THE
INVESTMENT
ASSOCIATION
INVESTMENT MATTERS

FCA CALL FOR INPUT:
PRIIPS REGULATION – INITIAL EXPERIENCES WITH THE NEW REQUIREMENTS

RESPONSE FROM THE INVESTMENT ASSOCIATION

28 SEPTEMBER 2018

EXECUTIVE SUMMARY

The Investment Association[1] (IA) welcomes the opportunity to respond to the FCA Call for Input: PRIIPS Regulation – initial experiences with the new requirements.

Our response is the product of a period of robust consultation with our member firms many of whom have provided us with data and thorough analyses. They regard this as a critical issue of potential customer detriment and, although they may not submit their own responses, a wide range of firms have indicated that they support our response and that it reflects their views and experiences.

Our response is in five parts.

Part One: Delivering customer-focused disclosure. Customers should be able to access complete, comparable, consistent, and above all, comprehensible information on investment products. The PRIIP Key Information Document (KID) moves that goal further away at a time when building greater confidence is critical. The new regulatory methodology for implicit cost calculation is profoundly flawed as is the approach of providing performance scenarios instead of past performance in the new KID. This also has consequences in the wider retail market and UK DC pensions market where the same transaction cost methodology is being used.

A range of stakeholder comments reinforces this assessment and points to the need for a different approach to development, including further consumer testing. Our response offers specific proposals on the way forward. This is based on pragmatic solutions which can provide customers with better and equally comprehensive data that can be explained in a more intuitive and accessible way.

Part Two: Slippage and the need to measure actual cost. Implicit costs are by definition different to all other product charges and to explicit trading costs, such as brokerage and tax, which all involve specific payments from one party to another. Implicit costs involve no direct payment but can be estimated to quantify for investors any loss of value that occurs when a stock or security is bought or sold. This loss of value results from the difference in capital markets between the price to buy and the price to sell.

Instead of capturing this cost at the relevant time of the trading process, slippage introduces a prescribed time (arrival price). In-so-doing, the goal appears to be to create consistency, which we would support as a general principle in regulation. However, for many strategies, asset classes and market sectors, arrival price has no connection to actual trading process or actual cost.

The consequence of this flaw is the widespread incidence of zero or negative transaction costs under slippage, which in turn reflect a wider distortion in all results. A fundamental issue here is market movement being introduced into the results.

[1] The IA champions UK investment management, a world-leading industry which helps millions of households save for the future while supporting businesses and economic growth in the UK and abroad. Our 250 members range from smaller, specialist UK firms to European and global investment managers with a UK base. Collectively, they manage nearly £7.7 trillion for savers and institutions, such as pension schemes and insurance companies, in the UK and beyond. More information can be viewed on our website.

We provide a range of examples in different strategies and asset classes to show the practical consequences of relying on what is a theoretical 'one size fits all' approach, derived from a specific technique focused on trading efficiency in highly liquid equity markets.

A wider risk is that this new approach will now directly influence actual trading behaviours.

Part Three: Ensuring effective charge and cost disclosure. Using a stylised example, we point to some of the challenges customers are now facing in interpreting the new aggregated information available. This is a feature of combining charges and transaction costs into a single number and it is exacerbated by slippage cost results. There is in fact a triple problem: estimated costs are presented as actual costs. They are then combined with different kinds of actual costs. All of this is presented in the PRIIP KID as a reduction in yield, based on performance and holding assumptions. The result is a confusing set of numbers that does not provide comparable, consistent or comprehensible information. We reiterate an alternative approach that can help reduce this confusion, but support further customer testing.

Part Four: Other issues arising in PRIIPs. We comment on wider issues arising in the PRIIP KID, including risk disclosure and performance scenarios. Performance scenarios remain an area of intense concern for a range of industry groups and wider stakeholders, particularly the removal of past performance which research had shown to be well understood for what it is – a reference and accountability tool, not a guide to future returns. In contrast to the transaction cost disclosure, where the challenge is in the calculation methodology, the issue here arises with the approach itself, ie. using scenarios instead of past performance. This is a more fundamental problem and not a question of whether there is a methodology that would be more meaningful for the scenarios themselves.

Part Five: Proposed way forward. Despite the complex technical areas under consideration, there are clear paths to improvements. We recommend the following steps:

- An open and collaborative approach by EU and UK regulators to working with the industry and other stakeholders to develop the best solutions for investors. This would see a spread-based measure established as the starting point for implicit cost disclosure, and the inclusion of past performance within the PRIIP KID.
- Immediate unilateral action by the FCA to suspend the use of slippage and substitute a half spread measure for MiFID and DC workplace pensions.
- Extension of the PRIIPs Article 32 exemption for UCITS and non-UCITS retail funds at least until the KID regime is amended to address the issues raised and thereby ensure that retail investors continue to have access to the most useful information.

There are two Annexes:

- Annex One presents evidence on the incidence of zero and negative transaction costs in current MiFID reporting in the UK retail fund market.
- Annex Two presents results of IA performance scenario modelling that shows how the PRIIP methodology risks misleading investors.

PART ONE: DELIVERING CUSTOMER-FOCUSED DISCLOSURE

1.1 The Investment Association strongly supports the need to provide complete, comparable, consistent and comprehensible information on product charges and transaction costs. In addition to engaging with regulators in the context of UK and EU reform in this area, the IA has been closely involved in initiatives to develop new reporting templates in the institutional market, including the work undertaken by the Institutional Disclosure Working Group (IDWG), to which the IA is fully committed. We have also developed a machine-readable consistent framework for the provision of transaction cost data to pension schemes under the requirements of COBS 19.8.

1.2 Our response to the Call for Input focuses particularly on offering a detailed analysis and potential solutions in the area of the PRIIPs 'slippage' methodology for estimating transaction costs. There are two reasons for this focus:

- MiFID acts as a transmission mechanism into the retail funds market for the PRIIPs transaction cost methodologies and the FCA has elected to hardwire the slippage calculation into its rulebook for the UK DC pensions market. Therefore the problems already apply on a much wider scale than PRIIPs.
- As a consequence of the exemption of retail funds for the first two years of PRIIPs implementation, most first-hand experience of the KID itself resides with managers of investment companies and providers of insurance products and structured products. In this respect we note the Association of Investment Companies' recent publication[2] "Burn before reading". We recognise the concerns it raises and we support the recommendations. We also offer our own analysis of the challenges posed by the KID performance scenarios in Annex Two of this response.

SLIPPAGE IS PROFOUNDLY FLAWED

1.3 The Call for Input sets out a defence of slippage by suggesting that most results are not unreasonable, that the small number of unreasonable results are mostly due to firms making errors and that negative transaction costs are not necessarily inaccurate. We acknowledge that any new regulation needs some time to bed in, and this is particularly so for slippage given the innovative nature of the data sets required. However, the FCA technical explanation fails to address a key question: does a methodology that is capable of producing literally accurate but negative costs help customers to understand the charges and costs they are paying, to compare investments and to make informed investment decisions?

1.4 Our conclusion remains that this is categorically not the case. We provide clear evidence on this point and call for a change of direction that will help industry and regulators deliver the necessary transparency in this area. A new approach is urgently needed, particularly as the problems are far more widespread that the Call for Input suggests. Annex One sets out in detail our findings regarding the incidence of zero and negative costs in the UK market.

WIDER ISSUES AROUND PROCESS AND IMPACT

1.5 Both the approaches on transaction costs and performance scenarios are now subject to significant challenge by industry and wider stakeholders. We encourage the FCA

[2] The Association of Investment Companies, Burn before reading, September 2018

and the European regulatory authorities to learn lessons from the process that led to the introduction of these methodologies. Specifically, the customer testing of the design of the KID, although extensive, focused entirely on presentation and did not consider any methodologies and approaches that customers may have found more helpful and insightful. The methodologies were not subjected to robustness testing, such as pilot projects, or to direct customer testing.

1.6 In this regard, it is important to acknowledge the verdict of prominent UK academic Professor John Kay, who issued the following warning about the new KID:

"I am a board director of Scottish Mortgage Investment Trust (SMIT), a £6bn fund based in Edinburgh. You can receive material about the trust through its newly published key information document (KID). But please, please, do not Google or download this document. And if you have received a hard copy, burn it before reading. Above all, keep it out of the hands of widows and orphans."[3]

1.7 Guillaume Prache, Managing Director of Better Finance, the Brussels-based consumer organisation, joined the European Fund and Asset Management Association (EFAMA) in writing that there would be *"clearly negative consequences for retail investors"* from the combination of the new methodologies for past performance and transaction costs.[4]

1.8 In the UK, the Independent Governance Committee (IGC) of a leading pension provider, Royal London, warned savers that it too was concerned about the slippage methodology that has been transposed from PRIIPs into the UK DC pensions market:

"A significant weakness in the FCA prescribed methodology is the challenge it presents in measuring the implicit costs, particularly for certain types of asset. In addition, the methodology will result in volatile results reported from year to year as the size of the implicit items, and whether they're negative or positive, will vary year by year as market prices go up or down."[5]

1.9 The IA has held events with IGCs and trustees to help communicate the new methodology. The responses have generally mirrored the comment above. The complexity of slippage is such that it is not clear to us on what evidence the FCA's expectation that the methodology will be understood over time is based.

[3] Financial Times, Risk, the retail investor and disastrous new rules, 19 January 2018.
[4] EFAMA and Better Finance, Letter to the co-legislators, 13 October 2016.
[5] Royal London IGC, Annual Report 2017, Page 22.

PART TWO: SLIPPAGE AND THE NEED TO MEASURE ACTUAL COST

Parts Two and Three of this response focus on the issues raised in question 3 of the Call for Input (transaction cost calculation).

