

Closet Indexation

A UK Epidemic

under the bonnet

September 2013

Contents

Summary	3
Key Research Findings	4 - 5
Methodology	6
Research Sample Criteria	6
Sample Size	6
Closet Tracking Activity in the UK Fund Management Industry	7 - 12
The UK versus the US	13
Recommendations & Conclusion	14



For decades the UK fund management industry has been selling funds claiming to beat the market (known as the index) and charging significant fees based on this objective.

Whilst it is fairly common knowledge that some funds are doing as they claim and some are not, this research has found that of the funds analysed, **an average 40% of each fund is identical to the same index the fund is aiming to beat.** The result is that the investment returns in many of these funds are highly unlikely to achieve the objectives marketed to investors.

SCM Private's analysis is one of the most comprehensive undertaken covering £120 billion of UK funds, and £453 billion of US funds. The findings highlight a scandalous *index cloning epidemic* which is nearly five times more prevalent in the UK than in the US.

Had UK investors chosen a low cost index fund over the various underperforming *active* funds which were found to be disguised index clones, they could have saved an estimated £1.86 billion in UK equity fund fees and £1.17 billion in overseas equity fund fees over the last five years; making a total investor loss of c. £3 billion. The conundrum is whether investors should be paying full active fees if, for example, only 35% of the fund they are invested in is actually different to the index. This issue was summarised by one of the original inventors of 'active share'¹ as:

'The problem is that closet indexers are very expensive relative to what they offer. A closet indexer charges active management fees on all the assets in the mutual fund, even when some of the assets are simply invested in the benchmark index. If a fund has an Active Share of 33%, this means that fund-level annual expenses of 1.5% amount to 4.5% as a fraction of the active positions of the fund. Since only the active positions of the fund can possibly outperform the benchmark, in the long run it is very difficult for a closet indexer to overcome such fees and beat its index net of all expenses.'

The evidence from this report raises serious concerns about whether or not there has been extensive mis-selling or misrepresentation to UK investors, together with questionable fairness of charges and fees; as well as the urgent need for 100% transparency of holdings.

Nearly half (46%) of UK retail funds were found to be potentially misleading the public and breaching the Financial Conduct Authority's (FCA) over-riding principles that fund management companies *'must conduct their business with integrity, and communicate information in a way that is clear, fair and not misleading'*.

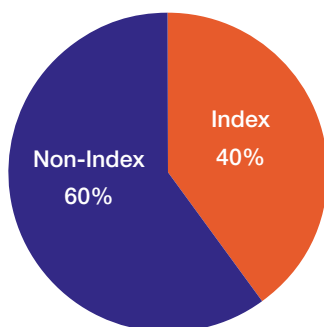
SCM Private is advocating that the FCA needs to urgently bring in standards of transparency that mirror those that have been in place in the US since 2004. The present lack of transparency brings into question the integrity of the index cloning funds masquerading as active funds.

Action needs to be taken to reform these practices and prevent misrepresentation to investors whose expectations are unlikely to be met.

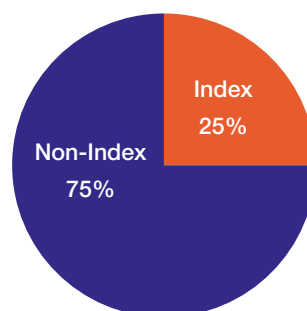
¹ Active Share and Mutual Fund Performance Antti Petajisto
December 15, 2010

- In a typical UK equity fund, investors can expect 40% of the portfolio to be a clone of the index compared to 25% in the US. These funds' fees are often at three times the fees of a typical index fund.

Typical UK Equity Fund

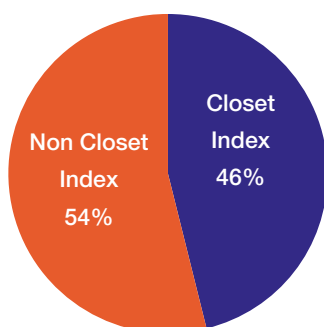


Typical US Equity Fund

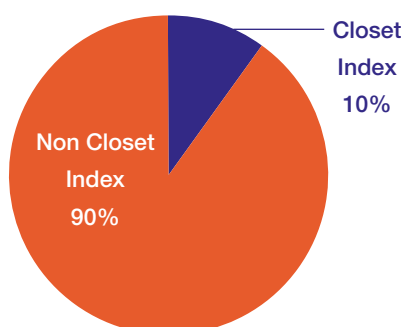


- Nearly half the UK equity funds analysed - 46%, were found to be 'closet indexers'² versus 10% in the US.

