

Ideal Fund

Reengineering the fund value proposition

June 2009

Foreword

The unprecedented breadth and depth of the 2007-9 Credit Crunch will engender a response from savers and investors; governments and regulators; that will influence the future of finance for many decades to come. It is useful to recall that the Glass-Steagall Act of 1933, that was born out of the 1929 crash in the United States and governed the structure of US financial markets and its regulation, was only repealed in 1999, some 66 years later.

There will be a number of knee-jerk responses to the crisis. There always is. There will be calls for the Industry to show greater transparency, more prudential controls and better risk management and for government to regulate more. But this crisis is different than the last six international crises. The 1994-95 Tequilla and the 1997-98 Asian financial crises had severe economic consequences and the market dislocation around LTCM's debacle and the Russian default in 1998 was debilitating for a while, but this crisis brought the financial system to a dead stop. The day after the collapse of Lehman Brothers in September 2008, the cost of capital rose to unsustainable levels for almost every banking institution in the US and Europe. When savers who appear to have done everything expected of them - putting aside regular amounts for a lifetime, investing in liquid, well-rated instruments, using established and regulated intermediaries - end up losing more than half of their savings just before retirement, the pressure will be for more than just greater transparency, controls and risk management. This is not the time merely to redouble previous, failed, efforts, but to rethink their direction. The authors of this report bravely do that and consider three critical areas that require an overhaul: long-term investment products, fund governance and investor education.



This report brings together a number of fundamental observations, that could have been made before the crisis, but the crisis has made these observations stark. First, while there has been much emphasis on wealth management and High Net Worth Investors, the 800lb gorilla in the fund space in Europe in coming years will be retirement provision for the general population. Today the State pension of one retiree is paid for with the taxes of four workers. By 2050 a retiree will be supported by just two workers. The situation is even worse than that suggests because State coffers have been raided by bank bail outs and people are living on pensions for considerably longer than when the state pension scheme was first thought up. By hook or by crook, over the next ten years there will be a massive increase in demand for private savings products that replace or top up State pensions. In keeping with the “nudge” school of social policy, this report supports the idea of automatically signing people up to individual savings accounts and requiring savers to actively “opt out” if they wish to.

How will this new demand for savings products sit with the existing supply? In the noble pursuit of investor protection, fund regulations in Europe have supported the proliferation of standardised, liquid funds with strict risk limits and benchmarked to a market sector or strategy. However, the crisis has shown that many of the over 50,000 funds may not be particularly relevant to what long-term savers need. This is a bold assertion that requires some elaboration.

There is a misguided view of risk that says risk is an absolute, constant property of an asset, which can be sliced, diced and redistributed. This is an elegant view of risk and has the merit of being measurable in a way that allows financial institutions to build highly complex models based on it to assure investors that risk is being controlled. It is also an artificial construct that has little bearing on the nature of risk. In reality, there is not one risk. The three broad financial risks are

credit risk, liquidity risk and market risk. These risks are very different. Moreover, the potential spillover risks of someone holding an asset depends as much on who is holding it. Different holders have different capacities for different risks. Consequently, the distinction between “safe” and “risky” assets is deceptive: in the wrong hands a lot of damage can be done with an indexed equity fund, or as we have seen, with a low-income mortgage.

Capacity for a certain type of risk is best assessed by considering how that risk is hedged. Liquidity risk - the risk that an immediate sale would lead to a large discount in the price - is best hedged through time and held by institutions that do not need to respond to an immediate fall in price, perhaps because the financing for that asset is fixed. A fund which offers investors immediate liquidity has little capacity for holding liquidity risk and for earning the liquidity risk premium. This premium above the risk free rate can be in the region of 3% to 10% as evidenced by long-run outperformance of old-fashioned private equity funds. The liquidity risk premium is precisely the risk premium a fund should earn if it is for long-term savers looking to grow savings until the point of retirement. Equally, long-term savers should not generally invest in assets which offer the best liquidity, because they would then be paying expensively - reducing future returns - to avoid a risk that is not a risk to them.

The implication of all this is that there is a large missing market in the funds space in Europe: the market for funds that are designed for long-term investors and are managed, measured and regulated in such a way that encourages them to maximize long-term absolute returns and not to reduce long-term returns for the sake of needless short-term liquidity or hugging a benchmark of passing relevance to the long-term liabilities of individuals. It seems to me and the authors of this report that these types of funds will become commonplace in the future.

