Summary
• The financial regulator is taking a closer look at fund managers claiming active management fees for benchmark hugging.
• Investors and their advisers have tools available to ensure they are getting what they are paying for.
• Options are available if investors think they've been short-changed.

Throwing open the doors on closet trackers

They say in life that you get what you pay for, but that does not always ring true in finance, finds Elizabeth Pfeuti

In April, the Financial Conduct Authority announced it had instructed a group of fund houses to repay £34 million in active management fees charged on products that it deemed to have been passively managed over an undisclosed period.

The regulator accused some 64 (as yet unnamed) funds of 'closet indexing' and made them change their marketing material to reflect their actual approach to selecting securities.

The money was returned, T&Cs updated and the FCA warned the industry that as part of its 2016 review in to fund management tricks like this would no longer be tolerated.

Most believed the funds in question were aimed at retail investors, who generally have little or no knowledge of what happens behind the shiny windows of The City, but the episode – and ongoing monitoring by the FCA – has provoked some institutional investors to take a closer look at their portfolios.

The first question for pension funds is why should it matter? If returns are hitting their target – and after an incredibly long equity bull run and almost a decade of quantitative easing, many of them likely are – what difference does it make?

For Aon partner John Belgrove, the reason is clear: "It is effectively ripping off the consumer."

Belgrove, who has worked with pension funds for more than 30 years, says while it is less common for these larger investors to be sold such products, it does still happen, and it is important to stamp it out.

"Why it matters, and why the regulator cares, is because small margins make long-term outcomes," says Belgrove. Paying 100 basis points in fees rather than 10 mounts up – especially considering the timescale over which pension funds invest and the amount of assets on which they are paying fees.

"Pension funds should be paying either for the skill of an active manager, or very little for a passive fund," says Belgrove.

This is the key point for Mercer senior manager research consultant Gareth Anderson.

"We always emphasise the importance of fees and costs to the end return," says Anderson. "You have to ensure fees are fair and aligned to performance."

Anderson says the regulator has clearly indicated it thinks the fund management sector could give up some of its often vast profits to give better value to the end consumer – retail or institutional – and closet trackers is one of its key areas to watch.

The USA's University of Notre

Dame's Bernard J. Hank professor of finance, K.J. Martijn Cremers, has studied what makes active managers, 'active'.

His papers on the so-called 'active share' have informed many global investors on their approach to selecting managers.

Using his formulae, investors can work out which and how much of a security a fund manager is holding that is identical to the relevant benchmark. The remainder of the fund is classed as the 'active share'. The lower the active share, the less a fund manager should be charging as they are taking their lead from elsewhere. Additionally, the small active share will have to work much harder to enable the fund to outperform and earn the fees paid by the investor – something that is true whether the manager discloses his true approach or not.

Cremers says the danger for pensions is not that they invest in funds that have a low active share, but that they pay a large fee for those that does not.

"The combination of funds with low active share that are not inexpensive are strangely predictive of future underperformance," he says.

It does not always follow, however, that high active share funds must be actively managed. Exchange-traded fund provider WisdomTree create its own indexes upon which to base its investments.

"We could not exist if we just tracked the benchmark," says its head of research Chris Gannatti. The larger providers, some of whom have cut their fees to zero on large, popular index-tracking funds, have priced them out of the market.

"We have to be innovative," Gannatti says. The WisdomTree US multi-factor ETF has an active share of 85 per cent with a net expense ratio of 0.3 per cent.

Is there any chance that a fund manager holding similar stocks and weights to the standard market-cap-based index is a coincidence? Not really, according to industry experts.

"If the fund manager believes the largest stocks really are the best, there will be a low active share," says Cremers. "However, it should be evident that they hold a really overweight position, not just one that is identical to the index."

There are other excuses, or reasons, why a fund manager might be hugging an index – but these are only valid for a small number, according to Redington head of manager research Nick Samuels.

"Some products are specifically designed to track the index and take lots of little views on a large range of stocks," says Samuels. "These quant funds make decisions much more quickly than a human could and should not be discounted – as long as they are priced accordingly."

Other managers use an index-hugging strategy, but for a different end, according to Belgrove.

"If we keep paying attention to short-term performance, some managers will hold stocks they don't like, but are in the index, just so they do not underperform," says Belgrove. "They see it as a business risk if their returns are lower than the benchmark and they have a large tracking error."

This is a hangover from an earlier time when hugging the index was seen as a safe bet.

A lawsuit brought by the Unilever pension fund in 2001 accused Mercury Asset Management of taking too much risk – straying too far from the benchmark – and significantly underperforming.

The case was settled out of court with MAM accepting no blame.

However, for a good while after, Belgrove says, managers made a low tracking error a selling point, while continuing to charge fees that sat out of kilter with their approach, to protect their businesses from such an event.

Today, with the focus from the regulator ensuring all investors get what they pay for, consultants are keenly looking under the bonnet of funds that claim to be actively managed.

Anderson says over the past decade, managers have become more willing to disclose their holdings, weightings and want to explain how their strategy gives them the expensive "edge".

"It is important for clients to see how the manager is different," says Anderson. "You have to look at the input and output to understand why they might be performing or not, depending on market conditions."

Looking back over the long term will also show whether a manager has had a brief dalliance with an index or hugging it is structural to their process.

Of course, actively managing a fund is no guarantee of positive performance. A high conviction trade can go one of two ways. The important thing is recognising what you have signed up to – and ensuring you get it.

If you suspect this might not be the case, there is a remedy.

Legal firm Signature's commercial litigator, Daniel Spendlove, says regulatory announcements like the one from the FCA often open a path to claims.

"While there is no firm data yet – no one apart from the asset managers themselves knows how endemic it is – it is clear the regulator believes that closet index-tracking is more than a theory," he says.

Whether it is sub-conscious tracking or playing it safe in a moment of high volatility, the legal liability kicks in when you hand over the money – and under English law, investors can look back over six years to find it.

"Active management is no guarantee of outperformance," says Spendlove. "But with closet-trackers you are not getting what you paid for – and if active management could have given you that outperformance, it is a double loss and you have a legal claim."

Written by Elizabeth Pfeuti, a freelance journalist