Did ESMA's Recent Report Out all European Closet Indexers?

Research by SCM Direct, 16 May 2016

Introduction

Following a public statement on 2nd February 2016, by the European Securities and Markets Authority (ESMA)[1], SCM Direct analysed a number of UK mutual funds, UK OEICs, UK index funds and ETFs traded in the UK, with the aim of evaluating how widespread closet indexing is occurring in the UK currently.

Our research paper in February 2015[2] found:

- The 10 worst offending UK funds cost investors £346m in terms of under-performance when compared to similar index funds during 2014 alone
- More than 1/3 of UK funds (36%) were no more than expensive copies of index funds
- Rolled out across the retail industry, based on these worst 10, this wide spread deceptive practice could have cost investors £803m in 2014
- Rather than the purported charge of c. 1.5 - 1.6% pa, the real cost of the genuinely active part of the fund was over 7% pa in the worst two cases.

The new research sought to identify how many active funds are still misleading investors by marketing themselves as active, and purporting to be significantly different to passive, index funds. To conduct this analyse requires statistical interrogation, commonly identifying the Active Share of a fund, its Tracking Error and its R squared.

The **Active Share**, is defined as the percentage of a portfolio or fund that differ from the underlying equity benchmark. The academics who devised this, Cremers and Petajisto[3] said that "closet index" funds were those with an Active Share of 0.6 (60%) or less.

Tracking Error, is the volatility of the difference between the return of the fund and the return of its benchmark.

R squared, is the percentage of variation in returns of a fund that can be explained by the benchmarks returns, the higher the R squared, the closer the performance of the fund is correlated to that of the benchmark.

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[1] https://www.esma.europa.eu/press-news/esma-news/esma-updates-supervisory-work-closet-indexing
[2] https://scmdirect.com/sites/default/files/Closet%20Indexation%20Epidemic%20Continues%20-%20Report%20February%202015%20SCM%20Direct.pdf
[3] http://www.petajisto.net/media/20090831h.pdf

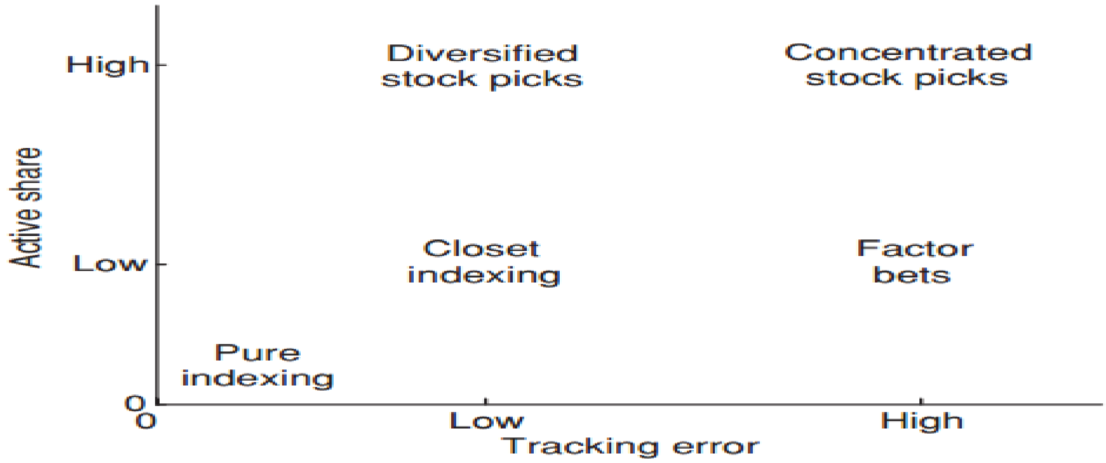

Fig. 1
Different types of active and passive management. Active Share represents the fraction of portfolio holdings that differ from the benchmark index, thus emphasizing stock selection. Tracking error is the volatility of fund return in excess of the benchmark, so it emphasizes bets on systematic risk (Cremers and Petajisto)

The ESMA Report and Analysis – February 2016

ESMA looked at closet UCITS equity funds, domiciled in EU Member States that were not categorised as index-tracking UCITS and had:

- assets under management of more than € 50mn
- an inception date before 1 January 2005; and
- Management fees of more than 0.65% of the net asset value (NAV) of the fund.

