (See for example; Certain Limited Partners v Henderson PFI Secondary Fund II 2012).</p>
<b>5. Performance Fee Calculations</b>  {EQ, FI, AI} {SEG & P}	<p>The method used to calculate the amount of performance-related fees payable to the asset manager.</p> <p>Some performance fee calculations can involve many steps before the performance fee is calculated.</p> <p>Some asset managers will model performance fee calculations to optimise expected performance fee income.</p>	<p>Performance fees are often marketed as a way to align incentives but in reality the asymmetric nature of the fee means that unless you are refunded for early losses, or can get a full refund, or only pay the fee at the end, you may end up having paid performance fees even if the asset manager has not delivered the intended outcome or any excess return during the full holding period.</p> <p>The methods used and parameters set (including hurdle rate, term and claw-back provisions) can have a huge impact on the performance net of all fees ultimately received by you, the investor.</p>	<p>Some asset managers model performance fees using different methodologies. The calculation methodology arrived at is usually the one that delivers the highest performance fee. <b>(E)</b></p> <p>Be careful with any 'hurdle rates' that are reset annually or triannually as it may mean you pay for the same performance twice. <b>(E)</b></p> <p>In addition, no investments should be excluded from the performance fee calculation. <b>(E)</b></p> <p>Performance fees can often be negotiated and better calculation terms achieved. <b>(CDB)</b></p>

# Cost Table

Source of Cost	Description	Why Important?	Key Examples
<b>6. Erroneous Fee Collections</b>  {EQ, FI, C, AI} {SEG & P}	<p>Fees, costs and charges taken over and above what has been allowed in the IMA/Pooled Fund documentation.</p> <p>This occurs when the asset manager does not follow the practice stated in your IMA or Fund Documentation.</p> <p>This can happen by accident and may not be intentional.</p>	<p>In our experience, incorrect charging happens more frequently than you might expect and could have a significant impact on performance. This is often due to incorrect system settings or manual error.</p> <p>Depending on what contractual term has not been followed it may result in extra charges, loss of interest or capital or by being disadvantaged in another way.</p> <p>You may be entitled to a refund of all these charges plus any interest foregone.</p> <p>The total amount could be significant.</p>	<p>To identify these cost items you first need to know everything that is being charged to the fund, then map these charges against the contract. This can take time, but once the process is in place it is relatively easy to monitor on an ongoing basis. <b>(CBD)</b></p> <p>Ensure that the Invoice Payment Date as stated in your IMA has the same payment date as that on the invoice when it is received. <b>(E)</b></p>
<b>7. Undeclared Income</b>  {EQ} {SEG & P}	<p>This is income derived from the management of your investments that may be due back to you but is not necessarily refunded.</p>	<p>Clearly, receiving all monies due to you improves investment returns, especially if compounded over time.</p>	<p>This is common in the US where competition amongst exchanges is leading to higher trade rebates for brokers.</p> <p>Investigation of the investment value chain may uncover trade-related rebates that are received by the asset manager (or the broker further down the trade value chain) but have not been passed on to the investor. <b>(CBD)</b></p>

# Cost Table

Source of Cost	Description	Why Important?	Key Examples
<b>8. Unresolved Conflicts of Interest</b>  {EQ, FI, C} {SEG}	<p>Conflicts of interest are common and even when declared may not be properly managed.</p> <p>Principal-agent issues arise when two parties have different interests and asymmetric information.</p> <p>For example a custodian or fiduciary manager (the agent) will be acting for you on a fee basis but may also act as a principal, possibly via a subsidiary or related company, on certain transactions.</p> <p>Some older IMA's may include principle-agent terms.</p>	<p>The agent is charging fees and is also making a profit via the spread on the transaction. Should the agent have oversight on the principal transaction then it is possible that larger than expected profits can be made by the agent and/or the principal.</p> <p>Avoid this kind of relationship where possible.</p> <p>The lawsuits brought by some pension funds in the US with regards to the quality of the foreign exchange execution provided by their custodian banks illustrates the sizeable costs incurred from suboptimal execution.</p>	<p>Check that you are getting best execution on your FX rates and avoid submitting large orders in advance to be executed at a benchmark fixing as this might impact the setting of the fixing rate itself. <b>(E)</b></p> <p>Check the interest rate that you are getting from your core deposit accounts whether at a bank or at your custodian and compare them to the best market rates. Be aware of banking and custodian service providers treating you like a captive client by paying you less than market rate. Consider the pros and cons of moving your cash deposits to another provider. <b>(E)</b></p> <p>Unresolved conflicts of interest are also inherent in investment consulting and fiduciary management and is a stated area of concern for the FCA<sup>1</sup>. Some of the conflicts cited are: incentives to over-recommend complex investment strategies; promoting churn to generate revenue for themselves; and for lacking in transparency on their own fiduciary management fees and performance. <b>(CBD)</b></p>