UK Fund Industry



US Fund Industry

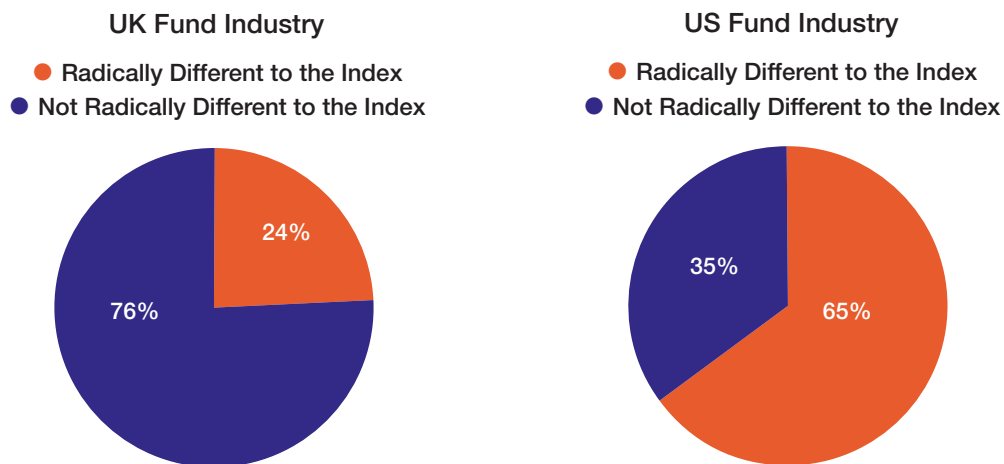


- The cost in fees to investors of the under-performing UK equity closet index-tracking funds is estimated at £1.9 billion over the last five years alone.³ If this was to be deemed mis-selling, the liability could potentially be c. £3 billion across all equity retail funds within the UK.
- The vast majority, 88%, of the funds in which most of the fund was found to clone the index (i.e. active share under 50%), under-performed over the last five years.
- Applying a typical Annual Management Charge (AMC) of 1.5% to the part of the fund actually different to the market, suggests investors are really paying nearly 4% per annum for the active part of their investments.

² H K.J. Martijn Cremers and Antti Petajisto, "How Active Is Your Fund Manager? A New Measure That Predicts Performance, Working Paper, Yale School of Management, March 31, 2009. They define potential 'closet indexers' as those funds with 60% or less active share.

³ This figure was calculated by looking at the return once would have received within the various UK funds analysed in which the majority of the fund was identical to the index (50% or less active share) and which had under-performed an index tracker (the L&G UK Index Fund retail class was used) over the 5 years to end August 2013 – the difference was £1.22 billion. This implies £1.86 billion within retail UK equity funds overall, after deducting the passive sector's share of assets run by IMA members which was 9.6% as at July 2013. The £3 billion assumes similar levels of closet indexing and under-performance across the other IMA non small cap IMA equity sectors of Europe Excluding UK, Europe Including UK, Japan, North America and Global Emerging Markets.

- The research findings give significant concerns that the UK investment industry may be breaching two of the FCA overriding principles⁴ that firms must '*conduct their business with integrity, and communicate information in a way that is clear, fair and not misleading*'.
- Only a quarter, 24%, of the UK funds analysed were radically different to the index (assumed to be a 70%+ active share) as compared to 65% of US funds.



- UK fund management companies are currently nine years behind US peers in providing quarterly full disclosure of holdings online. Since 2004 the US Securities and Exchange Commission (SEC) has demanded all funds to provide 100% portfolio disclosure quarterly.⁵

⁴ <http://www.fshandbook.info/FS/html/FCA/PRIN/2/1>

⁵ <http://www.sec.gov/news/press/2004-16.htm>

SCM Private's research interrogated the 'active share' of funds based on the 2009 definition of active share from Yale Professors, Martijn Cremers and Antti Petajisto⁶ - *'active share is defined as the fraction of a portfolio or fund that is invested differently from its benchmark.'*

SCM Private analysed retail (non-institutional), active (non-index) UK equity funds within the leading Investment Management Association (IMA) equity sectors of UK Equity Income and UK All Companies in which most UK equity funds can be found.