These filters resulted in a sample of more than 2,600 UCITS funds from which ESMA was able to retrieve data for further analysis for **1,251** (48%), for the period 2012 – 2014.

ESMA classified and filtered funds based on Active Share < than 60% and 50%, Tracking Error < than 4% or < 3%, R squared > 0.95

The ESMA results were:

Criteria	**Active share <60% Tracking error <4% [ESMA TEST ONE]**	**Active share <50% Tracking error <3% [ESMA TEST TWO]**	**Active share <50% Tracking error <3% R squared >0.95 [ESMA TEST THREE]**
Potential equity closet indexing funds	15%	7%	5%

Whilst 15% of funds within Europe were found to be closet index funds by reference to the first ESMA test, once the other two more stringent filters were introduced the prevalence fell to just 5%.

Following this research, ESMA published a statement highlighting the necessity for national authorities to commit to additional work on potential closet indexing and the need for further supervision in this area.

FCA's Recent Analysis – April 2016

In the UK, the FCA has known about this industry 'malpractice' for many years. In fact, the former FCA Chief Executive, Martin Wheatley, stated in September 2012, "*Should I be concerned if the tracker fund I invest in is lending shares to short sellers, or that the managed fund I buy charges five times as much as that same tracker, but its holdings seem to be broadly the same?*"[4]

Belatedly, the FCA recently published a Thematic Review entitled ***'Meeting Investors' Expectations'***[5]. It is SCM's view that the sample size for this review was disgracefully small - just 23 UK authorised funds and four segregated mandates, available to retail investors were analysed.

The FCA found that three of the 23 actively managed equity funds were following enhanced index strategies without adequately disclosing this. They also found that two other funds had material passive holdings that were not adequately disclosed. Unfortunately, despite yet another example of what would be deemed mis-selling or fraud in any other sector, the FCA have not named or shamed the culprits.

This is in marked contrast to the Norwegian regulator that ordered DNB, Norway's largest bank by market capitalisation, to lower the pricing of one of its best-selling equity funds or "*bring it in line with the characteristics of active management".* [6] Even the Vice Chairman of a leading UK fund management company, Jupiter, now admits "*A lot of active fund managers are effectively closet indexers, with only small over and underweights by sector and by holdings relative to their benchmark. It is a big problem if [a closet tracker's] total fee is five times the level of a passive product*."[7]

Despite comprehensive papers on this consumer abuse, including two by SCM, firstly in September 2013[8] and then in February 2015[9], the FCA continues to effectively turn a blind eye to this insidious practice. SCM's interpretation of this lack of action by the FCA is that they are aware how widespread closet indexing is, but due to the potential multibillion mis-selling claims they have chosen to completely ignore the situation in order to 'protect' the industry. As a result, the FCA is failing to meet at least two of its three operational objectives – namely protecting consumers, and ensuring market integrity.[10]

[4] http://www.fsa.gov.uk/library/communication/speeches/2012/0925-mw.shtml
[5] http://www.fca.org.uk/static/documents/tr16-3.pdf
[6] http://www.ft.com/cms/s/0/caad1152-c97e-11e4-a2d9-00144feab7de.html#axzz46HPuNa9F
[7] http://www.ft.com/cms/s/0/4b3fe164-0894-11e6-a623-b84d06a39ec2.html#axzz46vlYVIdy
[8] http://www.scmprivate.com/content/file/knowledge/research/closet-indexation-report-full-sept-13.pdf
[9] http://www.trueandfaircampaign.com/wp-content/uploads/2015/02/SCM-direct-closet-indexation-epidemic-continues-report-february-2015.pdf
[10] https://www.fca.org.uk/your-fca/documents/approach-to-advancing-its-objectives

SCM Direct's Research into UK Funds Utilising the Same Criteria as ESMA

SCM Direct looked at 168 UK Retail Unit Trusts/OEICS, which according to Bloomberg, had AUM of over £39m, were not index funds, and invested in UK equities within the Investment Association UK Equity Income and All Companies sectors.

The ESMA criteria of Active Share, Tracking Error and R squared over the last three years were available within Bloomberg for 133 of these funds.