2.1 As we have emphasised in past submissions[6], rules and practice around disclosure of areas of cost that are implicit and do not involve an actual payment between one party and another require very careful calibration. Unlike product charges and explicit payments such as broker commission and stamp duty, which can be straightforwardly quantified in pounds and pence terms, implicit costs can only be estimated as they are interwoven in the pricing mechanism of the market. Wrong calibration can give a wholly misleading view of both real cost and the role performed by investment managers.

2.2 To summarise how cost accountability should work in an investment fund context (focus of PRIIPs), we suggest there are the following key elements to consider:

- Payments to managers and others in the delivery chain (eg. custodians, administrators). These are captured effectively in the ongoing charges figure (OCF) which, together with any additional charges such as an entry fee or performance fee, appears in the UCITS KIID.
- Brokerage fees to transact in equity markets.
- Transaction taxes, as applicable (eg. UK stamp duty).
- Market spread which can only be estimated, but which in commercial terms constitutes a transfer of value to those institutions who act as market makers, measurable in the difference between a price to buy and a price to sell at a given moment in time.

2.3 The last point is critical to the discussion about whether slippage is accurate, as currently defined. The cost elements above provide a series of data points about how agents in the delivery chain, from market makers through to fund managers, effectively constitute a friction on the returns achieved by savers. Taken together, these data points can help to provide full economic accountability for a service provided. Taken separately as charges and transaction costs, they can help customers understand the costs of using a fund as distinct from the costs inherent in the underlying investment process.

What is spread?

Spread is a measure of the difference between the price to buy and the price to sell at a given point in time. It measures the implicit cost of transacting and can be added to the explicit costs (brokerage commissions and transaction taxes) to give total transaction costs. Typically half the spread is assigned to purchases and half to sales.

For example, shares might be quoted at 100p to buy and 98p to sell. Within this spread, the shares would be valued at a mid-price of 99p. The spread cost will be 1p per share for both buyers and sellers. If the manager uses £1,000 to buy these shares there will be an implicit cost of £10. At the same time a seller of these shares would realise £980 having also incurred an implicit cost of £10.

[6] IA response to CP16/30: Transaction cost disclosure in workplace pensions, January 2017.

2.4 The objective with implicit costs needs to be the separation as far as possible of real trading costs from market movements, which reflect activity of all participants in a market and represent a different kind of potential benefit/cost to investors. Gains or losses arise in a number of ways through the investment process. Some are straightforward: a gain/loss as measured over a period of days, weeks, months or years as a security rises or falls in value. Others are more complex and could be described under the umbrella of 'opportunity cost': the actual outcome against 'what might have been'. Opportunity costs occur in every walk of life as a result of decisions delayed, postponed or not taken at all. They can occur in both actual investment decisions and the trades made to execute those decisions. Within the trading process specifically, opportunity costs may arise as a result of delays to trades being executed.

2.5 Such costs in the trading system matter, and are subject to a variety of measurement processes, known as transaction cost analysis (TCA), to help firms understand, manage and optimise them. They are closely connected to the concept of best execution, which is defined not just in terms of cost of trades, but factors such as the likely impact on the market, speed and likelihood of execution. The critical point here is that there is no one size fits all approach to the measurement of transaction costs. Different techniques are used for different objectives. Slippage, in essence, is based on trying to look at the difference in cost between a realised outcome and one that may have been targeted. In advanced form, it is part of a suite of tools that help firms assess the quality of their trade execution.

What is slippage?

In effect, slippage uses an estimate of implicit costs calculated by comparing the value of the shares bought against a benchmark value (the arrival price) when the order to buy or sell them was transmitted. The critical flaw is that there is a time delay between order transmission and execution during which the market moves. Therefore the benchmark value might be higher or lower than the value actually traded.

In a stylised example, the manager might use £1,000 to buy some shares. If the benchmark gives a lower value, say £990, the estimated implicit cost will be £10. If it is higher, say £1,005, the implicit cost will be -£5 (negative costs) because the market moved in the buyer's favour during the time delay.

It is essential to understand that this is purely theoretical: at no point does the £1,000 benefit from negative costs and rise in value. On the contrary, in the absence of market movement, £1,000 will be worth less the moment after the transaction takes place as a result of half the real bid-offer spread. This is the actual cost that should be measured.

2.6 The conceptual justification for using this approach in PRIIPs and UK DC pension disclosure is that trading processes should aim to achieve a price as close to that available when the order was transmitted. If the market has moved against the investment manager, it would represent a cost to the customer that should be quantified. On the other hand, if the market moves in favour (creating negative costs), then this is a gain.

2.7 We have consistently taken the view that this approach is profoundly flawed for the reasons set out below.

2.8 Slippage confuses the goal of estimating implicit costs in the market for aggregated disclosures to customers with the concept of measuring trading efficiency for maximising investment returns. The slippage methodology aims to measure trading efficiency based on one specific conceptual approach (derived from equity market transaction cost analysis). The result is that the goal of pursuing actual cost is subverted by a theoretical measure, which in many cases may not even provide an insight as to how efficient a manager has been, let alone meaningful cost measures.

2.9 To understand this fully, we need to return to the concept of implicit cost as a leakage of value. If an investor were to simultaneously buy and sell shares, the difference between the offer and bid prices (ie. the spread) would represent the implicit cost due to value leakage. Assuming no other investors are active in the market, at any given moment, the bid will always be lower than the offer. In simple terms, this is how market makers and brokers trading as principals will generate revenue. In practice, in active markets, prices will often move very quickly as a result of the combined impact of multiple participants' buy and sell decisions executed increasingly at fractions of a second within the most liquid markets. Capturing the spread is the key to capturing the economic cost of the trade.

2.10 In markets with good data quality and availability where trades are relatively small and placed with the goal of immediate execution, the time gap between the arrival price and the execution price may be extremely short and measurement using the slippage approach can give a reliable indication of implicit cost. In reality, the investment world is much more complex than this and there are a number of trading strategies that necessarily widen the time gap and thereby increase the significance of market movements in the measurement of slippage.

2.11 A firm provided the data in Exhibit 1 which demonstrate the effect on implicit costs of market movements during longer time delays under slippage compared to a measure of half spread (calculated using the time-weighted average spread over the time from order transmission to last execution). They illustrate very clearly issues with the reliability of slippage, which gives a theoretical result.

2.12 Returning to the £1,000 example used earlier, the investment is not subject to a fall in value of 0.81bps (row 1) or a rise of 80bps (row six). In contrast, half spread will be much closer to the actual economic experience of the investment. It is also evident that the half spread approach both eliminates negatives and some of the extreme results in terms of the overall range.

Exhibit 1: Impact of time delay on implicit costs – slippage versus half spread

Elapsed Trade Time (Time from order transmission to last execution)	**Slippage**	**Half spread**
1 hour 20 minutes	0.81bp	0.03bp
6 hours 15 minutes	1.54bp	0.01bp
7 hours 30 minutes	1.30bp	0.01bp
7 hours 50 minutes	-0.45bp	0.01bp
8 hours 10 minutes	1.26bp	0.02bp
8 hours 35 minutes	-0.80bp	0.03bp

2.13 Data from another firm also illustrates the distortion caused by widening the time gap. Exhibit 2 shows an analysis of trades in an index tracking fund over a six month

period. It reveals significant total transaction costs (implicit plus explicit) arising from nearly 4,000 trades in the six to nine hour window that contribute a negative £137,757 of transaction costs. This equates to negative 40 basis points of the overall three year average of negative 30 basis points. Returning to the economic experience of the investment, it is absolutely not the case that investors have benefited by £137,757 as a result of the trading process. This is again theoretical.

2.14 This will particularly impact passive funds that often place orders earlier in the day for execution at close and therefore the six to nine hour time difference between the arrival time and execution time can produce slippage results with significantly large negative (or significantly large positive) transaction costs which are not representative of the actual transaction costs incurred.

Exhibit 2: Market on close trading strategies – slippage costs (£)

Elapsed Trade Time	Number of trades	Slippage
Less than 1 hour	85	-£458
1 to 3 hours	1,137	-£1,022
3 to 6 hours	207	£2,213
6 to 9 hours	3,897	-£137,757
More than 9 hours	161	770

2.15 These results reflect a fundamental timing issue that cannot be dismissed without further discussion of why they are occurring: namely that cost to investor cannot effectively be measured using an arbitrary arrival price hours before an individual trade occurred. The efficiency with which the overall transaction has been executed will only be picked up within TCA analysis appropriately adapted to the trading strategy chosen.

MEASURING COSTS IN DIFFERENT TRADING STRATEGIES

2.16 The examples in the previous section arise because different managers and dealers will use different approaches to trading, rendering the assumption behind a single 'arrival price' timing point incorrect and irrelevant. Exhibit 1 and Exhibit 2 were based on specific approaches:

- Exhibit 1 reflects the reality that many portfolio managers and dealers utilise dynamic trading strategies whereby opportunities to trade are exploited throughout the day. Such approaches are sometimes described as Value Weighted Average Price (VWAP) strategies and are characterised by the use of multiple measurement points over the duration of a trade, not a single 'arrival price'.

- Exhibit 2 reflects a trading style routinely used by passive index-tracking funds, which routinely place orders throughout the day in response to investor flows for execution at close, or another fixed time, in order to most closely replicate the index. The result is significant costs (negative in this case but could also be positive) that are unrelated to the strategy being followed. This also creates an undesirable incentive for managers to change their trading style to mitigate this cost distortion with adverse consequences for the fund and the wider market.

2.17 We take no position in the debate about appropriate trading strategies, other than to note that firms are incentivised to develop these in order to deliver both best execution and the best overall investment outcomes for customers.