Those with enough grey hair would say that we are going back to the future, and that these funds sound like the balanced funds run by corporate pension funds of old. Essentially this is correct. However, this is not a product that companies will offer any more. Blame the passing of life-time employment or the advent of fair market accounting of corporate pension fund liabilities, but whatever the reason, individuals are having to take responsibility for their own pension. To do so, they need to be better equipped and supported than they are at the moment.

A key concern of this report is the absence of independent, unconflicted advice for long-term savers at a time when more financial risks are being shifted to individuals by governments and employers. The report discusses some radical ideas on improving investor education. I am a little sceptical over what can be achieved in this area. Many highly numerate, sophisticated, experienced investment professionals lost their savings and jobs in the credit crunch, suggesting that a little more education of investment amateurs would not have made much difference. One idea I do like is for fund distribution companies to place a small fee whenever they have achieved a sale into a pan-European investor education pot which funds an investor education voucher for every citizen. This voucher could be spent on independent financial advice. This would help create a private market in advice that is separate from fund distribution, fund management and government, while at the same time ensuring that low-income savers have access to advice even though their savings pot may be smaller. Ultimately if these investor education vouchers are paid by the distribution companies it comes out of the returns of investors, but a system where successful fund distribution finances independent investor advice on funds has built in checks and balances.

This report raises the critical questions and offers some interesting practical answers. In so doing this report will help to set the debate over the fund of the future. I strongly commend it to you.

Individual Fund



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Message from the authors

PricewaterhouseCoopers

At PwC Luxembourg, we believe that the fund industry and the general long-term savings market in Europe has arrived at a watershed whereby the industry and the State need to re-assess the role long-term savings vehicles should play and how those vehicles need to be designed and supported to provide proper access to the financial markets for the broader population. UCITS as a framework has enjoyed tremendous success since its introduction in 1985 and we believe any long-term savings vehicle available for retail investors should be required to provide an equivalent degree of transparency and governance and further that such vehicles could be better targeted to long-term retail investor needs. What we propose in this paper is fairly far-reaching and is designed to encourage debate and consideration of steps which could be taken in both the short and long-term. What is clear is that the establishment of a sustainable long-term saving solution in Europe today is no longer a “nice-to have” but is critical for the financial well-being of millions of individuals in Europe today. The current crisis is a golden opportunity for state and industry to collaborate in building a truly world-class model designed for the mass-market as well as the mass-affluent. In this paper we have chosen to focus primarily on the area of retirement planning whilst also covering the general long-term savings market; we plan to supplement this paper with further studies more focused on both the liability management and wealth accumulation segments of the mass-market. We hope that this paper serves to facilitate the debate as we move into a new era for the fund industry.


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CACEIS Investor Services

CACEIS, as a global asset servicing provider is very closely linked to the fortunes of its clients and ultimately those of the end-investor. Our decision to tackle the topic of an “Ideal Fund” for our annual research paper stems from this, as when the asset management industry suffers, we also suffer, albeit indirectly. This closeness of the interplay was demonstrated by the extraordinary measures we took during the recent crisis, such as leveraging our considerable financial resources to help clients remain liquid and in business. The crisis also impacted the investment industry’s long-standing model, which if not broken, was severely damaged. Such a hiatus provided an ideal opportunity to take an introspective look and understand how best to address the boom and bust cycle that has characterised long-term investing’s more recent past. By stepping back and viewing the industry from the investor’s perspective, we can take stock of both the failures and successes of the industry, whilst identifying the characteristics most desirable in a fresh, updated model. Such a model would incorporate new features designed to better protect investors’ ability to achieve their long-term investment objectives. This paper looks at every stage of the investment industry, from initial investor education to product design, seeking to make realistic proposals for enhancing the current framework. It is designed to serve as a catalyst, driving positive change in the long-term investment industry, restoring its tarnished image, promoting the development of secure investment products that are well matched to realistic, long-term savings goals and ultimately stimulating sustainable growth for the investment industry.


José-Benjamin Longrée

Member of the CACEIS Executive Committee

Introduction

The asset management industry has seen tremendous growth over the past ten years. Assets in European investment funds have more than doubled since 1998 from €3.04 trillion to €6.14 trillion at the end of 2008.

