New Name, Old Nonsense

SCM Direct / True and Fair Campaign Response to the IA Report[1] - 'Investment costs and performance - Empirical evidence of UK fund industry delivery' 9th August 2016

It was the IMA under Richard Saunders that produced an intellectually bankrupt and thoroughly amateurish piece of research in 2012 which we proved was totally misleading.[2]

The tone then, as now, was a PR exercise to show how wonderful the UK fund management industry is, how there is no hidden costs to speak of and how amazing all active funds are.

Now under new management and a new name, the IA is still producing nonsense. This new research paper[3] is not worth the paper it is printed on.

1. **Whole Basis for the Report is Fundamentally Flawed**

Neither the Investment Association nor Fitz Partners understand the meaning of the word "hidden". To hide something is normally defined as 'to conceal from sight; prevent from being seen or discovered' – this is precisely what transaction costs are. They are not shown within the published fund cost numbers e.g. the OCF but 'hidden' within the notes to fund accounts, rarely viewed by investors. But Fitz Partners has decided to then add back these transaction costs to the published costs in its various calculations – it has added back a hidden cost to a declared cost in its half-baked attempt to show there are no hidden costs in the first place!

The report then attempts to show that in various markets over 3 years, funds have outperformed before costs. This, again, does not prove there are no hidden costs as it could well be that but not for the existence of other costs, the funds might have outperformed (before costs) by a greater extent.

2. **Transaction Costs Ignores Market Maker Spreads**

The report states that '*We find that: On an asset weighted basis, transaction costs across IA equity sectors between 2012 and 2015 were 17 basis points (0.17%), the result of an average portfolio turnover rate of around 40%.*'

Transaction costs should include the spreads of securities, the bid/offer spread but these have been totalled ignored as the analysis just looks at those transaction costs reported within the fund accounts. **These spreads are hidden from their accounts and excluded from the analysis.**

Woodford recently revealed (https://woodfordfunds.com/blog/further-fee-transparency/) that such spread related costs accounted for 22% of the total transaction costs for his fund.

Furthermore, the analysis of transaction costs by the IA includes just a 3-year period – '*We are careful not to over-interpret this data given that it is based on a transaction costs database which covers only the period 2012-2015*.'

[1] http://www.theinvestmentassociation.org/assets/files/press/2016/IAInvestmentCostsPerformance.pdf
[2] http://www.ft.com/cms/s/0/66e0cb8a-99e5-11e1-aa6d-00144feabdc0.html#axzz4GpHZtYWp
[3] http://www.theinvestmentassociation.org/assets/files/press/2016/IAInvestmentCostsPerformance.pdf

3. Convenient Time Period Selected

The period of analysis of 2012-2015, was a period in which mid-cap stocks performed well in most markets. For example, in the UK, the mid-cap (FTSE 250) massively outperformed large caps (FTSE 100), so active funds which tend to be overweight in such companies performed well. Equally, so far in 2016 (conveniently ignored by the report) UK mid-caps have fared badly vs larger peers, as have most UK active funds:

	2016 YTD to 9 August	2015	2014	2013
FTSE 100 TR in GB	11.6	-1.3	0.7	18.7
FTSE 250 TR in GB	1.9	11.2	3.7	32.3
FTSE All Share TR in GB	9.7	1.0	1.2	20.8
IA UK All Companies TR in GB	4.9	4.9	0.6	26.2
Vs FTSE All Share	**-4.8**	3.9	**-0.5**	5.4
IA UK Equity Income TR in GB	4.7	6.2	3.2	25.2
Vs FTSE All Share	**-5.0**	5.2	2.0	4.4

Source: FE Analytics, SCM Direct

4. The Report Claims It's a Four-Year Analysis but It's actually less than 3 Years (2 years and 10 months to be precise):

'So overall, while we recognise that this is a relatively short-run dataset, the analysis over four years shows that on an asset-weighted basis, there is no evidence that there are significant hidden costs damaging investor outcomes'

We make the period of analysis 3 years not 4. As an industry we are encouraging people to take a long-term investment timeline – should the research therefore not be over a longer time period than 3 years?