2.18 In this context, some firms might chose VWAP for two reasons. First, it tends to minimise the market impact on the stock being traded (which is clearly for the benefit of clients, and one of the key objectives of this new regulation). Second, it has value in providing a dealer and fund manager with additional data points and market information about liquidity of the stock, supply and demand dynamic etc. throughout the period of execution.

2.19 However, measuring the efficiency of this trading approach through the lens of the current single FCA methodology produces results that are random and not reflective of the dynamic intentions of traders and the portfolio managers, as is illustrated by the following examples.

2.20 A firm provided this commentary with respect to VWAP versus arrival price:

"We refer to a relatively small (in terms of assets managed) all cap equity strategy that consistently uses VWAP for trading in and out of the stocks. When viewed through a prism of a VWAP trading strategy, the realised prices achieved by the trading desk tend to be very tight and therefore indicate that the market impact on stocks was minimised. Given a very small size of this fund, any trading in stocks is unlikely to constitute a material part of the daily trading volumes, so this result is consistent with reasonable expectations. However, the arrival price method provides an entirely different result which is materially impacted by the prevailing intraday price movements during the period of execution.

For example, if stocks happened on average to go up during the days when the dealers were in the market, this methodology would assign that price appreciation to the unwelcome impact of the trading and show it as high measure of slippage. At the other end, if those intraday stock moves happen to be negative (prices of stocks being traded were moving in the opposite direction to dealing – for example a stock one wants to buy becomes cheaper during the trading session) then this becomes captured as extremely positive outcome of trading.

In both cases however, it is random, irrelevant and potentially confusing to investors. The impact lacks any context to explain to the investor why the manager chooses a particular trading strategy (eg. VWAP) over any other (eg. arrival price)".

VWAP TRADING EXAMPLE

2.21 A firm provided us with a detailed example of using a VWAP strategy highlighting the importance of using an appropriate benchmark for the strategy being utilized. "When a trader uses a broker's VWAP algorithm, the expectation is that the algorithm will behave in a way that the average execution price will be close to the VWAP from first fill to last fill. Consequently, implicit costs in these cases should be measured as the average execution price vs the interval VWAP. Instead, regulations dictate that we use the slippage methodology which measures arrival price versus average execution price. When using the slippage methodology in momentum driven market for example, you will often see negative cost performance."

2.22 Exhibit 3 shows this example in which a Buy of 33,479 shares of HQY US EQUITY was entered in at 10:06 AM with an arrival price of 36.16 (orange line at bottom of exhibit 3) and executed through the day. As a result of the stock and the overall market adversely trending upwards from the arrival price, the performance against arrival was a slippage cost of 97 basis points. However when compared against VWAP (which was what the trader and the algorithm intended to do), the result achieved was a positive contribution of 3.82 basis points where the VWAP benchmark was 36.52 (purple line) and the average execution price was 36.51 (green line). In other words the trader had beaten the market in executing the trade and had therefore delivered value for the customer.

Exhibit 3: Example of VWAP v arrival price of HQY purchase[7]

2.23 We also emphasise that inaccurate positives occur alongside inaccurate negatives. Although we have focused on negative transaction costs in a range of previous public comment, the existence of negative transaction costs is not just counter-intuitive in and of itself. It is also the most tangible sign that all results are flawed, including the positive outcomes.

MEASURING COSTS IN DIFFERENT EQUITY STRATEGIES

2.24 It is not just a question of different trading techniques per se, but also the different investment strategies and markets driving those techniques, which produce misleading outcomes when using slippage.

2.25 We present four examples here:

- **Small cap equity.** Smaller companies tend to be less liquid, particularly when dealing in volume, and liquidity is a critical point we return to in other parts of the submission. Investment managers seeking to access these markets may find that thin trading volumes result in several hours elapsing between arrival time and execution time. This can result in execution price being both lower or higher than arrival price. Neither will give a very accurate reflection of real trading cost. Instead, the emerging data will reflect the nature of the market.
- **Less liquid regional equity markets.** One firm provided us with an assessment of price availability in less liquid equity markets, where data availability can also be affected by less transparency. The conclusion was that the availability of intra-day prices fell sharply outside North America and developed Europe. This will result in what they described as "arbitrary rather than meaningful" cost assessment under arrival price.

[7] Trade Details: Ticker: HQY US EQUITY; Total Size: 33,479; Average Execution price: 36.510; Placement Arrival Price: 36.16; Placement Interval VWAP: 36.524.

- **Style approach 1:** Falling stocks. A strategy may aim to buy a stock whose price has been/is falling – eg. off the back of a profit warning announcement. This is consistent with a value-based investment style and is a reasonably common occurrence across the industry. In such an approach, the purchase execution price may be lower than the arrival price, generating a negative transaction cost.
- **Style approach 2:** Rising stocks. A strategy may aim to sell a stock whose price has been/is rising – eg. the manager feels that the target price has been realised and wishes to recycle that capital into a new investment. Again, this is consistent with a value-based investment style and is a reasonably common occurrence. In such an approach, it is possible that the sale execution price will be higher than the arrival price (negative cost).

2.26 A firm deploying these style approaches to small cap equity portfolios informed us that *"one of our central tenets is to buy shares at sensible prices, being careful not to pay more than what we think is fair value. This means it might take months (or longer) to work an order. As a general rule, the arrival prices for our buy transactions are generally higher than the execution price and the arrival prices for our sell transactions are generally lower than the execution prices."*

2.27 The firm provided us with detailed calculations on this point. These covered transactions for the first six months of 2018 for which they had sourced arrival prices at the time of order transmission (and excluded data prior to 2018 which was based on the fall back to opening prices). The results gave annualised implicit costs of negative 3 basis points that reduced total transaction costs to 8 basis points compared to 11 basis points of explicit costs.

2.28 Comparing these style approaches illustrates the difficulty for customers in interpreting this data. We return to this in Part Four, particularly with respect to what transaction costs mean, relative to product charges. But assuming that both funds have the same charges, the customer may wrongly assume that one style is cheaper than another and therefore better.

REPORTING OVER TIME (EQUITY SLIPPAGE)

2.29 There has been some suggestion from UK and EU regulators that the kind of results set out in the previous sections will average out over time, such that annual reporting will not see some of the distortions clearly evident at the level of individual trades. The data we are seeing suggests otherwise.

2.30 One firm compared slippage and half spread over an extended period (calendar year 2017) and the results are presented in Exhibit 4.

Exhibit 4: Implicit Costs at fund level – slippage v. half spread

Fund Type	Slippage	Half spread
A global large cap equity fund	8bps	3bps
An emerging markets equity fund	24bps	6bps
The equity portion of a multi-asset fund	82bps	22bps

2.31 We have also explored longer time periods. The effect of distortions to the total transaction costs is dampened but not removed by employing a 3 year rolling average figure. A firm provided an example of the volatility of implicit costs calculated using slippage compared to stable explicit costs. This example relates to an investment trust seeking growth opportunities by investing in a single jurisdiction's equities. The

calculations follow the PRIIPs methodology and use intraday arrival prices over a full three year period. The calculations have been performed in each month of 2018.

Exhibit 5: Summary of transaction costs in 2018

Figures in basis points	**Implicit cost (slippage cost)**	**Explicit cost (actual costs)**	**Total transaction costs**
January	7	27	34
February	17	27	44
March	5	27	32
April	1	27	28
May	2	27	29
June	10	27	37
July	10	27	37

2.32 Exhibit 5 shows consistent results for actual explicit transaction costs but the implicit costs vary considerably month to month. In isolation it might be tempting to rely on these results as evidence that slippage works because they are not negative and are not unexpectedly large but their variability casts considerable doubt on their reliability. In terms of customer decision making it is entirely unclear what level of transaction costs can be reasonably expected to arise.

2.33 Another firm provided data that showed how the volatility of implicit costs illustrated in Exhibit 5 will inevitably impact the consistency of ex post and ex ante assessment of cost, whereby the two are differing markedly in initial calculations. As a result, the reliability of disclosure material may be significantly undermined.

2.34 This effect is also apparent when the methodology is used to fulfil the FCA's application of the slippage calculation to single year disclosures for UK workplace pensions. Another firm provided examples for 28 funds comparing four calculations, which are presented in Exhibit 6:

- Using a half-spread calculation over three years (pre-sale for MiFID)
- Using a half-spread calculation over one year (post-sale for MiFID)
- Using the PRIIPs slippage calculation over three years (pre-sale)
- Using the FCA's slippage calculation over one year (post-sale)

2.35 In each case the calculations relate to the period to 30 June 2017. Exhibit 6 shows that the half-spread calculation used for MiFID gives results that are in line with reasonable expectations and are consistent over one and three year calculations. This indicates that the three year averages used for the pre-sale disclosures are generally good indicators of actual one year costs.

2.36 The slippage calculation is less reliable: it gives negative or zero (due to rounding) results in 12 of 28 funds (43%) for the three year average used for pre-sale disclosures. Moreover there are a number of material differences between the figures for one and three years suggesting that the pre-sale disclosures are less reliable as indicators of actual one year costs.

2.37 The firm has carried out extensive analysis of some of these results. For example, the first fund, an index tracker, shows a negative cost of 30bps over three years made up of negative 80bps in the first year, negative 10bps in the second year and zero in the

most recent year. Their analysis reveals that the most significant negative costs arise when the trade orders are open for more than six hours.

2.38 The last fund in the list shows three year average pre-sale figures consistent with the MiFID measure, but underlying this are one year figures of 38bps, 21bps and negative 30 bps. This illustrates the difficulties IGCs will face in interpreting transaction cost data and assessing value for money/members.