Research Sample - Fund Criteria

- Funds that benchmarked themselves against the most widely used UK equity benchmark, the FTSE All-Share Index.
- To represent funds typically sold and bought by retail investors, only those funds managing over £100m of assets were analysed.
- All the funds were required to have active share data available via Morningstar and charge an annual management fee/ongoing charge of 0.75% or more to screen out any index or quasi-index funds.

The active share, where available, was calculated at twice yearly intervals over the five years to end June 2013 and then the average was taken. The holdings of each fund was compared to the holdings of a leading FTSE All-Share index tracker.

Timing differences between the dates at which various funds disclosed their holdings to Morningstar were smoothed out by taking an average of 10 data points for every fund.

Sample size

UK - 127 retail UK equity funds, managing a combined £120 billion.

US - Applying the same criteria to US equity funds sold to retail investors, translated to funds that benchmarked themselves to the S&P 500, within the Morningstar sectors of US Equity Large Cap Blend or US Equity Large Cap Growth or US Equity Large Cap Value. All funds were required to have 5 year active share data available via Morningstar and charge an AMC or ongoing charge of 0.5% or more to screen out any index or quasi-index funds.

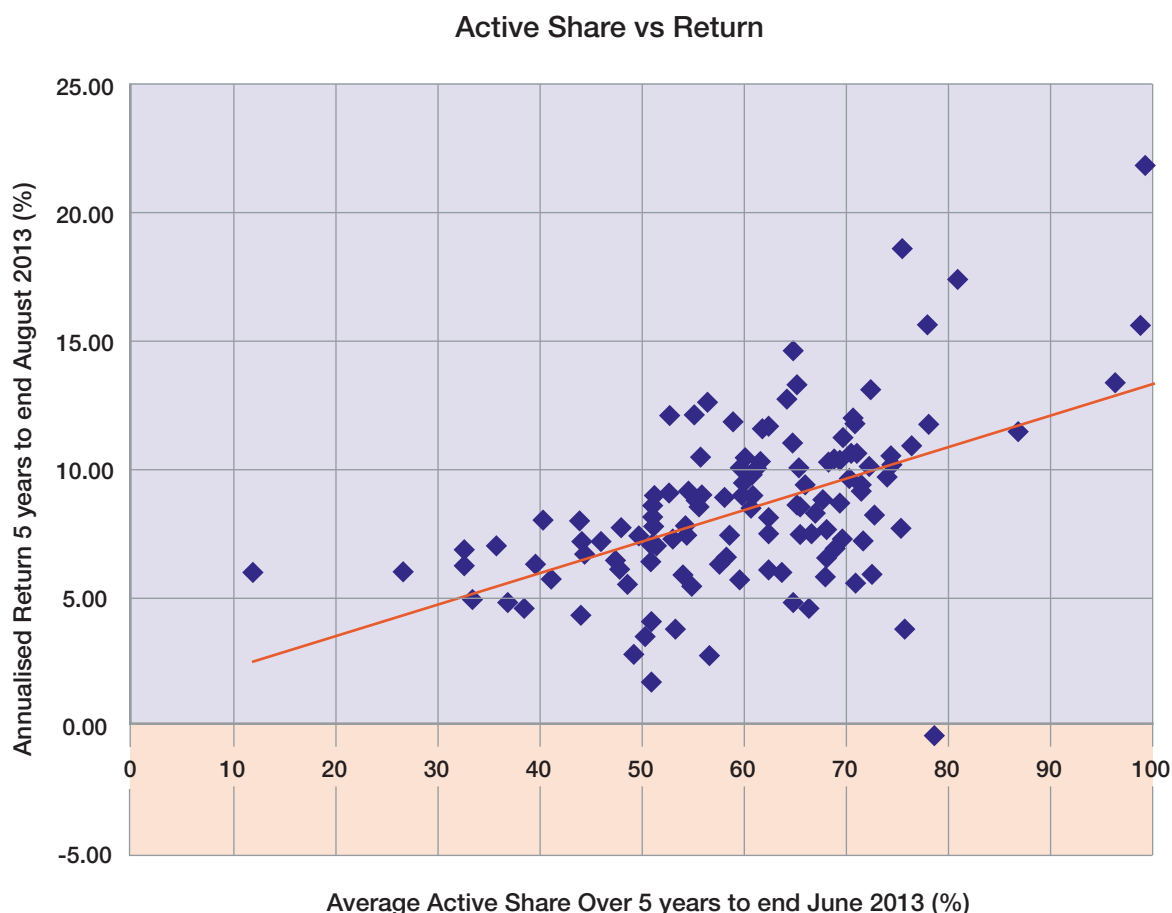
The resulting sample analysed was 227 US mutual funds managing more than £100m each, with a combined value of £453 billion.