# Cost Table

Source of Cost	Description	Why Important?	Key Examples
<b>9. Inappropriate Benchmarks</b>  {EQ, FI, C, AI} {SEG & P}	<p>Benchmarks are the standard against which the performance of an asset manager or investment strategy can be measured.</p> <p>Inappropriate benchmarks can lead to a loss of performance as the asset manager is not held properly to account.</p> <p>The selection of appropriate benchmarks is therefore paramount to establishing and comparing Value for Money.</p> <p>Negotiating a correct and proper benchmark with an asset manager is as important as negotiating fees and should be an integral part of the due diligence carried out prior to investing.</p> <p>Strongly reject an asset manager or advisor who tells you that their strategy cannot be benchmarked, or that establishing relevant benchmarks will negatively impact their ability to add value.</p>	<p>Are you paying a higher fee for something that typically would attract a lower fee?</p> <p>Asset managers, fund selectors or advisors all have rational incentives to set benchmarks that are easy to beat in order to make performance look as good as possible. Inappropriate benchmarks can also be used to hide excessive costs and charges or to enable the charging of excess and unfair performance fees.</p> <p>The use of accurate investible benchmarks that fully reflect the holdings and activities of an asset manager make performance assessment easy and almost always leads to better performance.</p> <p>Incomplete or missing investment controls could mean that undue risk is being taken in the management of your money.</p>	<p>Any benchmark that is purely aspirational and not investible. <b>(CBD)</b></p> <p>Any benchmark that does not explain a very high proportion (90% or more) of the performance variation of the pooled fund or segregated mandate versus the benchmark in any given period. <b>(CBD)</b></p> <p>Typical examples of inappropriate (aspirational) benchmarks are: <b>(E)</b></p> <ul style="list-style-type: none"> <li>-Cash, or Cash + 2%</li> <li>-RPI or CPI + 3%</li> <li>-Gilt or Liabilities + 2%</li> <li>-Peer group benchmarks.</li> <li>-Fully or partially unconstrained mandates</li> </ul> <p>The use of inappropriate benchmarks (according to the CFA UK paper<sup>2</sup>) can be a particular problem in Fiduciary Mandates, Implemented Consulting, Absolute Return, Diversified Growth Funds, Private Equity, Hedge Funds, Multi-strategy and Infrastructure (i.e. everything that is labeled 'Private Markets', 'Alternative' or 'Unconstrained').</p>