Exhibit 6: Comparing total transaction costs at fund level

Fund	Half-spread		Slippage	
	3 years	1 year	3 years	1 year
1	0.02%	0.01%	-0.30%	0.00%
2	0.02%	0.03%	-0.04%	0.02%
3	0.02%	0.03%	-0.03%	-0.07%
4	0.01%	0.02%	-0.03%	-0.05%
5	0.03%	0.02%	-0.02%	0.01%
6	0.02%	0.02%	-0.02%	0.01%
7	0.01%	0.02%	-0.01%	-0.10%
8	0.04%	0.01%	-0.01%	-0.02%
9	0.03%	0.05%	-0.01%	-0.01%
10	0.02%	0.03%	-0.01%	0.04%
11	0.01%	0.01%	0.00%	0.00%
12	0.01%	0.03%	0.00%	0.03%
13	0.01%	0.02%	0.01%	0.02%
14	0.02%	0.02%	0.01%	0.02%
15	0.01%	0.02%	0.01%	0.03%
16	0.01%	0.05%	0.01%	0.04%
17	0.01%	0.03%	0.02%	0.05%
18	0.02%	0.04%	0.02%	0.03%
19	0.02%	0.04%	0.02%	0.04%
20	0.03%	0.03%	0.03%	0.02%
21	0.04%	0.11%	0.03%	0.11%
22	0.02%	0.04%	0.03%	0.04%
23	0.02%	0.02%	0.04%	0.05%
24	0.06%	0.06%	0.05%	0.06%
25	0.08%	0.08%	0.06%	0.02%
26	0.01%	0.01%	0.07%	0.11%
27	0.01%	0.04%	0.09%	0.21%
28	0.10%	0.08%	0.10%	-0.30%

2.39 Our examples so far have focused on different equity trading approaches and investment approaches. These all present challenges even where the arrival price exists. However, outside equities, the arrival price is not even a viable concept in over-the-counter asset classes such as fixed income and derivatives.

2.40 One firm provided an analysis of fixed income benchmark coverage:

"In order to abide by the slippage methodology, we have elected to use a vendor provided streaming price source as our primary cost benchmark. This is a real time/streaming composite based on the most recently available executable contributions. It fits well with the regulator's definition of slippage as it is designed to provide an accurate indication of where one can currently transact. However, when applying this or other streaming pricing sources to various types of Fixed Income instruments, we are seeing noticeable coverage gaps. For example, when we view Corporate Bonds, we notice that meaningful amounts (28 percent of notional traded) are not covered by the streaming price source. Furthermore, we see an even larger gap in streaming price coverage for Whole Loan Collateralised Mortgage Obligations (CMOs), Agency Bonds, and Asset Backed Securities (ABS). As a result, we are forced to use a vendor derived evaluated price source as a secondary benchmark. The drawback with this is that it is an evaluated price that provides pricing snapshots at various points during the day, rather than a streaming price.

Furthermore, as the evaluation is model-derived, it is dependent on the inputs that are feeding it. In order to measure the reliability of the input data being used for evaluation, the vendor assigns a "Confidence Score". When analysing the confidence scores for the aforementioned instruments, we observe that the confidence scores are low especially in the case of Agency Bonds, Whole Loan CMOs, and ABS."

This is illustrated in Exhibit 7 which shows the low coverage of streaming price sources and the low quality of evaluated prices.

Exhibit 7: Benchmark Coverage and Evaluated Price Confidence

VENDOR-DERIVED STREAMING PRICE AND EVALUATED PRICE COVERAGE GAP			EVALUATED PRICE MODEL CONFIDENCE SCORE			
INSTRUMENT	STREAMING PRICE COVERAGE GAP %	EVALUATED PRICE COVERAGE GAP %	HIGH	MEDIUM	LOW	UNCLASSIFIED
CORPORATE BONDS	28%	1.6%	90%	8%	.4%	1.6%
AGENCY BONDS	99%	9%	4%	2%	85%	9%
WHOLE LOAN CMO	100%	9%	0%	0%	91%	9%
ABS	100%	35%	31%	9%	25%	35%

Strong Coverage or High Confidence Model Inputs
Moderate Coverage or Moderate Confidence Model Inputs
Weak Coverage or Weak Confidence Model Inputs

2.41 Only a comparatively small number of bonds are traded more frequently than once a week, in sharp contrast to large cap equities where trading frequency can be fractions of a second. As we note in Annex One, we are seeing a very high proportion of negative trading costs in the bond market, which may partly reflect the challenge of sourcing data.

2.42 A firm provided the following example of the effect of liquidity on slippage costs:

"When analysing implicit costs results from vendor-derived streaming price benchmarks, we have seen several cases where the results inadequately represent the difficulty of executing different transactions. Specifically, we have seen examples of large negative costs for several high yield bond transactions.

For example, on a sell order of 4,627,500 of Credit Bank of Moscow, we saw a large negative transaction cost of 2.01% (-$195,960 Notional) when measured against the vendor provided streaming price. The result came from a streaming price of 78.70 (mid-price at time of trade) and a trade execution of 77.31." (See Exhibit 8).

Exhibit 8: Sell order of corporate bond with low liquidity

"When you investigate this trade, you see that the liquidity for this instrument was very low. For example, there were no transactions reported to TRACE until a month after the trade in question occurred. This is possibly a result of traders either not having access to all broker quotes, or that the quotes being used for these pricing sources are not truly executable." (See Exhibit 9).

Exhibit 9: Credit Bank of Moscow TRACE prints 18/05/18 – 30/06/2018

2.43 We recognise that alternatives, such as half spread, may also be problematic as arrival price in markets with these kinds of liquidity characteristics. This underscores the conclusions and recommendations we reach below regarding the need for a more considered approach by regulators that acknowledges how restrictive the arrival price is as a concept, across all asset classes.

CHANGES TO TRADING BEHAVIOUR

2.44 There is also an additional behavioural point, which may partly be driven by reactions to the disclosure by customers and decision-makers: the risk of changes in the way firms trade, which may not be optimal given their overall investment objectives. By imposing a single way to view trading efficiency and costs, the FCA and European authorities appear to be giving a view on TCA and best execution.

2.45 One firm made the following observation:

2.46 *"Given the complexity and specialist nature of the argument, there is a clear risk that many investment management houses will opt to amend their trading strategies to suit the benchmark against which their trading is going to be measured. In addition to having some impact on the investment processes of those managers who previously relied on variations of VWAP trading strategies, this might also have some impact to the structure of equity market. It is difficult to estimate this impact as the volume and reaction to this changed pattern of behaviour is impossible to assess now. Another possible tactic that could be used by investment managers is the splitting of trade tickets so each individual ticket is implemented quickly, thus suiting the benchmark, whilst the benefit of nimble trading is not lost completely. However, this could lead to* proliferation of trades and ticket costs."

2.47 This leads to a wider point that the slippage methodology is too simplistic in breaking down trading costs in the context of traders (and portfolio managers) intent. A firm provided us with the following example: a trader received a large order of 2,731,251 shares with specific instructions to execute the order as quickly as possible. As a result, the trader decided to aggressively source liquidity for a large portion of the order by executing a block of 1,600,000 out of a total 2,731,251.

2.48 In order to execute this block, he had to sell at two points below where the market was trading at that time. He incurred a large slippage cost of 96.15 bps ($5,265,929). When comparing this trade against other relevant benchmarks, he actually outperformed these benchmarks significantly.

2.49 Therefore in the context of the overall portfolio, this was a generally successful trade. The trader's decision to trade aggressively is correct due to his anticipation of adverse momentum (the share fell sharply in the following minutes) and adherence to the portfolio manager's instructions. However, the trader incurs a high transaction cost measured vs arrival. There is clearly a risk that a methodology that appears to penalise such behaviour will drive different approaches that may not be optimal from a delivery perspective.

IMPLICATIONS

2.50 The combined effect of this is complex and potentially damaging for both the disclosure and investment process:

- Data is emerging that in the view of investment managers does not represent the actual cost of trading in many asset classes and strategies. It may work better in some highly liquid markets because the timing points happen to provide a number that is close to the actual spread. This provides no basis for suggesting that it will therefore work elsewhere.
- The evidence does not support the view that the data will normalise over longer time periods. Rather, we see clearly that some funds will continue to experience significant differences between calculation approaches.
- As we explore in the next part, the impact of then taking these unreliable estimates and mixing them with other data is to further distort customer disclosure once aggregate numbers are presented in the PRIIP KID and/or MiFID reporting.
- Finally, there may also be an impact on trading behaviour whereby the way in which reporting takes place incentivises managers to change their approach in ways that they do not believe is in line with their overall investment objectives.

PART THREE: ENSURING EFFECTIVE CHARGE AND COST DISCLOSURE

Part three of this response relates to the wider cost disclosure issues falling under question 9 of the Call for Input

3.1 The PRIIPs legislation is focused on helping consumers compare investments and make informed investment decisions. One consistent theme in customer testing is the difficulty in explaining concepts of charges and costs, and we support further work in this area to help develop clearer language and enhance understanding.

3.2 We focus here on broad concepts and present a stylised analysis of different cost components. For investment funds, the proposition is that a customer pays a manager to invest their money. For example £1,000 invested, £10 fee[8] deducted. Clearly the fee represents leakage of value for the customer. The aim is that the manager will make the investment grow: £1,000 becomes £1,100 yielding a profit for the customer of £90 after fees. Therefore, it is essential that customers are able to compare fees when deciding where to invest.

3.3 In order to make the investment grow the manager must first invest it. Buying and selling investments necessarily incurs transaction costs on behalf of the customer; often the most significant component is tax in the form of stamp duty. The manager might use the customer's £1,000 to buy shares and pay explicit transaction costs of £5. The shares grow to £1,100 and the result for the customer is still a profit of £90.

3.4 As we discussed in Part Two, spread indicates the leakage of value as a trade takes place. If the manager in our example were to buy shares at 100p at a time when the selling price was 99p half the spread would be allocated to the purchase giving an implicit cost of £5 and a total transaction cost of £10.