⁶ H K.J. Martijn Cremers and Antti Petajisto, "How Active Is Your Fund Manager? A New Measure That Predicts Performance," Working Paper, Yale School of Management, March 31, 2009.

Within UK equity funds, the research found considerable evidence that those funds where the manager does not have a portfolio significantly different to the index have little chance of beating the market. In contrast those funds that are constituted differently to the index have mostly outperformed.

Average Active Share 30th June 2008 to 30th June 2013	Average Performance Relative to FTSE All-Share Index over 5 Years to End August 2013	%age of funds under-performing
Less than 50% (i.e. <u>majority</u> of fund the same as the index)	-1.1% per annum	88%
More than 50% (i.e. <u>minority</u> of fund the same as the index)	+1.6% per annum	28%

The graph below illustrates a relationship, within UK equity funds between the levels of active share and the performance. The variation in performance is more marked in funds with higher active shares, the average performance is greater.



The table below compares the analysed funds' holdings compared against an index fund.

	Weighting in a leading FTSE All- Share Index tracker 30 July 2013 (%)	Weighting in Halifax UK Growth 30 May (%)	Weighting in Santander PF UK Equity 29 June 2013 (%)	Weighting in NFU UK Growth 29 August 2013 (%)	Weighting in Santander UK Growth 29 June 2013 (%)	JPM UK Higher Income 30 May 2013 (%)	Weighting in Scottish Widows UK Growth 30 July 2013 (%)
Royal Dutch Shell PLC Class A + B Combined	7.05	6.92	4.93	4.12	5.60	7.44	6.58
HSBC Holdings PLC	6.79	6.57	6.51	5.38	7.02	7.06	6.33
Vodafone Group PLC	4.68	4.61	5.41	4.67	7.03	5.07	4.49
BP PLC	4.23	4.95	4.59	3.98	6.74	4.88	3.92
GlaxoSmithKline PLC	4.04	3.30	5.22	3.72	6.55	3.26	4.22
British American Tobacco PLC	3.28	3.45	4.13	3.35	4.59	3.84	3.29
Diageo PLC	2.52	2.22	0.71	2.75	0	0	2.7
AstraZeneca PLC	2.02	2.87	0.93	0.96	1.13	2.5	1.85
BHP Billiton PLC	1.95	1.70	1.52	2.45	2.40	2.36	1.93
BG Group PLC	1.95	1.31	1.98	2.47	3.06	0	2.15
Rio Tinto PLC	1.82	1.04	2.05	2.36	3.12	2.02	2.03
Barclays PLC	1.81	2.02	2.10	1.95	1.34	2.3	2.07
Unilever PLC	1.58	0.91	2.17	1.64	3.08	1.99	1.33
Reckitt Benckiser Group PLC	1.47	2.09	0.63	1.21	0.36	1.84	1.25
Standard Chartered PLC	1.47	1.50	2.05	1.82	2.57	1.91	1.71
SABMiller PLC	1.47	1.29	0.56	1.58	0	0	1.61
Prudential PLC	1.45	1.42	2.31	2.32	2.82	0	1.71
Tesco PLC	1.43	0.66	0.63	1.30	0	1.94	1.59
National Grid PLC	1.40	0.76	0.88	1.70	1.99	1.87	1.54
Lloyds Bank PLC	1.38	1.26	0.60	1.75	0.55	0	1.30
Fund Size		£5,741m	£606m	£329m	£1,100m	£298m	£3,056m
Average Active Share** 30th June 2008 to 30th June 2013	0%	11.9%	26.5%	32.6%	32.6%	32.7%	33.4%
Under-Performance vs. FTSE All-Share 5 Yrs to end August 2013	-0.3% pa	-1.4% pa	-1.4% pa	-0.5% pa	-1.1% pa	-0.7% pa	-2.5% pa
Annual Management Fee	0.4% pa	1.5% pa	1.0% pa	1.25% pa	1.25% pa	1.5% pa	1.5% pa

*Source: Morningstar latest available holdings as at 10th September 2013.