# Private Equity

Source of Cost	Description	Why Important?	Key Examples
<p><b>Private Equity</b></p> <p>Private Equity (PE) has received significant negative news coverage for hidden and unfair costs &amp; charges and for poor practice<sup>7,8</sup>.</p> <p>PE is, therefore, deserving of a dedicated section in this Guide. Some of the items listed could equally apply to alternative investments such as hedge funds, fund of funds, absolute return and infrastructure (or anything else in private markets).</p> <p>It is highly likely that you will need professional help to get to the bottom of PE and private markets-related investment costs.</p> <p>{AI} {SEG &amp; P}</p>	<p>The terms and assessment criteria applied by the industry can leave room for a multitude of opaque costs and charges which, over a 10 year life cycle, could equate to 50-80% of the initial investment amount according to PE specialist Barwon Investment Partners<sup>9</sup>.</p> <p>The calculation of carried interest (performance fees) against low and easy to beat hurdles instead of relevant market returns and the charging of annual management fees on committed, but not vested capital explains a significant part of these high costs.</p> <p>The use of Internal Rate of Return (IRR) for performance fee calculation purposes can be opaque and can lead to higher fees.</p> <p>The actual total cost can be many times stated costs, potentially leaving very little on the table for investors.</p>	<p>It may be near impossible to get to the bottom of what your actual investment costs are. However, according to a recent presentation by Railpen, a UK Pension Fund, 20% of earnings of the biggest PE firms comes from. 'Other fees'<sup>10</sup>.</p> <p>The complexity of the fund and investment structure, the various cost items and the IMA or Limited Partnership Agreement (which lacks transparency) is mostly stacked in the PE manager's favour. We are not aware of any standardised disclosures which cover all costs.</p> <p>PE is currently an asset class where fees can not necessarily be negotiated down to a more reasonable and fair level. Understanding all cost items and the total impact on expected returns over the life of the investment is therefore a prerequisite before committing capital.</p> <p>The costs related to the sale of any PE investment, due to illiquidity and its esoteric nature, may also prove to be high. It may also take many weeks, months or even years for you to realise the sale proceeds.</p>	<p>Invoices may contain cost items that are not specifically mentioned in your contractual documentation or you may find that cost items on invoices are rolled up so that you cannot discern what is what. (CBD)</p> <p>The potential hidden charges that you pay for as a Limited Partner are typically located in the following functions: consulting fees at invested companies, audit &amp; accountancy, debt arrangement, bank fees, operations and transaction &amp; monitoring fees.</p> <p>It is therefore important to understand how these costs are charged to you. According to a Preqin survey they may be split as follows<sup>11</sup>;</p> <ul style="list-style-type: none"> <li>i. Mainly to the LP (37%)</li> <li>ii. Equally between LP and GP (44%)</li> <li>iii. All to the GP (19%)</li> </ul> <p>(CBD)</p> <p>According to academics who carried out an in-depth analysis of the economics of 238 private equity funds between 1993 and 2006 it is not clear what transaction and monitoring fees are paying for since substantial management fees are already being paid to the General Partner (GP). Usually one would expect the GP (as the asset manager) to be performing this duty as part of the offering to invest in private companies<sup>12</sup>. (CBD)</p> <p>If management fees are charged at 2% on committed capital but 40% of your committed capital is never drawn down and invested – then your true management fee paid to the manager is closer to 3.3% before any other fees are added. (CBD)</p>

# A Roadmap for Measuring and Managing Investment Costs

Any initiative led by trustees or governance professionals to better understand the complex and opaque world of investment costs and charges need not involve jumping in at the deep end and reviewing every single applicable cost and charge from the outset. However it is better to have a reasonable estimate of all costs than none at all and this can be achieved relatively quickly.

From the investment profile of a typical pension fund, it is possible to work out what the major cost items are and where the major risks and unknowns lie with reasonable accuracy. It is certainly possible to then go on and quantify them within a range.

Trustees and governance professionals should start this process by reviewing their investments, whether segregated mandates or pooled funds, and prioritising those that they believe lack cost and performance transparency or where their understanding of costs and investment risks needs to be improved.

A roadmap can then be put in place to analyse costs gradually, perhaps by reviewing explicit costs first, and then by going on to demand more transparency from asset managers on specific items as they are analysed.

The process will provide increasing levels of transparency over each iteration until such a point as either full transparency is reached or until trustees and governance professionals fully understand where costs are hidden and how much they equate to. Once known, they can then go on to manage or mitigate these costs accordingly.

Fiduciary duty can be evidenced by following a strong, proven and well-documented methodology and by actively working on the findings, recommendations and other outputs.

As a further step, a new operating model should be implemented to lower risk and costs and actively monitor investments. Trustees and governance professionals that follow such a process will have moved from a *reactive* to a *proactive* footing which will enable them to challenge and ask more pointed questions of their asset managers and other service providers on an ongoing basis.

**Improvements in transparency and controls will lead to lower costs and better outcomes.**

# Summary

The sooner that you are able to investigate and understand all of the investment costs in your pension fund, the sooner you will be able to reduce them and provide better outcomes and 'Value for Money' to your scheme members.

This purpose of this guide is to assist the governance process in measuring and managing transaction costs, pooled fund costs and segregated mandate investment costs. We have done this by highlighting a subset of the key sources of cost inherent in the management of pension fund assets.

The CLERUS self-assessment Check List is intended to highlight the number of potential 'red flags' in your current investment costs and 'Value for Money' governance process.

It is our hope that this guide will allow trustees and governance professionals to identify and measure a part of the true cost of investment. This should provide them with a meaningful understanding of how investment performance has been impacted and therefore help them comply with their regulatory as well as fiduciary responsibilities.

You may not be able to rely on your existing service providers to provide some or all of this information as they will typically be part of the cost structure and may be reluctant to share your desire for transparency.

In most cases you will have to drive this process directly, using in-house or independent specialist resources to take you on this journey.