3.5 Also discussed in Part Two was the fact that slippage uses an estimate of implicit costs calculated by comparing the value of the shares bought against a benchmark value (the arrival price) when the order to buy them was raised; this benchmark value might be higher or lower than the value actually bought. For this example, if the benchmark is higher, say £1,005, the implicit cost will be -£10 giving a total of -£5 (negative costs) because the price would have moved in the customer's favour.

3.6 Exhibit 10 illustrates these examples and compares the disclosures with and without transaction costs and slippage costs.

3.7 The first column (simple disclosure) gives an account of the customer's experience whereby, regardless of the approach to disclosing costs, the manager invests the customer's £1,000, the investment grows to £1,100 and the customer makes a profit of £90 after the manager (and other parties) get paid £10. The manager achieves growth of 10% before fees.

3.8 The second (only explicit transaction costs) and third (explicit costs plus spread) columns highlight the impact of aggregating charges and transaction costs into a single figure: including transaction costs inflates total costs and charges such that it is no longer possible to see the fees paid to the manager (and other parties). Moreover, in order to give a full account of the customer's experience, it is necessary to add

[8] Collectively all fees paid to the manager and other parties are described as ongoing charges.

back transaction costs to the investment return; this implies that the manager achieved a higher apparent growth than was actually achieved.

3.9 It also highlights the challenge to the customer's ability to compare investments. In this example, a customer may conclude, wrongly, that the second and third columns represent a more expensive proposition than the first in terms of the fees payable.

3.10 The fourth column illustrates how the slippage cost calculation can cause significant variation in the numbers disclosed; in this instance, slippage has turned the total transaction cost negative.

3.11 Despite hearing from consumer groups that customers may be struggling to understand the significance of transaction cost information, the FCA asserts that greater familiarity should encourage better understanding. Transaction cost disclosure is largely untested with customers and in our view this remains an ambitious assertion given other evidence about the challenges.

Exhibit 10: Disclosure of charges and transaction costs

	Simple disclosure (product charge)	Explicit transaction cost disclosure	Spread cost disclosure	Slippage cost disclosure
Value of investment	£1,100	£1,100	£1,100	£1,100
Original investment	£1,000	£1,000	£1,000	£1,000
Actual investment growth	£100	£100	£100	£100
Explicit cost adjustment		£5	£5	£5
Implicit cost adjustment			£5	-£10
Implied investment growth	£100	£105	£110	£95
Costs and charges *	**-£10**	**-£15**	**-£20**	**-£5**
Profit to customer	£90	£90	£90	£90
Implied gross return	10.0%	10.5%	11.0%	9.5%
Net return to customer	9.0%	9.0%	9.0%	9.0%
* Made up of:				
Ongoing charges	-£10	-£10	-£10	-£10
Explicit transaction costs		-£5	-£5	-£5
Implicit transaction costs			-£5	+£10
Costs and charges	**-£10**	**-£15**	**-£20**	**-£5**

IMPLICATIONS

3.12 This is a simple example showing four disclosure scenarios with identical fees, identical investments and identical outcomes. Nevertheless, it illustrates the possibility for considerable variability in the disclosure of costs, the implied performance of the manager and the consequences for customers' investment decisions. Aggregation of charges and transaction costs hides the true level of fees and in some cases (column four) causes the total costs and charges figure to be less than the actual fees.

3.13 Very few investors are likely find it straightforward to understand the difference between the transaction cost element and the rest of the charges. There is therefore a balance to be struck between different elements:

- Clarity for retail customer decision-making. Aggregating total product, distribution and advice charges is undoubtedly helpful in this regard. Equally, FCA evidence in Occasional Paper 32 illustrated that retail customers can work well with OCF information in fund selection. Importantly, transaction costs have not yet been tested as part of that process.
- Full cost accountability where customers would like to see the full economic experience of money invested. This requires further testing with respect to how best to present and explain. As we have previously indicated, a starting point would be to revise the PRIIP KID costs and charges presentation to present actual charges and costs alongside aggregated figures, rather than rely purely on reduction in yield calculations subject to significant assumptions. A front line document that cannot answer the question: "what I pay in fund charges and transaction costs" in a clear way appears to us in need of significant modification.[9]
- Pounds versus. percentage disclosure. Presenting charges in both percentage and monetary terms is intended to be to help those investors who struggle with percentages, but if all KIDs are based on the same £10,000 investment then the monetary figure is irrelevant to all investors (other than those investing exactly £10,000). Investors will either understand they need to use the percentage figure to calculate the appropriate monetary figure for their investment (so the monetary figures serves no purpose) or they will not understand this and latch onto the monetary figure, which could be misleading if they think it applies to them.

3.14 The industry has begun a programme of customer testing as part of the Market Study work to improve the clarity of language in fund disclosure documents and we welcome the FCA's observer role to this work. The IA and member firms are keen to work further with UK and European regulators to look in more detail at the issues raised above. The goal is absolutely to provide full disclosure of all charges and investment costs, but to look at how this can be done in a way that maximises useful information at relevant points in the customer journey.

[9] Question 24, IA response to ESMA Consultation Paper on PRIIPs KIDs, January 2016

PART FOUR: OTHER ISSUES ARISING IN PRIIPS

Part Four of this response addresses questions 5-8 of the Call for Input

4.1 We provide comments in this section on wider aspects of the PRIIP KID, including performance scenarios. A more detailed analysis of why the performance scenarios are so problematic is presented in Annex Two.

RISK DISCLOSURE

4.2 In the new PRIIPs risk disclosure section, the 1 to 7 scale looks exactly the same on a PRIIP KID and a UCITS Key Investor Information Document (KIID) – yet they mean different things. Firms who are currently distributing via life funds or vehicles within the scope of PRIIPs are seeing different risk ratings where the unit trusts and directly linked life funds are compared. For example, a firm has produced analysis of their funds showing the UCITS Synthetic Risk and Reward Indicator (SRRI) being consistently 1 or 2 grades higher than the PRIIPs Synthetic Risk Indicator (SRI). Although this discrepancy will be resolved once UCITS and PRIIPS align with the use of the new KID, the intervening period may prove confusing for investors. There are also some specific issues with the KID framework, whereby less liquid assets appear lower risk because prices do not move significantly from day to day.

PERFORMANCE SCENARIOS

4.3 Presented in the correct way, past performance can help investors to understand both how a fund has performed (an essential part of pre-sale information and post-sale accountability) and some of the associated risks. In the UCITS KIID, past performance could be seen on a discrete annual basis.

4.4 To ensure that this past performance in the UCITS KIID does not mislead investors by creating the false expectation that previous track record will be replicated in the future, this information is always accompanied by a disclaimer that *"past performance is not an indicator of future outcomes"*. Despite this, there remained concerns amongst policymakers that investors might still read past performance as a guide to what they would get in the future.

4.5 The chosen solution for the PRIIP KID was to not feature past performance and, instead, to require the presentation of scenarios on possible future returns. In order to give investors an indication of the range of possible outcomes, four different scenarios were designed from the very positive *"favourable"*, to the average *"moderate"*, to the negative *"unfavourable"*, to the extremely negative *"stress"* scenario. But importantly, all these scenarios are the outcome of a sophisticated calculation which is based on the distribution of the historical return data.[10]

4.6 In simple terms this means that the question *"what could I get in return?"* is now answered by *"what did I get in the past?"* So, with this approach, the PRIIP KID does what many were concerned that the UCITS KIID might lead investors to do in the first place: it effectively makes past performance an indicator of future outcomes.

4.7 As such, the issues arising from the performance disclosure in the PRIIP KID are very different in nature from the issues arising from the cost disclosure, discussed

[10] See Annex II, point 10, page 6. The technical standards require that for daily observations one needs at least 2 years of observed returns, for weekly observations at least 4 years and for monthly observations at least 5 years.

above. While there is an alternative methodology to better estimate implicit transaction costs, there is no methodology that would solve the problem of using past performance to predict future outcomes (scenarios). The underlying problem is one of principle and one that goes against actual warnings that regulators have, rightly, made more prominent in communication material.

4.8 Consumer testing has fed into the presentation of these scenarios, eg. it indicated that a simple graphic incorporating a table or line graph was more helpful than complex designs that involved a probability histogram or a 'funnel of doubt' chart. But, as designed, this consumer testing never attempted to answer the question whether past performance would be more useful information than scenarios. The salience of past performance simply did not feature in the KID consumer testing.

4.9 The removal of past performance information in favour of scenarios could mislead investors about likely investment experience in two ways. First, there is no longer visibility of the simple fact that a fund may make gains in some years and losses in others. The presentation of past performance on a discrete annual basis over the preceding 10 years not only indicates the track record but also illustrates in a very simple way the volatility of returns, ie. risk.

4.10 Second, and much more important, since the scenarios are based on past performance, in any given point in time they will be driven by market conditions in the years preceding the calculations. Several commentators have already pointed to the fact that the investment trusts KIDs currently in the market are misleading because all scenarios look unusually positive following strong market returns over the last few years. For example, John Kay presented as an example the performance scenarios of the Scottish Mortgage Investment Trust KID (see Exhibit 11) and noted the following: *"The recent performance of Scottish Mortgage has been particularly strong, but most investment funds have benefited from bull markets over the past five years. And so you will find a wide choice of funds from which, according to their Kid, you can expect to earn more than 10 per cent a year."* [11]

Exhibit 11: Scottish Mortgage Investment Trust

Investment £10,000 Scenarios		1 year	3 years	5 years (Recommended holding period)
Stress scenario	What you might get back after costs	£3,510	£4,593	£3,551
	Average return each year	-64.90%	-22.85%	-18.70%
Unfavourable scenario	What you might get back after costs	£9,670	£12,333	£16,603
	Average return each year	-3.30%	7.24%	10.67%
Moderate scenario	What you might get back after costs	£12,261	£18,597	£28,207
	Average return each year	22.61%	22.97%	23.05%
Favourable scenario	What you might get back after costs	£15,518	£27,990	£47,833
	Average return each year	55.18%	40.93%	36.76%

4.11 The Call for Input asks whether consumers who are using KIDs to make investment decisions have encountered any issues with the performance scenarios presented to them.[12] Annex Two outlines specific examples where all scenarios diverge significantly from the actual outcomes that customers would have experienced had they invested as the PRIIP KID would suggest.