**Average Active share calculated as average active share of fund in comparison with the L&G UK Index Fund as at 30th June 2008, 31st December 2008, 30th June 2009, 31st December 2009, 30th June 2010, 31st December 2010, 30th June 2011, 31st December 2011, 30th June 2012, 31st December 2012, 30th June 2013 using the Morningstar data regarding active share.

SCM Private is not suggesting that these funds are in any way breaking any FCA rules or general UK laws.

This table lists the UK funds analysed, showing the fund size, their active share and their total returns annualised over five years to the end of August 2013. Over this time period the index returned 7.4%.

Name	Fund Size GBP	Average Active Share* (%)	Total Annualised Return 5 Yrs to end August 2013 (Index Return = 7.4% pa) (%)
Halifax UK Growth C	£5,741,488,701	11.9	6.0
Santander PF UK Equity A	£605,561,962	26.5	6.0
NFU UK Growth B	£328,567,973	32.6	6.8
Santander UK Growth Acc	£1,099,915,516	32.6	6.3
JPM UK Higher Inc A Acc	£297,867,471	32.7	6.6
Scottish Widows UK Growth A	£3,055,823,148	33.4	4.9
HSBC UK Growth & Income Retail Acc	£870,153,427	35.7	7.0
Marks & Spencer UK Selection Acc	£123,567,001	36.9	4.8
JPM UK Equity A Acc	£266,587,589	38.4	4.6
Barclays UK Core A Inc	£329,269,937	39.6	6.3
HSBC Income Retail Acc	£248,260,788	40.2	8.0
Halifax UK Equity Income C	£2,951,846,471	41.0	5.7
BlackRock UK Equity A Inc	£820,851,223	43.9	7.9
Scottish Widows UK Equity Income A Acc	£679,493,467	44.1	4.3
JPM UK Strategic Equity Inc A Acc	£129,095,741	44.1	7.2
SWIP MM UK Equity Growth A Acc	£216,495,091	44.3	6.7
M&G UK Growth A Inc	£663,839,909	45.9	7.2
Investec UK Blue Chip A Acc Net	£163,557,791	46.0	7.2
PSigma Income Acc	£375,915,377	47.3	6.4
Royal London UK Equity A	£428,860,959	47.7	6.1
Barclays UK Alpha (2) A Acc	£101,389,085	47.9	7.7
F&C UK Equity Income 1 Inc	£209,412,460	48.4	5.5
Halifax Special Situations C	£189,739,360	49.1	2.8
Santander Equity Income	£167,275,848	49.6	7.4
BlackRock UK A Acc	£532,932,006	50.3	3.5
Cazenove UK Growth & Income B Acc	£347,629,070	50.4	7.4
SWIP MM UK Equity Income A Acc	£1,319,048,493	50.7	6.4
Ignis Balanced Growth Inc	£145,516,189	50.8	4.0
BlackRock UK Dynamic A Acc	£507,119,879	50.9	1.6
Barclays UK Alpha A Dist	£714,124,599	50.9	8.1
Threadneedle UK Monthly Inc RN GBP	£596,657,045	51.1	8.5
Barclays UK Eq Income (2) A Acc	£238,122,965	51.1	9.0
Schroder UK Equity Inc	£636,779,176	51.2	7.8
M&G Dividend A Acc	£664,441,515	51.3	7.0
Threadneedle UK Fund Retail	£1,350,417,874	52.6	9.0
Majedie UK Equity A Acc	£2,072,294,470	52.8	12.1
Threadneedle UK Select Ret Net GBX	£197,843,600	52.9	7.3

SCM Private is not suggesting that these funds are in any way breaking any FCA rules or general UK laws.