The SCM analysis produced the following table:

Total	**Active share <60%**	**Active share <60% Tracking error <4%** **[ESMA TEST ONE]**	**Active share <50% Tracking error <3%** **[ESMA TEST TWO]**	**Active share <50% Tracking error <3% R squared >0.95** **[ESMA TEST THREE]**
Closet trackers potentially passive funds	**19%**	11%	2%	0%

Common Sense Test

We were puzzled as to why 19% of funds were identified as closet index funds, according to the Cremers and Petajisto academic definition of active share, but the percentages fell to just 11%, then 2%, then 0% when the three ESMA tests were applied.

SCM therefore tested a control group of index mutual funds, to see whether or not they would themselves be shown up as being 'closet index funds' by the three ESMA tests.

SCM analysed funds which either tracked the FTSE100 or FTSE All Share. Available data was found for 30 of these funds.

Total	**Active share <60% Tracking error <4%** **[ESMA TEST ONE]**	**Active share <50% Tracking error <3%** **[ESMA TEST TWO]**	**Active share <50% Tracking error <3% R squared >0.95** **[ESMA TEST THREE]**
100%	90%	83%	70%

We were astonished to find how even many of the UK mutual index funds, failed the ESMA more stringent tests.

For example, the following index funds would be deemed not to be closet index funds by reference to ESMA test two: Halifax UK FTSE 100 Fund, Scottish Widows UK Tracker Fund, M&G Index Tracker Fund, Barclays FTSE 100 Fund, Schroder UK Mid 250 Fund.

In addition, in ESMA test three, the following funds in addition to those above, would also not be deemed closet index funds: Halifax UK FTSE All-Share Fund, Henderson UK Equity Tracker Fund, Royal London All-Share Tracker Fund, Invesco Perpetual UK Enhanced Fund, Old Mutual UK Index Fund.

It is our conclusion that there may be a fundamental issue with the ESMA tests regarding the pricing of retail funds that means that the two most stringent ESMA tests are prone to misleading results.

Virtually every UK mutual fund is priced at 12 noon and any movements in reported prices for funds will never exactly match the benchmark since the index level will be at the market close. Consider this example, a fund perfectly matches the index but if you look at the return of the fund from yesterday to today vs the index their returns may be completely different as you are analysing the fund from 12 noon yesterday to 12 noon today, but the index from say 4.30 pm yesterday to 4.30 pm today.

We tested this hypothesis by looking at ETF index funds investing in UK equities. The ETFs were analysed based on their daily closing prices, thereby exactly matching their underlying benchmarks.

ETF Comparison

SCM analysed 26 UK equities ETFs.

The results were as following:

Total ETFs	**Active share <60%** **Tracking error <4%** **[ESMA TEST ONE]**	**Active share <50%** **Tracking error <3%** **[ESMA TEST TWO]**	**Active share <50%** **Tracking error <3%** **R squared >0.95** **[ESMA TEST THREE]**
100%	100%	100%	100%

These findings confirmed our hypothesis. Of course, there may be a partial explanation that ETFs are better at tracking their index as they do not bear the costs associated with investors buying or selling their fund, and that fund houses managing ETFs tend to be more expert in managing index funds as this is their core expertise. However, it is unlikely that this would fully account for the differences our research found.

Conclusion

The recent ESMA research into the prevalence of closet index funds may have been flawed in respect of the more stringent tests used. ESMA found that just 5% of European funds met their most stringent test of being a closet index fund.

In our view, the more stringent ESMA tests may have materially under-reported the levels of closet indexation, simply due to the fact that mutual funds price at different times to their index benchmark closing prices. This artificially made their performance look different, even when it really is not. However, it is commendable that ESMA's research sample extended to 1,251 funds, rather than the FCA's tiny sample of just 23 funds and 4 segregated mandates. In addition, ESMA's methodology is more methodical and transparent, whereas the FCA research appears to lack either rigour or depth.

It is therefore SCM's conclusion that the FCA, by not properly researching nor properly addressing the closet indexing epidemic, may have failed to meet at least two of its three operational objectives – namely protecting consumers, and ensuring market integrity. Due to the magnitude of these issues and the negative effect closet indexing is having on UK investors, it is imperative that the Treasury Select Committee should now intervene.

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