Greater transparency delivers better value

David Hutchins looks at the recent FCA interim market study and asks how better value can be delivered to members

AT A GLANCE

- Low cost does not necessarily mean value for money
- Separating out investment and administration costs would make it easier to hold providers to account
- The focus on greater transparency should not stop at charges. Schemes need to be held accountable for the performance they deliver

The Financial Conduct Authority interim report in November once again highlighted that asset managers need to raise standards when it comes to transparency and investment products' ability to deliver genuine value for money.

We agree with this focus – particularly since we believe better transparency is critical in identifying value for money. It enables those responsible for safeguarding saver outcomes to recognise what constitutes value. Too often it is assumed that the simply cheap constitutes good value.

In our view, securing genuine value for money involves defined contribution (DC) schemes taking a long hard look at their systems and processes. They need to do everything they possibly can to secure the best outcomes, net of costs, for savers' investments and ensuring nothing gets lost along the way on cost-of-investment inefficiencies.

Will extra costs secure extra 'value' for members – for instance, by including currency hedging or diversifying asset classes – or will these simply 'disappear' into a convoluted administration system?

As a starting point, we believe it is key to gain transparency on how overall pension costs break down between universally accepted administrative charges (including communications, marketing and governance) and investment elements. A single bundled charge, with little or no transparency on how it is spent, hardly encourages good behaviour from pension providers or buyers.

Separating out investment and administration costs would enable regulators, independent advisers and employer pension committees to hold providers to account and make sure there is a fair balance between what is spent on administration and what is spent on investment.

Getting this balance right can ultimately improve retirement outcomes for the vast majority of scheme members who contribute and invest in line with the plan's default strategy.

Too often, we think, the balance is wrong. As an increasing number of providers sell to plan sponsors on headline prices alone, investment budgets have decreased faster than any other item in overall cost budgets.

This effectively ensures there's a focus on those services most valued by the plan sponsor to the detriment of typical plan members.

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Some asset classes can be marginally more costly to access, but, if used appropriately, can secure better diversification and, therefore, better member outcomes. Liquid alternatives (such as private equity, infrastructure or smart beta products) are good examples.

At the same time, certain pension strategies can benefit from exposure to more sophisticated risk control mechanisms, such as currency hedging overseas investments.

It may seem obvious but this inherent value is very difficult to capture if the bulk of costs are spent on administration rather than on investment budgets.

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The US experience

In the United States, administrative fees can be as low as single-digit basis points. There are important structural differences between the UK market and its US counterpart.

But the US experience clearly shows what can be achieved when administrative cost efficiency and transparency about how costs are incurred are a key focus – instead of just overall costs.

In the UK there is a lot of divergence in how pension scheme charges break down. Instead of focusing on 'all-in' costs, schemes should be clear about how much is allocated to generating investment returns and how much is spent elsewhere, especially for default strategies.

We think it's sensible to spend around 40% of the pension charge on the investment-related budget (around 20-30 bps, assuming a 50-75bps charge).

In our view this would deliver a better product mix and greater diversification, thereby allowing for better risk-adjusted returns that could significantly improve many peoples' pension outcomes.

The focus on greater transparency should not, however, stop at charges. In addition, schemes need to be held accountable for the performance they deliver.

We would like to see default strategies being required to publish their historic returns, net of all costs incurred by members.

When we surveyed DC savers, 64% said that they'd welcome this kind of performance information.

Therefore we regard annual reviews of pension schemes' default investment strategies, and the value they provide to members, as a must.

We think trustees and investment governance groups will need to consider whether the same investment strategy could be achieved at a lower cost to members – and also whether better net outcomes could be achieved by spending more.

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