Summary
- DC pension schemes must disclose transaction costs to members.
- The FCA's IDWG will soon publish a universal template for total ownership costs.
- Disclosure can be a starting point to reducing costs.
- The message to members should be carefully managed.

Towards transparency

The quest for total cost disclosure remains incomplete but there are plenty of measures for trustees to implement now, finds Alastair O'Dell

There is now little doubt about the final result of the decade-long quest to gain transparency into pension schemes' hidden costs. The most pressing concern this year is DC transaction cost disclosure, but this is just a stepping stone to total cost disclosure.

DC trustee boards, since 2014, and contract-based schemes' independent governance committees (IGCs), since 2015, have been required to report transaction costs in their Chair's Annual Statement but have enjoyed only limited success, with asset managers taking varying and incomplete approaches to disclosure.

That all changed on 3 January 2018, when the FCA imposed a legal duty on regulated firms to respond to transaction cost requests, using the slippage cost methodology employed by MiFID II and PRIIPs.

In March, DWP regulations considerably increased trustees' obligations, requiring the publication of transaction costs for all investment options and an illustration of the compounding effect of costs and charges. It came into force on 6 April 2018, but trustees have seven months after the next scheme-year ending to comply.

Lane Clark & Peacock, partner Matt Gibson says: "The data we are going to get will not really be sufficient to make sensible decisions – unless a manger's costs are particularly out of line. There are so many approximations used that I don't think comparing them is going to be very helpful."

Improving governance

In February, ShareAction reviewed IGCs' approaches to reporting and found that just nine of 16 IGCs reported any data on transaction costs, but highlighted the Legal & General IGC for good practice.

"We made an effort to make it as digestible as possible, but it is not simple," says independent director Daniel Godfrey and member of the Legal & General IGC.

The former Investment Association chief executive adds: "It's important that IGCs get the best information they can and articulate meaningful information to members in a digestible form."

Pembroke visiting professor at the University of Cambridge's Judge Business School David Pitt-Watson states: "Not telling people what is being charged to their account isn't reasonable. It's unacceptable that the fund management industry has been holding back on transparency."

However, he notes that it is not viable for a lone asset manager to break ranks so an industry standard is essential. Transparency Task Force founding chair Andy Agathangelou has been instrumental in bringing asset managers to the table, with regular events and initiatives such as the Transparency Trophy.

The whole truth

The FCA, determined to impose transparency across all investment funds, turned to Chris Sier to chair its Investment Disclosure Working Group (IDWG). *Pensions Age* requested an interview but he declined to speak until his FCA work is complete.

However, the direction of travel is clear. Sier created the template for the most effective initiative to date – the Local Government Pension Scheme (LGPS) Code of Transparency – and the FCA requested an even stronger version.

The £250 billion LGPS requires all managers of listed assets to sign up before any of its regional funds can invest (it has £180 billion in listed assets). More than 50 managers have committed and it continues to grow.

All pension schemes can piggyback on the LGPS code as its advisory board's website lists all signatories. "Clients outside the LGPS are asking for the same thing," says Local Government Association head of pensions Jeff Houston. "And the LGPS tick logo provides a level of confidence."

The IDWG template will operate on the investment fund level so it can be universally applied. "We went back to first base to identify every possible cost," says Houston, who is also a deputy chair of IDWG. "The important thing is the trustees are assured all is being disclosed.

"We are all *[in the working group]* pulling in the same direction – everyone is signed up to the principle – the question is how to break it down."

The IDWG is creating two templates. Asset managers will fill out the account level template to a high level of granularity. This feeds through into the user level one, which is useful to trustees. The primary purpose is to "inform whether it's the best asset class to be in and whether it's the right way to be in that asset class," says Houston.

Simplitium head of pensions product development Stewart Bevan, who also sits on the IDWG, says: "There have been competing methodologies for cost data collection but the introduction of the IDWG standards, which has involved cross-industry participation in designing the new templates, identifies consistent, standardised, industry-agreed cost categories for the first time."

The IDWG aims to finalise the documents by June and the LGPS has committed to adopt it.

Ongoing issues

It is important to note that asset managers do not profit from hidden costs. Indeed, the fees accrue to third parties and degrade performance. Nonetheless, "it is fair to say costs have not been monitored as closely as they should've been," says Mercer director Alasdair Gill.

Asset managers have resisted when they view the data as proprietary and/or commercially sensitive. They may also lack the operational capacity, particularly if acquisitions have led to parallel systems. And, some complain of difficulties securing third-party data. "It's always an issue when asset managers run funds with underlying managers," says Houston.

For example, if a private equity fund-of-funds invests in an underlying fund in the US, it may not be able to force it to provide data and, if it can, it may be supplied on a calendar year (not UK financial year) basis.

Asset managers have also pointed out they may have nothing to do with agreeing the fee schedule in areas where they incur charges. A DB scheme with segregated mandates purchases the custodial relationship – but may not have secured it at best price. Asset managers have not viewed it as their responsibility to monitor such costs – one benefit of disclosure is that it will motivate a feedback loop.

For example, Pitt-Watson notes that there is a concern that short term trading must, in aggregate, reduce returns to pension beneficiaries. "Not only is it taking money out of your pension pot but it is encouraging short termism, an activity that most people would say they rather did not happen. Disclosure of costs will bring this to their attention."

Counting costs

Hidden charges can be hugely significant and their disclosure can lead to actionable measures. In 2011 Railpen reported total costs of £90 million but forensic accounting later found an additional £200 million; negotiations and reallocations facilitated savings of £70 million. Likewise, the West Midlands Pension Scheme reported costs for 2013/14 of £11.2 million but this shot up to £87.3 million under a new standard, but has declined each year since.

Innovation foundation Nesta found that 20-25 per cent of the income from its endowment went in costs. Gill says: "The management fees were only 42 per cent of the total cost of running the portfolio. Costs can be material and clients don't realise they are being incurred in their name."

The power of disclosure was also observed when MiFID II separated out research costs, which managers almost universally absorbed. "The amount spent on research has come down and they are much more selective about what they are purchasing," says Gibson.

Mercer global director of strategic research Phil Edwards adds: "It was a good marginal win for investors. Hedge funds decided to pass these on to investors – they behave a little bit differently."

Understanding and interpreting costs is an essential starting point for assessing value. High transaction costs are not necessarily a problem – identifying short-term mispricing can produce great returns.

"It's important this is interpreted correctly," says Godfrey. "They may be being incurred to achieve higher performance. It's a friction to be overcome."

But even if net returns are strong, it provides a warning for the future. "You are definitely going to pay the costs – you are not necessarily going to get outperformance," adds Gibson.

Written by Alastair O'Dell, a freelance journalist

Communicating with DC members

The new DWP rules compel schemes to publish an illustration of the compounding effect of the costs and charges affecting their pension savings.

There is a danger that, if not properly managed, disclosure would discourage DC members investing. It needs to be explained that the new figure reflects the total cost of ownership, and is not an increase in costs.

Houston says: "If it suddenly costs 10 times more that it seemed to cost, how do you manage that out to the public, press and members?" He suggests one approach would be to recast previous years costs using the new standard.