The sooner that you are able to investigate and understand all of the investment costs in your pension fund, the sooner you will be able to reduce them and provide better outcomes to your scheme members

Everyone will have their own idea as to what is the most effective approach to cost discovery. Be aware that embarking on your journey of cost discovery using an in-house approach could take you a long time. Railpen, for example, says it took them more than 12 months to uncover their full investment costs. Railpen are still mid-implementation in terms of making the recommended changes 18 months into the process<sup>10</sup>.

# REFERENCES

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1. See Financial Conduct Authority MS15/2.2 “Asset Management Market Study - Interim Report” issued 18 November 2016.
2. According to a recent paper from the CFA UK Market Integrity and Professionalism Committee, a significant proportion of benchmarks used by investment managers and consultants are ‘inappropriate’ and ‘fall short of the criteria required for a valid benchmark’ (see “Benchmarks and Indices” CFA Society UK, January 2016).
3. In finance Arbitrage Pricing Theory is a general theory of asset pricing which suggests that by the time attractive risk, return or even diversification attributes are broadly discovered the expected future return difference to other factors has already been, or is about to be, arbitrated out by investors.
4. Harris S, Jenkinson T and Kaplan S (2015) “How Do Private Equity Investments Perform Compared to Public Equity?”
5. See “The Occupational Pension Schemes (Charges and Governance) Regulations 2015 No. 879” as well as Financial Conduct Authority “PS15/3: Final rules for independent governance committees”, effective April 2015
6. See “CP16/30: Transaction cost disclosure in workplace pensions” issued by the Financial Conduct Authority in October 2016. This Consultation Paper (CP) proposes rules and guidance to improve the disclosure of transaction costs in workplace pensions. It aims to standardise the disclosure of the transaction costs incurred by DC pension investments.
7. See for example: “\$20bn cost of hidden private equity fees – PE managers boosted profits at expense of investors, study reports” FTfm, December 13, 2015
8. Phalippou L, Rauch C and Umer M (2016) “Private Equity Portfolio Company Fees” Said Business School WP 2015-22.
9. Barwon research found a typical Total Expense Ratio, including carried interest, of 6.2% per annum for unlisted funds. “Listed PE vs. Unlisted PE fees” Barwon Research, February 2014.
10. See recent Railpen presentation: Understanding Costs - What is it we don't see?, Paul Trickett, April 2016. Available on [www.transparencytaskforce.org](http://www.transparencytaskforce.org) - Slides, Transparency Symposium #3, 20th April 2016.
11. Transaction and Monitoring Fees: On the Rebound, Dechert and Prequin, 2011
12. Metrick A and Yasuda A (2010) “The Economics of Private Equity Funds” Review of Financial Studies Vol 23 pp 2303-2341.

# GLOSSARY

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## **Benchmark**

A benchmark is a standard against which the performance of a security, pooled fund, segregated mandate or asset manager can be measured. Generally, broad market and market-segment stock and bond indexes are used for this purpose. A benchmark can be made up of one, two or more indexes (such as the FTSE100 and FTSE350).

## **Explicit Transaction Costs**

All transactions have explicit and implicit costs. Explicit costs are those that are disclosed prior to the trade and include cost items such as commissions, taxes, Takeover Panel (PTM) levy and other fees. All explicit transaction costs will be noted on the Contract Note that the asset manager or broker sends its investor client post-trade.

## **Implicit Transaction Costs**

All transactions have explicit and implicit costs. Implicit transaction costs are those that represent the costs that are not determined until after the execution of a trade or set of trades is completed. Cost items include bid/offer spreads and a number of other cost items relating to the quality of execution itself (i.e. market impact etc).

## **Index**

A market index is an aggregate value produced by combining several stocks, bonds or other investment vehicles together and expressing their total values against a base value from a specific date. Market indexes are intended to represent an entire stock market and therefore track the market's changes over a period of time. An index may be quoted including dividends re-invested (i.e. a total return index) or excluding dividends.

## **Investment Management Agreement (IMA)**

A formal contractual arrangement between a registered asset manager and an investor that outlines the terms under which the asset manager is authorised to act on behalf of the investor to manage the assets listed in the investment management agreement. The IMA outlines the performance target and risk parameters together with investment guidelines and other various investment and operational items, including fees.

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## Limited Partnership Agreement

A Limited Partnership Agreement is the key legal document used by investors in private equity funds that are formed as limited partnerships. It is similar to an Investment Management Agreement (IMA) but is particular to private equity due to the various nuances of investing in this asset class.