TABLE 2: EXPLICIT INVESTMENT COSTS AS A PERCENTAGE OF AVERAGE FUND ASSETS – UK ALL COMPANIES[3]

	Simple average			*Weighted average*		
	2012-2013	**2013-2014**	**2014-2015**	**2012-2013**	**2013-2014**	**2014-2015**

The actual length of study is just 2 years and 10 months as the data is from July 2012 to May 2015. The tables used by the report are extremely misleading – a heading of 2014-2015 would lead most readers to assume it's the calendar year 2014 but it seems in the world of the IA/Fitz Partners, it actually means from July 2014 to May 2015, a period of just 10 months.

5. Survivorship Bias Ignored

There is no mention whatsoever or attempted adjustment to account for survivorship bias whereby funds that perform well tend to grow whereas funds that perform badly get closed or merged into other funds so disappear from the data for analysis.

Lipper[4] recently calculated that only 52% of funds available to investors in 2005 survived to the present day as they were either merged or liquidated, thereby skewing performance figures.

The same must be true over a 3-year period to some extent, yet neither the IA nor Fitz Partners have made any adjustment to reflect the actual returns of investors received in the funds they could have invested in at the start of the period rather than those that existed at the end of the period.

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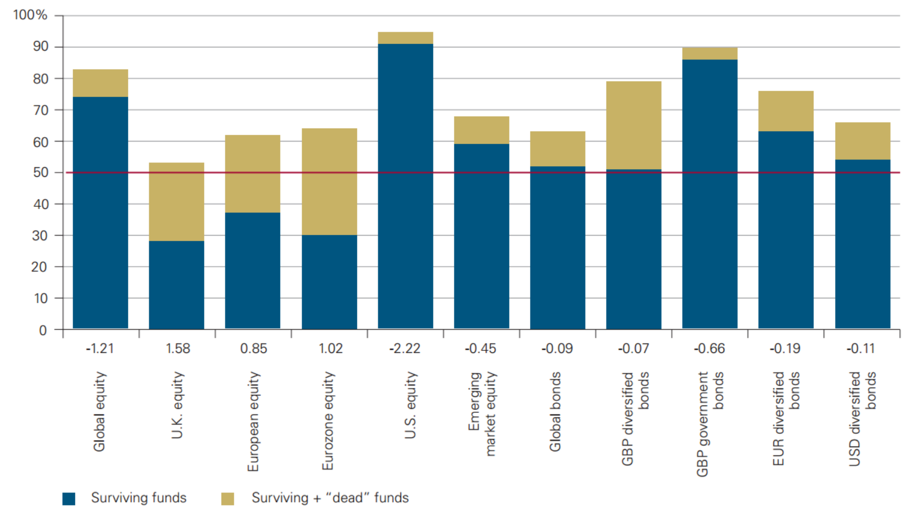
[4] http://www.ftadviser.com/2015/11/02/investments/uk/only-half-of-uk-funds-survived-last-decade-8pzRSW8HpX8kVOyHXPcvGO/article.html

Vanguard have also showed the impact of survivorship bias in a recent study[5] across many sectors that means in every sector analysed, more than 50% funds underperform their benchmark:

Figure 2. Including closed or merged funds impacts the performance figures



In September 2015 SCM Direct analysed UK funds over 5 years (not the three conveniently selected by the IA) to analyse the performance of UK active equity funds adjusted for their typical market cap size bias. We found, there was no genuine stock selection success – it was all due to the size effect:

Comparison

When you strip out the effects of this inherent bias to small and medium sized companies, the out-performance for UK All Companies Funds disappears and nearly disappears for UK Income funds.

If an investor had invested via a simple combination of a FTSE 100 tracker with a FTSE 250 tracker (SCM used the HSBC FTSE 100 and FTSE 250 index funds within this analysis), the results were astonishingly similar to the so called *'actively managed'* IA UK All Companies sector funds, again demonstrating that performance is largely dependent on the size bias of each fund.