Name	Fund Size GBP	Average Active Share* (%)	Total Annualised Return 5 Yrs to end August 2013 (Index Return = 7.4% pa) (%)
L&G UK Active Opportunities R Acc	£157,764,325	53.2	3.8
CIS UK Growth	£1,176,281,856	53.9	5.8
JPM UK Dynamic A Acc	£145,015,028	54.2	7.7
Fidelity MoneyBuilder Growth	£722,917,398	54.3	7.4
Aberdeen UK Equity Income A Acc	£171,340,310	54.5	9.1
SWIP MM UK Equity Focus A Acc	£1,290,865,893	54.6	5.4
Jupiter Growth & Income	£360,111,061	55.0	12.1
Aberdeen UK Equity A Inc	£195,320,126	55.1	8.8
Royal London UK Growth Fund A	£418,542,120	55.6	8.5
River & Mercantile UK Eq Hi Alpha A	£427,870,556	55.7	10.5
Artemis Income Inc	£5,972,755,548	55.8	9.0
Investec UK Special Situations A Inc Net	£1,038,755,218	56.3	12.6
L&G Equity R Inc	£193,773,965	56.6	2.7
Jupiter Income Trust	£1,989,230,296	57.5	6.3
IP Income & Growth Inc	£570,164,725	57.9	8.9
Newton Higher Income GBP	£2,191,340,664	58.2	6.6
BlackRock UK Income A Inc	£605,215,139	58.5	7.5
Cazenove UK Equity Income B Inc	£427,472,750	58.9	11.9
Threadneedle UK Overseas Earnings IN Inc	£119,680,546	59.3	10.1
Newton UK Equity GBP Inc	£1,145,519,310	59.5	5.6
Barclays UK Eq Income (2) A Acc	£238,122,965	59.7	9.0
Fidelity MoneyBuilder Dividend	£633,820,000	59.8	9.5
Troy Trojan Income I Acc	£1,277,986,574	60.1	10.4
Threadneedle UK Gr&Inc Ret Net GBP	£237,309,382	60.6	9.9
Fidelity UK Select	£277,616,777	60.7	8.5
HSBC UK Focus I A	£227,620,317	60.7	8.9
Old Mutual UK Alpha R Acc	£546,664,778	61.0	9.8
Threadneedle UK Eq Inc Ret Net GBP	£2,141,974,243	61.7	10.2
Schroder Specialist Value UK Eq I Acc	£131,514,839	61.7	11.6
Royal London UK Equity Income A	£517,275,028	62.2	11.7
Premier Income A	£356,053,871	62.4	8.1
AXA Framlington UK Growth R GBPAcc	£234,674,906	62.4	7.5
Neptune Income A Acc	£634,651,145	62.5	6.1
HSBC UK Freestyle Retail Acc	£147,479,628	63.6	5.9
Majedie UK Focus A	£383,436,154	64.1	12.7
Jupiter UK Special Situations	£1,192,214,858	64.6	11.0
AXA Framlington Equity Income GBPAcc	£138,477,373	64.7	4.8

SCM Private is not suggesting that these funds are in any way breaking any FCA rules or general UK laws.