## Management Fee/Annual Management Charge/Advisory Fee

A Management Fee, Annual Management Charge (AMC) or Advisory Fee is a periodic fee that is paid by an investor or investment fund to an investment adviser or asset manager for the provision of investment, portfolio management and certain administrative services. The amount and frequency of the fee/charge is agreed in the Investment Management Agreement, Limited Partnership Agreement or other governing contract between the investor or investment fund and the asset manager.

## Multi-manager

Multi-manager investment is an investment product that consists of many specialised funds. Each specialised fund may follow a different investment style and/or invest in different asset classes. Multi-manager investments normally involve paying different layers of fees which can significantly exceed those of a simpler diversified portfolio.

Where performance fees are charged by individual managers you will also pay an ‘asymmetry premium’ that can exceed 1% per annum according to analysis carried out by Mark Kritzman and summarised in his article “Portfolio Efficiency with Performance Fees” (2007).

## Ongoing Charges Figure (OCF)

The OCF, expressed as a percentage and calculated as being the ratio of the total “disclosable” costs to the average net assets of a pooled fund, are the charges an investor will pay each year for holding a pooled fund investment or other investment. The OCF includes the management fee and certain other cost items but, notably, has a number of cost items missing from the calculation meaning that the true costs of holding the investment can be markedly higher than stated and expected. The higher the cost the lower a pooled fund’s return.

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## **Performance Fee/Incentive Fee**

A Performance Fee or Incentive Fee is a periodic fee that is paid by an investor or investment fund to the investment advisor or asset manager. The fee is based on outperformance of a stated benchmark and is only payable on the excess return over and above the stated benchmark. Performance fees are most often associated with hedge funds and other alternative investment products but are increasingly used in traditional asset management products too.

## **Portfolio Turnover Rate (PTR)**

The PTR of a pooled fund or segregated mandate is a measure of how frequently assets within a fund are bought and sold by the asset manager. There are a number of calculation methodologies used to calculate a PTR. For example, it could involve either the total amount of securities purchased or sold, whichever is less, and then dividing that figure by the total net asset value (NAV) of the fund. Some pooled funds report their PTR and then smooth it over the last 3 years. We have identified over ten different PTR calculation methodologies in live use in the market today. The PTR figure is usually reported for a 12-month time period covering the last Financial Year of the pooled fund.

The flaw in most PTR calculation methodologies is that not every transaction is included - as each and every transaction generates a transaction cost. The correct PTR calculation methodology from an investor perspective should involve using every executed trade as part of this figure as a minimum. In recent years, PTR has climbed for the typical pooled fund or segregated mandate, resulting in much higher overall transaction costs.

## **Soft Commission**

Soft Commissions are a means by which service providers, such as brokerage firms, can be paid for their services through the use of commission revenue instead of through direct payments. The use of Soft Commissions allows asset management companies to cover some of their expenses, perhaps those related to the receipt of research or execution services, through client trading commissions.

Payments for soft commission items such as research are, arguably, part of the asset manager's cost of doing business and should be paid for by the asset manager out of the Annual Management Charge.

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## **Ticket/Execution Fee**

Normally applicable to DC pension funds (but can also apply to DB pension funds). It involves the asset manager charging a pre-defined fee per transaction for execution via their own dealing desk or via a third party dealing desk. Some parts of the industry want to move away from a pre-defined amount to a percentage-based fee per transaction which would undoubtedly result in higher costs for the underlying pension fund. Ticket Fees or Execution Fees are not included in the DC pension charge cap so, therefore, count as an additional chargeable item.

## **R-squared (in relation to Benchmark assessment)**

In statistics, the coefficient of determination, denoted  $R^2$  or  $r^2$  and pronounced “R squared”, is a number that indicates the proportion of the variance in the dependent variable that is predictable from the independent variable. It can be used in the assessment of past performance to provide a measure of how well the observed outcomes are replicated by the benchmark over a period of time. For example an  $R^2$  of 0.9 tells you that 90% of the performance variation in a fund can be explained by the performance of its benchmark.

**Henrik Pedersen**

henrik.pedersen@clerus.co.uk

+44 77 6765 6234

**Richard Rothwell**

richard.rothwell@clerus.co.uk

+44 77 1433 9939

**[www.clerus.co.uk](http://www.clerus.co.uk)**

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Registered in England No. OC390368

Registered address: 4th Floor, Rex House, 4-12 Regent Street, London SW1Y 4PE

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