[11] Financial Times, Risk, the retail investor and disastrous new rules, 19 January 2018.
[12] Question 8, page 17.

4.12 Research has shown that investors generally do understand that past performance is no guide to the future, but regard past performance as a useful indicator for both accountability and volatility – the UCITS KIID helpfully showed performance on a discrete annual basis, giving customers a much better sense of likely market experience than that seen in the new scenarios. Considering this as well as the evidence presented in Annex Two, we reiterate the exceptionally strong comments made by Professor John Kay and Guillaume Prache on behalf of customers, and stress the need for a return to the presentation of past performance, if not on its own, then alongside any model-based approach to future returns.

PART FIVE: PROPOSED WAY FORWARD

5.1 To resolve the issues identified in this submission, we recommend the following steps:

5.2 **An open and collaborative approach by EU and UK regulators to working with the industry and other stakeholders to develop the best solutions for investors.**

5.3 In the case of arrival prices, this may be best achieved by identifying and setting clear principles that should be applied to the assessment of trading and operational slippage, rather than the designation, and aggressive pursuit of one methodology for calculation. This should allow investment managers to apply the correct methodology to their trading that is reflective of their trading strategy and overall investment objectives. Presenting half spread as a starting point in this process appears the best way forward.

5.4 In the case of performance disclosure, performance scenarios should be replaced with past performance or, as a minimum, require past performance to be published alongside performance scenarios. Past performance is very clearly neither a prediction nor a promise of a future outcome. It has the advantage of providing some indication of track record and communicating in very simple terms the fact that some years may be positive and some negative.

5.5 **Immediate unilateral action by the FCA to suspend the use of slippage and substitute a half spread measure for MiFID and DC workplace pensions.**

5.6 Given the powers available to the FCA in the UK context, the UK regulator could take action to limit the extension of the slippage methodology beyond PRIIPS, particularly given the importance of ensuring accurate disclosure as part of UK pension reforms. This is particularly important as transaction cost information begins to be disclosed directly to scheme members.[13]

5.7 **Extension of the PRIIPs Article 32 exemption for UCITS and non-UCITS retail funds at least until the KID regime is amended to address the issues raised.**

5.8 To date, the direct impact of the PRIIPs Regulation upon the European fund universe is limited due to the phased implementation of PRIIPs. The significant problems identified in this and other responses from a range of industry organisations and wider stakeholders militate strongly in favour of extending the UCITS exemption in the PRIIPs Regulation until such a time as the flaws we have identified in this paper are addressed in both the Regulation and accompanying Regulatory Technical Standards.

[13] As required by The Occupational Pension Schemes (Administration and Disclosure)(Amendment) Regulations 2018

ANNEX ONE: TRANSACTION COST DISCLOSURE – EMERGING DATA FROM EUROPEAN MIFID DISCLOSURES

Throughout 2018 the IA has been monitoring transaction cost data emerging from MiFID disclosures. As we note in our introductory comments, the slippage methodology is being transmitted out both via MiFID requirements into the UK retail market, and via FCA rules on DC pension schemes into the UK pensions market. Our results suggest a far wider problem than is indicated in the FCA Call for Input, which is based on a narrower product sample (i.e. those products directly subject to PRIIPs currently).

DATASET

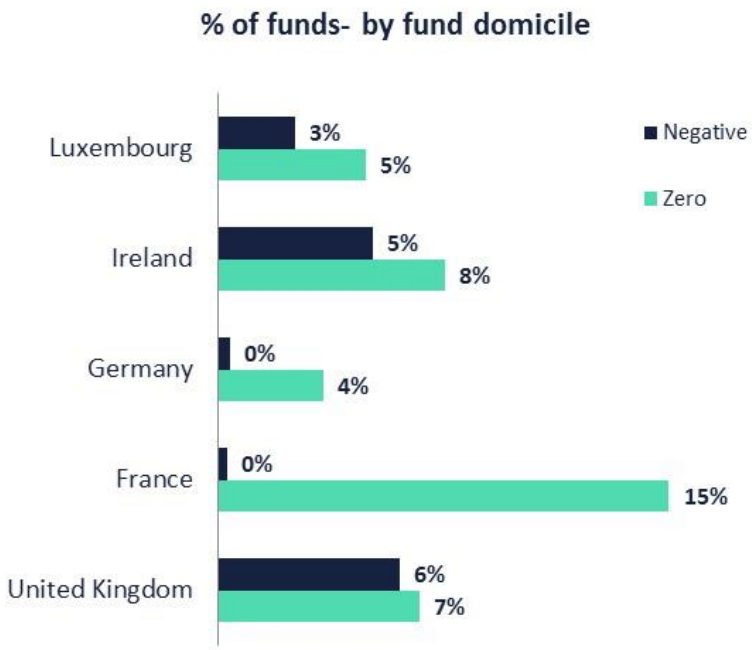
We have analysed data from Morningstar for 46,192 European domiciled funds as at 10 September 2018. Data availability remains an issue for some fund domiciles, with coverage across all European domiciled funds currently standing at 62%, i.e. about 28,600 funds. There is a substantial number of zeros that in some cases reflect negative transaction cost figures that have been truncated at 0.

Coverage for UK domiciled funds is at 89%, giving us confidence in the representativeness of the data presented below.

TRANSACTION COSTS IN EU MEMBER STATES

Across the whole of Europe there are over 3,000 (11% of available observations[14]) funds reporting negative or zero transaction costs. Figure 1 shows how these results are distributed across the main fund centres.

Figure 1: Incidence of zero and negative total transaction costs



[14] The percentages reported in this Annex are in respect to available observations.

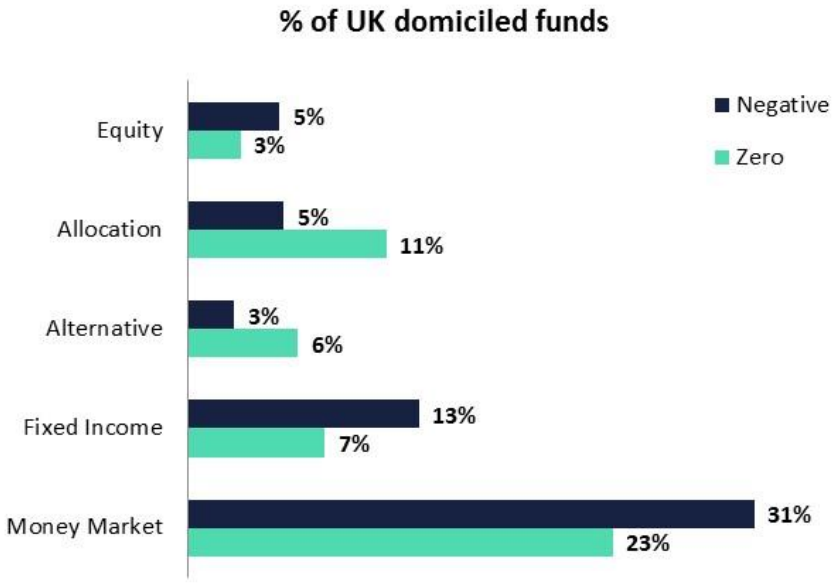
TRANSACTION COSTS FOR UK DOMICILED FUNDS

We currently observe that almost 400 funds (13% of UK domiciled funds) report negative or zero transaction costs. Figure 2 shows the distribution of total transaction costs, that is, the sum of explicit and implicit transaction costs. This distribution has strong tails both positive and negative. We reiterate that the reasons for the occurrence of zero and negative numbers outlined in the body of our response cause us concern about the accuracy of all transaction cost figures, whether positive or negative.

Figure 2: Distribution of total transaction costs (%) for UK domiciled funds

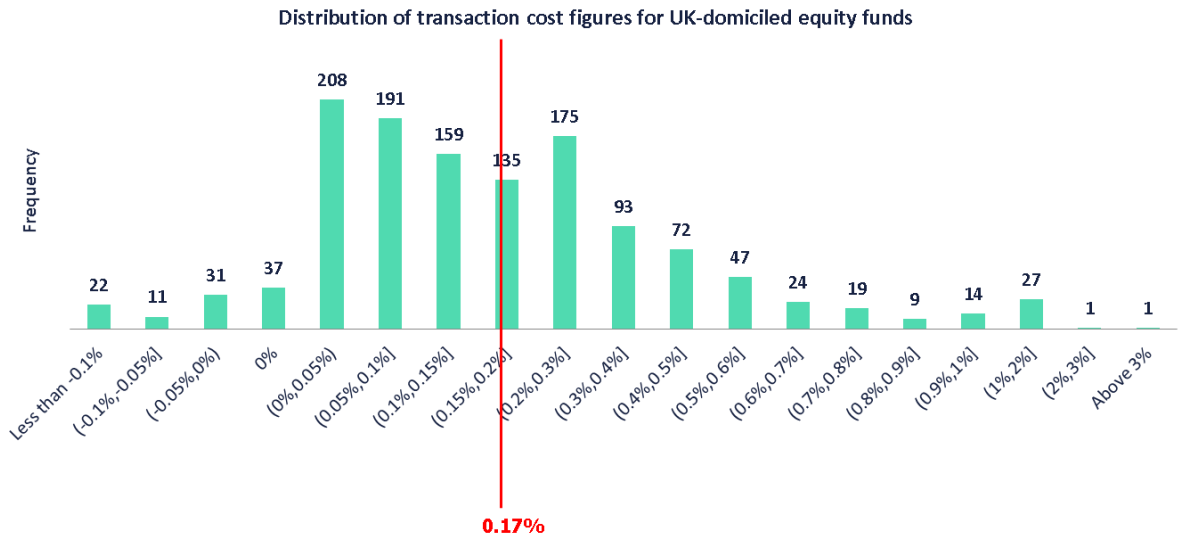
Importantly, we see an incidence of negative and zero transaction costs across all asset classes (see Figure 3). This is particularly prominent for fixed income where 78 funds, i.e. 20% of fixed income funds, report negative or zero transaction costs. Notably, even for equity, one of the most liquid asset classes, we see this with 8% of equity funds (101 funds) reporting negative or zero transaction cost figures. Moreover, it should be stressed that these are negative <u>total</u> transaction costs. This means that the negative implicit costs are large enough to offset the (positive) sum of commission and stamp duty.