Name	Fund Size GBP	Average Active Share* (%)	Total Annualised Return 5 Yrs to end August 2013 (Index Return = 7.4% pa) (%)
JOHCM UK Equity income B GBP Acc	£2,134,006,900	64.8	14.6
Premier Monthly Income A	£176,508,540	65.0	8.6
Ecclesiastical UK Equity Growth A	£131,026,848	65.0	13.3
M&G Recovery A Acc	£7,232,178,834	65.3	7.5
Artemis UK Growth R Acc	£560,363,797	65.3	10.0
Aviva Investors UK Opportunities 1	£159,705,610	65.4	8.5
Baillie Gifford UK Equity Alpha A Inc	£131,451,874	65.8	9.4
SWIP UK Opportunities A	£109,423,586	66.3	4.6
Newton UK Opportunities GBP Inc	£364,853,135	66.5	7.5
Liontrust UK Growth R Inc	£242,090,390	66.7	7.5
Royal London UK Opportunities	£517,887,499	66.9	8.2
JOHCM UK Opportunities B GBP Acc	£1,184,750,203	67.6	8.8
St James's Place UK & General Prog Acc	£1,058,423,250	67.8	5.8
Old Mutual UK Alpha R Acc	£546,664,778	67.9	7.6
Artemis Capital	£383,544,694	67.9	6.5
IP Children's	£204,912,094	68.1	10.2
F&C Stewardship Growth 1 Inc	£628,724,801	68.5	6.8
Threadneedle UK Eq Alpha Inc RN GBP	£504,922,285	68.6	10.4
Rathbone Income R Inc	£599,823,231	69.3	8.7
IP UK Growth Acc	£1,039,436,626	69.4	10.3
CIS Sustainable Leaders	£376,192,313	69.6	7.3
AXA Framlington UK Select Opps R Acc	£4,414,710,764	69.6	11.2
Schroder Income Maximiser A Acc	£1,016,878,079	70.2	9.6
IP UK Strategic Income Acc	£288,236,125	70.4	10.6
JOHCM UK Growth B GBP	£269,167,214	70.6	12.0
F&C UK Alpha 1	£195,820,408	70.8	5.6
Schroder Income Inc	£1,375,593,428	70.8	11.8
Schroder UK Alpha Plus Acc	£2,027,071,028	70.8	10.6
IP Income Inc	£10,782,743,036	71.3	9.1
F&C Stewardship Income 1 Acc	£315,244,862	71.3	7.2
IP High Income Inc	£14,162,822,391	71.3	9.3
Artemis UK Special Situations	£1,133,315,505	71.3	9.4
Fidelity UK Growth	£396,976,819	71.5	7.3
FOUR Active UK Equity C	£111,621,558	71.8	7.2
Fidelity Special Situations	£2,804,721,620	72.0	10.2
Jupiter Undervalued Assets	£114,292,589	72.2	5.9
IP UK Aggressive Acc	£152,577,078	72.3	13.0

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Name	Fund Size GBP	Average Active Share* (%)	Total Annualised Return 5 Yrs to end August 2013 (Index Return = 7.4% pa) (%)
St James's Place UK High Income Acc	£1,318,979,261	72.7	8.2
St James's Place Equity Income Acc	£1,467,958,612	73.8	9.7
Jupiter UK Growth fund	£936,876,210	74.3	10.5
Ecclesiastical Amity UK A	£109,898,516	74.7	10.2
St James's Place UK Growth Acc	£242,261,916	75.2	7.7
Cazenove UK Opportunities B	£2,142,769,413	75.3	18.6
L&G Growth R Acc	£135,857,740	75.6	3.8
Henderson UK Equity Income A	£423,700,052	76.3	10.9
Schroder Recovery A Inc	£430,780,301	77.9	15.6
River & Mercantile UK Eq L/T Rec A	£156,741,605	77.9	11.7
Henderson UK Alpha A	£433,104,101	78.5	-0.5
Liontrust Special Situations R Inc	£1,119,818,165	80.7	17.4
SVG UK Focus A	£119,203,635	86.6	11.4
L&G UK Alpha R	£166,291,001	96.3	13.3
PFS Chelverton UK Eq Income Ret	£143,257,286	98.7	15.6
Unicorn UK Income A Inc	£328,185,582	99.5	21.9

*Average Active Share calculated from Morningstar by comparing the holdings of each fund as against a leading FTSE All-Share Index Tracking Fund on the following dates – 30th June 2013, 31st December 2012, 30th June 2012, 31st December 2011, 30th June 2011, 31st December 2010, 30th June 2010, 31st December 2009, 30th June 2009, 31st December 2008, 30th June 2008.