Figure 1

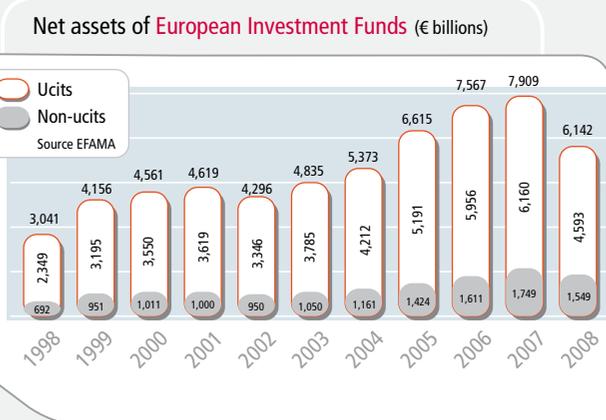
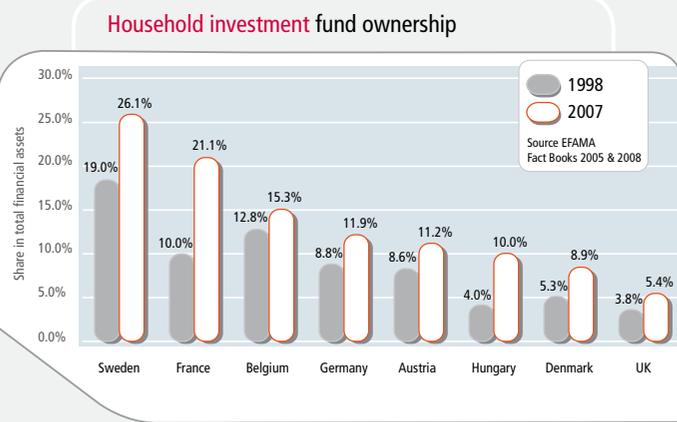


Figure 2



¹Source: Lipper FMI

The increase in share of household financial assets held in mutual funds across Europe during the past decade has been one of the factors of this growth, demonstrating the importance of the retail investor for the industry.

However, the sustainability of this success is under question and industry shortcomings are increasingly being voiced by regulators, investors and even the industry players themselves. In the crisis year of 2008 the European market saw net redemptions of €300 billion in comparison to €98 billion of net outflow in the US market which is twice as large. The Asian market, despite being a fraction of the size of the European market, enjoyed positive net inflows of €75 billion over the same period¹.

Our premise for this paper is that this relative underperformance is, in whole or in part, indicative of certain challenges facing the European mutual fund market. Surveys among investors have shown that the asset management industry has become increasingly distant from the consumers of its products over the past few years. Even before the current crisis, a number of shortcomings had driven this gap between supply and demand expectations, and the financial crisis and recent fraud cases have only served to further damage investor confidence in the industry.

In order to ensure the sustainability of the industry's value proposition, we need well-educated investors who receive appropriate advice, with access to an industry with a sound governance framework and which provides them the right product at the right price and with the right level of transparency.

Although the UCITS Directive already provides a sound regime for the regulation and transparency of funds, there is a need for labelling and defining the characteristics of long-term investment products, as well as creating a level playing field for all products designed to cater for the long-term investment needs of the investor.

Scope of the study

This paper takes an investor-centric approach to examine the mutual fund value proposition and outlines recommendations for governments and the industry to promote sustainable solutions that will serve investors. The focus is on the long-term investment goals of European retail investors.

To facilitate an investor-centric approach, it is necessary to start by identifying the three fundamental levels of long-term investor needs:

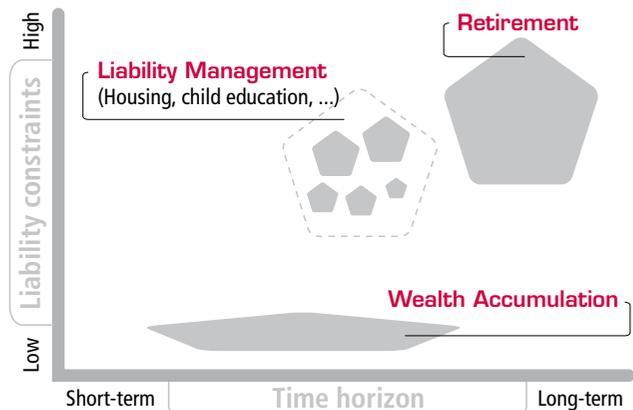
1. Retirement planning
2. Liability management
3. Wealth accumulation

An overview of the long-term investor objectives is provided below in figure 3, looking at both the underlying need of the investor together with the relative time horizon. Within the long-term financial needs of the investor, retirement impacts the majority of the population, has the largest liability constraint and the longest time horizon, whereas liability management has a lower time horizon and the liability constraint is lower than for retirement needs. Wealth accumulation is not targeted towards fulfilling a liability and can have varying time horizons. Furthermore wealth accumulation does not involve the low income population.