Figure 3: Incidence of zero and negative total transaction costs in UK domiciled funds



In more detail, previous IA research[15] has indicated that the average explicit transaction costs (commission and stamp duty) across UK domiciled equity funds was in the order of 17 bps. This means that implicit transaction costs are negative enough to reverse this. It also implies that zero or negative *implicit* transaction costs are likely to be far more widespread in equity funds than what we would infer from the incidence of negative *total* transaction costs. Figure 4 shows the distribution of total transaction costs for UK domiciled equity funds and assuming an average explicit transaction cost figure of 17 bps, negative implicit transaction costs could be occurring for over 650 funds.

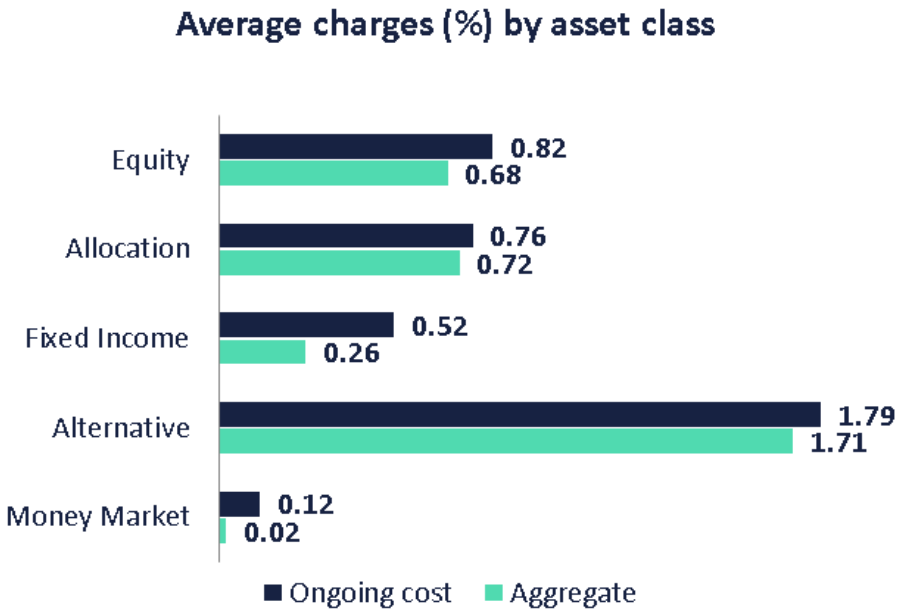
Figure 4: Distribution of total transaction costs (%) for UK domiciled equity funds



In the context of MiFID aggregation, the widespread occurrence of negative transaction costs would mean that the total fee that aggregates both ongoing costs and transaction costs, will appear to investors to be lower than the ongoing costs. Figure 5 shows the average aggregate fee compared to the average ongoing charges figure for those UK domiciled funds that report negative transaction costs. For example, for fixed income funds that report negative transaction costs, investors would get the impression that the total cost is 26 bps lower than what they are charged for ongoing charges.

[15] The Investment Association, Investment costs and performance: Empirical evidence of UK fund industry delivery, August 2016.

Figure 5: MiFID aggregate fees for UK domiciled funds with negative transaction costs



ANNEX TWO: IA PERFORMANCE SCENARIO SIMULATIONS

To see what may happen in practice when investors are presented with performance scenarios, we carried out a simple experiment. We replicated both the UCITS KIID and the PRIIP KID for each IA sector that served as a proxy of the typical fund in the respective sector. For this, we took monthly sector performance data from Morningstar from January 1990 to November 2017. We then calculated performance scenarios (PRIIP KID) and past performance (UCITS KIID) as they would have appeared in each month from January 1996 to November 2017, assuming a one-off investment at the beginning of each month of £10,000 and the prescribed formulae[16] for a holding period of 1, 3, and 5 years. Finally, for each sector, we compared the four scenarios against the return that an investor would have really received after 1, 3, and 5 years.

An example of very positive scenarios following a period of strong market returns could have occurred for a typical Europe excluding UK equity fund at the beginning of 2008. Figure 1 shows what the KID for the Europe excluding UK equity sector would look like in January 2008 with the addition of two rows at the end (that are not part of the KID disclosure) showing what an investor would really get after each holding period had they actually invested £10,000 in January 2008. The actual outcome was significantly lower than all scenarios with the exception of the stress scenario. For example, the KID would indicate to investors that in the average "moderate" case they would get £23,488 after 5 years from a typical Europe excluding UK equity fund whereas in reality anyone invested in such a fund would have seen the portfolio value reduced to £9,862, which is just 42% of the moderate scenario.

Figure 1: Performance scenarios in PRIIP KID for the Europe excluding UK sector in January 2008

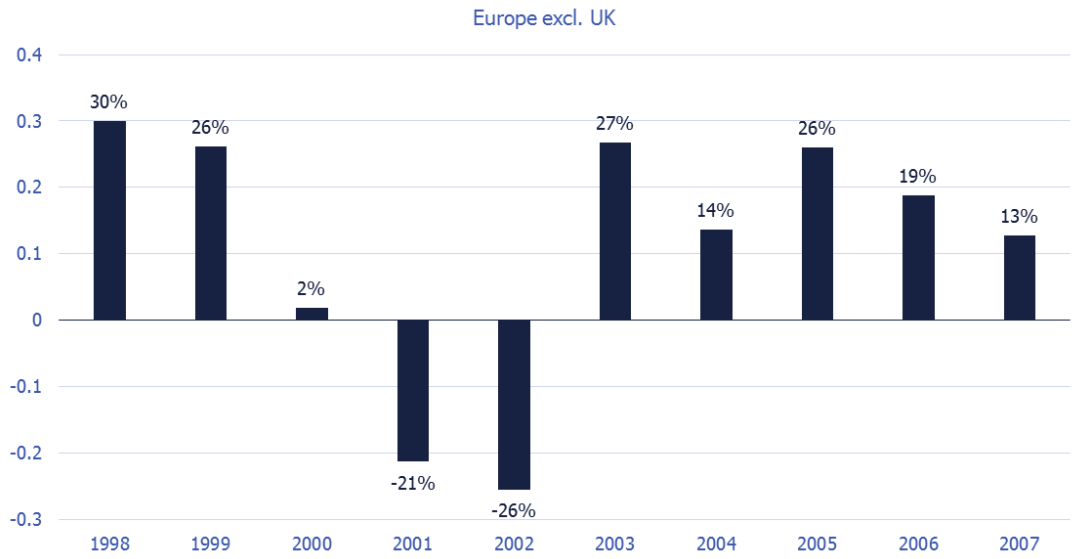
Investment 10,000 Scenarios		1 year	3 years	5 years
Stress scenario	What you might get back after costs	6,558	6,632	5,830
	Average return each year	-34.4%	-12.8%	-10.2%
Unfavourable scenario	What you might get back after costs	10,206	12,860	16,769
	Average return each year	2.1%	8.7%	10.9%
Moderate scenario	What you might get back after costs	11,876	16,701	23,488
	Average return each year	18.8%	18.6%	18.6%
Favourable scenario	What you might get back after costs	13,755	21,590	32,745
	Average return each year	37.5%	29.2%	26.8%
Actual outcome	What investor would have got	7,537	9,799	9,862
	Average return each year	-24.6%	-0.7%	-0.3%

By way of comparison, Figure 2 shows what an investor would have seen in the corresponding UCITS KIID at the same time. This does not indicate any outcomes since showing past performance in itself does not communicate in any shape or form that this is

[16] PRIIP KID Regulatory Technical Standards, Annex IV, points 9-12, pages 20-22.

what investors could get in return. Instead, it shows the annual track record over the preceding decade which gives investors a long-term view of how the fund performs. As discussed in the main text of our response, it provides a sense of the risk involved by showing that returns change from year to year. In this specific example it shows that although the typical Europe excluding UK equity fund had mostly positive returns it still saw two years of significant negative returns in the post dot-com period.