	5 Yr Return to End June 2015	**12m to End June 2011**	**12m to End June 2012**	**12m to End June 2013**	**12m to End June 2014**	**12m to End June 2015**
IA UK All Companies Sector	12.1% pa	+24.4%	-4.5%	22.2%	14.1%	6.8%
55% FTSE 100 tracker, 45% FTSE 250 tracker	12.2% pa	+25.1%	-3.8%	22.1%	13.6%	6.8%
Difference	-0.1% pa	-0.7%	-0.7%	+0.1%	+0.5%	0.0%

UK All Companies Funds

	Average over 5 years to end June 2015	Year to end June 2011	Year to end June 2012	Year to end June 2013	Year to end June 2014	Year to end June 2015
IA UK All Companies	12.1% pa	24.4	-4.5	22.2	14.1	6.8
FTSE All-Share Index	10.7% pa	25.6	-3.1	17.9	*13.1*	*2.6*
UK Index weighted by size of companies invested	12.6% pa	26.9	-2.3	21.8	14.4	4.8
Outperformance Vs Mkt Cap Invested Benchmark	**-0.6% pa**	**-2.5**	**-2.2**	**+0.4**	**-0.3**	**+2.0**

5 https://www.vanguard.co.uk/documents/adv/literature/survivorship-bias.pdf

6. IA Report's Performance and Benchmark calculations are a total farce

They have annualised performance when they do not have a full year's data:

'Fund performance was calculated as the cumulative monthly return in the 12 months covered by the annual report so as to match exactly the period over which transaction costs were reported. Where the fund existed for less than a year, the cumulative return has been annualised. Benchmark performance was calculated in the exact same way.'

When they find funds without a benchmark they had data for, instead of excluding such funds, they chose to add a new benchmark!

'To include funds for which no benchmark information was available, we took the most commonly used primary prospectus benchmark in each IA sector and applied that to all funds of that sector.'

Look at the benchmarks and you can see they have completely different benchmarks for active and passive funds (conveniently, the active funds have a lower benchmark) and none of these benchmarks are close to the actual annual returns of the leading FTSE UK benchmarks, presumably because of their shoddy, amateurish analysis.

	End June 2014 to End April 2015	End June 2013 to End June 2014	End June 2012 to End June 2013
UK All Companies - Active - fund benchmark per IA/Fitz Report	**5.1**	**15.6**	**13.6**
UK All Companies - Tracker - fund benchmark per IA/Fitz Report	**5.6**	**15.2**	**17.3**
Actual FTSE 100 TR in GB	3.1	12.4	15.8
Actual FTSE 250 TR in GB	10.6	16.8	29.9
Actual FTSE All Share TR in GB	**4.2**	**13.1**	**22.3**
UK All Companies - fund performance per IA/Fitz Report	**5.8**	**20.3**	**16.4**
Actual UK All Companies TR in GB	**6.4**	**14.0**	**22.2**
Difference between IA/Fitz Report returns UK All Cos Funds & IA's UK All Cos sector returns	**+1.1**	**+6.3**	**-5.8**

Source: FE Analytics, SCM Direct

Conclusion

To use an animal analogy, akin to the IA's, this research shows a leopard never changes its spots. This report is as amateurish and as totally misleading as the IMA's s previous attempt in 2012 to somehow prove the impossible.

Of course over the long-term the returns from investment after costs must equal the market returns less all the costs (including transaction costs). Selecting arbitrary time periods or funds, does not change this basic fact. Instead, the IA has taken a short time period, of just 3 years and a convenient time for analysis in which many active funds fared well due to their inherent small/mid cap size bias. They have also ignored completely the spread element of transaction costs and survivorship bias.

This report is not worth the paper it is printed on. The fact that the FCA has deferred their responsibility in terms of cost transparency to the conflicted amateurs at the IA is utterly shameful and should be halted immediately.

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