We have identified five primary dimensions around which the fund value proposition could be enhanced from an investor-centric perspective (see Figure 4) and which apply to greater or lesser degrees to each of the fundamental investment objectives noted previously.

Long-term financial needs of individuals

Figure 3



Five dimensions around long-term investment objectives

The importance of the different dimensions may vary according to the long-term investor needs. For example, we would contend that all the dimensions are of equally high importance with regards to retirement, whereas, in the case of wealth accumulation, the correct investment advice has a higher importance than education.

In addition to the varying importance of the dimensions regarding the respective long-term investor needs mentioned above, they will also have different implications when discussing possible solutions.

As such retirement and liability management products for example, should be designed keeping investors' time and risk objectives as well as the much lower ongoing liquidity requirements in mind. In contrast, for wealth accumulation, the focus should be more targeted on return on investment and access to liquidity. Figure 5 shows the different implications of the dimensions as to long-term investor needs.



Figure 4

Necessity of retirement planning

Retirement planning is widely recognised as the most vital long-term savings need which involves every working age individual of the population. Its importance and the necessity to deliver on this need become evident through the observation of the changing demographics in Europe. By 2050, for every retiree in the European Union (EU) (anyone over the age of sixty-five), there will be only two workers (anyone between the ages of fifteen and sixty-four), which represents a seismic deterioration from the current ratio of 1:4.

This greying of Europe, coupled with the increased longevity of the population, will pose a problem to pay-as-you-go pension schemes. European governments are reacting to this issue by shifting the responsibility of retirement planning to the working-age individual. This, however, creates a new challenge for the person who now has to make investment decisions for his/her own long-term financial well-being. These decisions need to take into account the savings required to meet the longer period of retirement due to the increase in life expectancy, as well as consider the risk of investment and inflation. Hence, products must be designed, not only to save for retirement, but also to allow for steady income flow after the accumulation phase and safeguard the investor against the risk of having insufficient cashflows in old age.

When designing long-term savings solutions in Europe, the key distinction for retirement specific products is clearly the vast scope of investors considered. As opposed to the investor's long-term needs for liability planning and wealth accumulation, which is likely to amount to millions or 10s of millions across Europe today, the retirement challenge is directly relevant to hundreds of millions of Europeans – a number that will continue to grow as we continue to become greyer. Therefore any solution has to be State or regionally led to have any chance of success. At the same time, the industry clearly has a critical role to play in supporting the State and – specifically – in product design.

Compulsory saving as percentage of salary

Regardless of the increasing deficit of the government pension schemes, a large amount of the population still saves too little for retirement, making it difficult to maintain an equivalent or even an acceptable standard of living as they move into retirement. A compulsory saving as a percentage of salary in private pension schemes (or at the minimum a default saving program with an opt-out possibility), instead of only encouraging savings in such schemes, could ensure that every individual is taking care of his/her retirement planning. Different segments of the population have different retirement needs ranging from basic subsistence through to life-style maintenance. However, what is needed are vehicles which are specifically designed for the mass-market (as opposed to the mass-affluent) and for which the mass-market has access to basic education and advice (either through advisors or built into the product). Such vehicles should be constructed and governed appropriately and, as a result, should form part of an eligible pool of vehicles for mass-market placement.

Executive Summary

On the following pages, we will review each of these dimensions and propose key recommendations specific to long-term products aimed at satisfying the retirement needs of the individual, taking into account the fact that this is targeted to the mass-market rather than just the mass-affluent and above.

Education

Basic education about investing and retirement planning is critical to the social well-being of Europe and should be compulsory and state provided – i.e. integrated into the school system. Further education for more advanced investing (liability management and wealth accumulation for the long-term) are also important but within the balance of priorities, state support needs to focus on ensuring a basic knowledge is provided (and not just made available) to all. We recognise that this is a very long-term goal and that, in the meantime, state-led campaigns may assist in raising the awareness of the mass-market.

Advice

Similarly, we would contend that the long-term goal should be that basic advice around retirement planning is made available to the mass-market on an independent basis. Within this context, the model used for basic healthcare within member states could be looked at to determine whether a similar model on a more limited basis could be applied for the mass-market. Advice could be limited to key inflexion points within an individual's life-span (change of career, pre-retirement, change of family status etc), but should be available to ensure proper advice is made available to maximize the likelihood of full provision on a personal level. Such advice should take a holistic view of the investors "financial health".