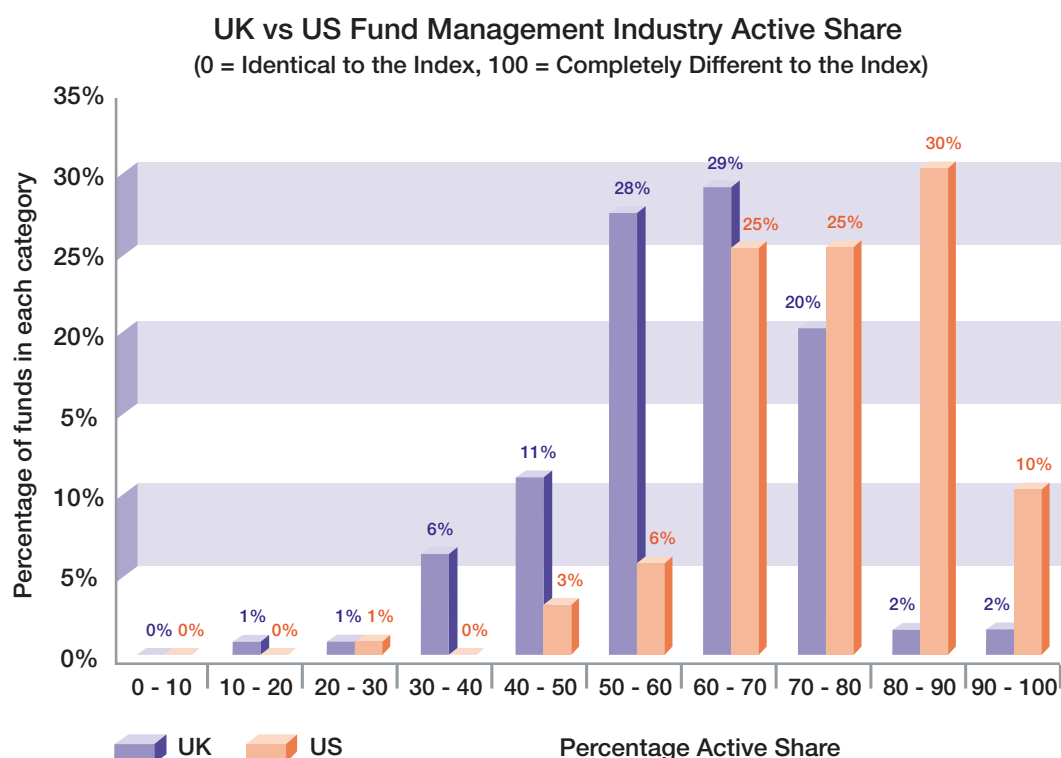
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When analysing funds in the UK and the US, SCM Private found an appreciable difference with far more funds in the US being genuinely active. One explanation may be that UK standards lag far behind the US; particularly in terms of transparency of fund holdings. As far back as 2004 US funds have been required to complete portfolio holdings quarterly via the internet.⁷

	UK Equities Active Funds	US Equities Active Funds
%age of funds analysed closet-indexing*	46%	10%
Frequency Full Portfolio disclosed to investors	Normally once a year via Report & Accounts posted	Every 3 months on-line with some disclosing monthly in full

*Utilising the Martijn Cremers and Antti Petajisto assumption within this paper that any fund with <60% active share was potentially closet-indexing.



⁷ SEC Adopts Enhanced Mutual Fund Expense and Portfolio Disclosure; Proposes Improved Disclosure of Board Approval of Investment Advisory Contracts and Prohibition on the Use of Brokerage Commissions to Finance Distribution, Washington, D.C. Feb. 11, 2004

To prevent this systematic abuse of the public by the UK fund management industry, SCM Private recommends:

1. Funds publish 100% of their holdings online at least quarterly (the US rule since 2004).
2. Any fund closely resembling an index fund should clearly state this within their marketing materials.
3. Funds should be forced to disclose their active share combined with their fund portfolio turnover data.
4. Fees should more fairly reflect the active share within a fund.

Conclusion

The evidence from these research findings shows that nearly half UK retail funds may have been misleading the public and breaching the FCA's over-riding principles that firms *'must conduct their business with integrity, and communicate information in a way that is clear, fair and not misleading'*.

The scale of index cloning uncovered by this research suggests wide scale misrepresentation is endemic in the UK fund management industry.

SCM Private is not aware of any factsheet, KIID document, prospectus or marketing literature produced by any UK funds which fell within the potential closet index tracking group that makes any reference to any form of quasi indexation or index tilt being employed in its daily management.

SCM Private firmly believes markets only function properly when people are dealt with honestly and transparently. The True and Fair Campaign (initiated by SCM Private in January 2012) has been calling for higher standards of transparency and disclosure in the UK and has been met with whole hearted resistance from the UK fund management industry and its representative body, the Investment Management Association (IMA). Perhaps the scandalous findings of this new research go some way to explain the industry's reluctance to engender change.

The FCA needs to urgently bring in US standards of transparency to reform these practices and prevent misrepresentation to investors by significantly improving consumer protection and increasing ethics and fairness within the UK fund management industry.



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m | PRIVATE
The Investment Family

2 Eaton Gate, Westminster, London SW1W 9BJ
Telephone 020 7838 8650 • enquiries@scmprivate.com

www.scmprivate.com

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