Figure 2: Past performance in UCITS KIID for the Europe excluding UK sector in January 2008



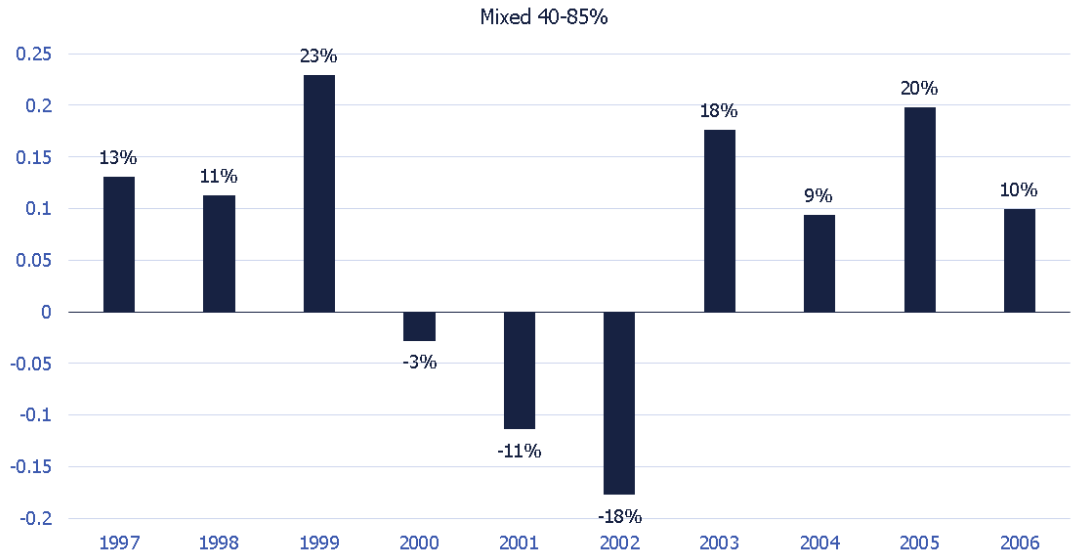
This is not the only instance and not the only sector where this could have occurred. Another example could have been the Mixed 40-85% sector in January 2007. Figures 3 and 4 show what investors would have seen in a PRIIP KID and a UCITS KIID respectively. Again, the moderate scenario in January 2007 would indicate to investors that for a typical Mixed 40-85% fund they can expect an annual return of about 6.5% whereas in reality after 5 years, investors would have got a return of 1.1%.

And once more, the past performance in the UCITS KIID would not hint in any way what investors may get in return but rather show that in this case there were 3 years in a row with negative returns and that year-on-year returns can vary from roughly 10% to 20%.

Figure 3: Performance scenarios in PRIIP KID for the Mixed 40-85% sector in January 2007

Investment 10,000 Scenarios		1 year	3 years	5 years
Stress scenario	What you might get back after costs	6,474	6,492	5,687
	Average return each year	-35.3%	-13.4%	-10.7%
Unfavourable scenario	What you might get back after costs	9,303	9,565	10,129
	Average return each year	-7.0%	-1.5%	0.3%
Moderate scenario	What you might get back after costs	10,696	12,092	13,669
	Average return each year	7.0%	6.5%	6.4%
Favourable scenario	What you might get back after costs	12,057	14,986	18,084
	Average return each year	20.6%	14.4%	12.6%
Actual outcome	What investor would have got	10,476	9,933	10,553
	Average return each year	4.8%	-0.2%	1.1%

Figure 4: Past performance in UCITS KIID for the Mixed 40-85% sector in January 2007



Although the current debate tends to focus on what investors are seeing now and the concerns relate to the overly positive scenarios, the other – and slightly overlooked – side of the coin is that we can have the opposite situation, i.e. the PRIIP KID could be showing overly negative outcomes if the preceding 5 years had seen low market returns, thus disincentivising investors from allocating savings in funds when it could have produced significantly positive returns.

Figure 5 shows what investors would have been presented with for a typical UK All Companies fund in April 2009. As the preceding 5 years were dominated by the events around the 2008 financial crisis, all performance scenarios look distinctly bleak. We see that

even the moderate scenario, that is supposed to show what the average outcome would be, indicates to investors that, at the time, investing in a UK All Companies fund would result in negative returns. Which could not be further from the reality, because someone investing in a UK All Companies fund in April 2009 would have seen it more than double in value after 5 years as indicated in the last two rows.

Figure 5: Performance scenarios in PRIIP KID for the UK All Companies sector in April 2009

Investment 10,000 Scenarios		1 year	3 years	5 years
Stress scenario	What you might get back after costs	4,353	4,566	3,558
	Average return each year	-56.5%	-23.0%	-18.7%
Unfavourable scenario	What you might get back after costs	8,056	6,794	5,991
	Average return each year	-19.4%	-12.1%	-9.7%
Moderate scenario	What you might get back after costs	9,997	9,724	9,459
	Average return each year	0.0%	-0.9%	-1.1%
Favourable scenario	What you might get back after costs	11,868	13,315	14,287
	Average return each year	18.7%	10.0%	7.4%
Actual outcome	What investor would have got	15,119	16,958	22,733
	Average return each year	51.2%	19.3%	17.9%

It should be emphasised that the examples above do not reflect one-off cases. Both situations, namely the PRIIP KID performance scenarios giving an overly positive picture after strong past performance and a too negative picture after poor past performance, will occur repeatedly. We plotted on a monthly rolling window basis the PRIIP KID figures against what investors really received had they invested in any given month from January 1996 to November 2017. Figure 6 shows what this would look like for the UK All Companies sector for a £10,000 initial investment and a 5 year holding period.

The vertical dotted line reflects the numbers in April 2009 as presented in Figure 5. The red line illustrates what investors would really get after 5 years stops in December 2012 because that is the latest month for which we can calculate total return for a 5 year holding period. In this respect, it is important to note that the four performance scenario lines reflect the PRIIP KID values in each month whereas the red line shows the actual outcome after 5 years – so it is forward looking.

Figure 6: PRIIP KID scenarios vs. actual outcomes for the UK All Companies sector

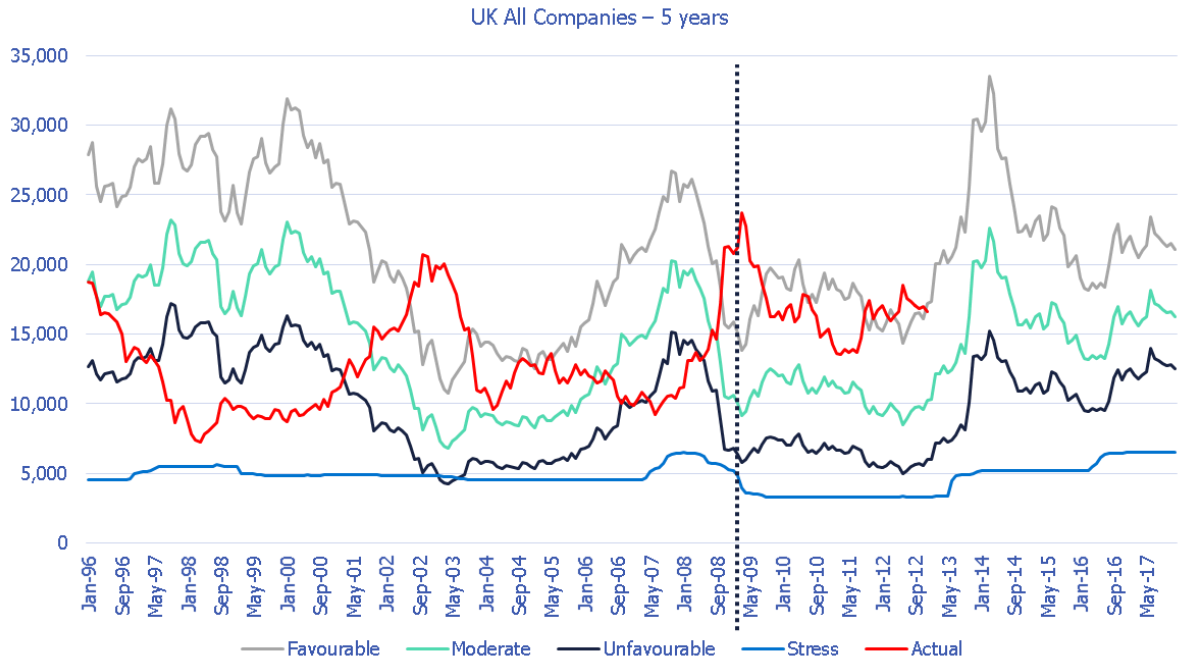


Figure 6 illustrates several points at the same time:

- As already stressed above, the case where all scenarios are too positive or too negative (thus potentially leading investors to the wrong decision) will occur repeatedly. The actual outcome was smaller than what the unfavourable scenario would predict 19% of the time and larger than the favourable scenario 11% of the time.
- The principle of using past performance for the scenarios means that effectively there is a 5 year lag between scenarios and actual outcome. For example, the scenarios in early 2008 reflect the 'actual' in early 2003. This means the KID in early 2008 would show returns that had already happened between 2003 and 2008 but would not be indicative of the returns investors actually got between 2008 and 2013.
- The stress scenario is so extreme, it is on average 53% of the actual outcome.
- The unfavourable scenario can be lower than the stress scenario (as can be seen around May 2003). This is because the unfavourable scenario is based on the (10th percentile) lowest return in the preceding 5 years whilst the stress scenario is calculated based on the highest volatility in the preceding 5 years. And with high volatility one can have high returns (or at least, higher than the 10th percentile returns).

Putting the technical issues aside, the main concern about the PRIIP KID performance scenarios is that they deviate so strongly from the previous principle of not using past performance as an indicator of future outcomes. That is not to say that showing only past performance is a panacea. The industry has a responsibility to ensure that investors receive communication material that provides all the necessary information in a meaningful way, i.e. the principle of clear, fair and not misleading information.

Although some investors may take past performance to be some indication of potential future track record (despite warnings), the performance scenarios explicitly take past performance and tell everyone along the investment chain what they can expect in the

future. This may not only mean investors taking the wrong decisions at the wrong time (as the above examples have illustrated) but it may have wider market stability issues to the extent in which the scenarios can cause pro-cyclical investment behaviour whereby large pools of savings are invested at market highs and disinvested at market lows.