Governance

Even within the UCITS regime, governance models vary and are arguably more or less effective. Outside UCITS, effective governance becomes increasingly difficult to establish. As part of long-term savings vehicles, there should be a basic governance model which is established and consistently applied across all member states. The components of such a model require two basic features:

- ◆ The product provider needs to assume legally an institutional responsibility for the proper operation of the vehicle within the best interests of the long-term investor in accordance with the vehicle's objectives;
- ◆ A clear framework outlining proper conduct of business rules and inherent conflicts of interest which exist should be created and parties independent of the promoter should be legally tasked with monitoring adherence to such a framework. Responsibility for such monitoring may fall to parties such as the depositary, independent directors or even the auditor. However, the framework should be clear enough to ensure that the inherent conflict which exists in appointment of the independent party minimizes the risk of "oversight arbitrage" which may arise. For products eligible as retirement vehicles, one could also consider the appointment of an "investor representative" which would likely be a state-registered individual with specific additional scope for protecting the long-term retirement interests of investors and thus managing the States "systemic" interest in the vehicles operation.

Fund Costs

- ◆ An industry-wide aligned definition and investor-friendly reporting of total fees (including costs endured through transaction fees) paid by the investor would foster transparency and confidence. In this

respect, the current practice in the U.S. could prove to be a good starting point.

- ◆ In addition to covering the providers' operational and opportunity costs, fees for retirement products should be linked to the risk-return objectives within the investors' timeframe ("objective fees") in order to align the investors' and asset managers' goals. Such "objective fees" would differ from performance fees which target outperforming a certain level of return, in that they would be determined in line with final and intermediate risk-return objectives.

Product Design and Transparency

- ◆ For vehicles categorised as long-term, the need for daily liquidity, as provided for within the major UCITS, is not required and represents a significant additional cost – and arguably a risk – for investors holding for the long-term. Vehicles designed for the long-term should not only be permitted, but should be required to offer liquidity designed with the long-term investor in mind. This could be accomplished through various measures such as managed redemption programs, swing price mechanisms or limitation of redemption possibilities over certain time periods. The current blurring within the UCITS world of vehicles accommodating short and long-term needs should be eliminated or at least managed for the benefit of the long-term investor.

- ◆ Vehicles designed to incorporate a one-stop solution as an objective (such as target date funds) should retain flexibility and, arguably, be required to incorporate mechanisms which protect the investor in times of crisis such as counter-cyclical hedges or triggers for safe-harbour investment.

- ◆ Transparency within the UCITS world remains extremely high in comparison with other vehicles on offer. Vehicles classed as long-term should all have the equivalent levels of disclosure which are designed for the long-term investor. For example, daily price publication or monthly fact sheets with benchmark performance indicators are arguably less relevant for products with a specific end objective than periodic (say quarterly) reporting on the performance vs. objective, together with any changes in the underlying risk features of the product.

- ◆ Long-term vehicles should be developed to meet the investor's financial objectives rather than to adhere to a fixed strategy such as a fund limited to a country or industry. The fund industry when servicing long-term financial needs, especially in the space of retirement planning, should shift focus from benchmarks to investors' time and risk objectives in constructing retirement eligible products. Such vehicles could be used either as building-blocks or have built-in solutions for investors looking to plan for their old-age financial security.

Figure 5

Implications of the five dimensions to long-term investment needs

	Education	Advice	Governance	Fund Costs	Product Design
Retirement	Compulsory	Access to basic financial advice to every individual ensured by the State	Promoter responsibility with defined 3 rd party monitoring framework	Objective fees in addition to fees covering operational and opportunity costs	Focus on time and risk objectives of investors
Liability Management	Compulsory	Discretionary	Promoter responsibility with defined 3 rd party monitoring framework	Objective fees in addition to fees covering operational and opportunity costs	Focus on time and risk objectives of investors
Wealth Accumulation	Voluntary	Discretionary	Promoter responsibility with defined 3 rd party monitoring framework	Objective fees in addition to fees covering operational and opportunity costs	Focus on targeted return on investment



Investor Education

Investor education helps individuals make better investment decisions, plan for retirement, understand their financial possibilities, and ask the right questions to their financial advisor. The lack of investor education is seen as one of the causes behind the current financial turmoil, with far too many individuals in the United States entering into loan agreements without understanding the risk of their undertakings and their financial limits in affording such loans.

CORE CHALLENGES FOR THE EUROPEAN FUND INDUSTRY

Poor financial literacy and lack of interest

In Europe the increasing shift from pay-as-you-go to investment-based pension schemes is pushing individuals to make their own investment decisions for their retirement, although the level of financial literacy is alarmingly low. According to an FSA report², 25% of adults in the United Kingdom have very low numeracy, meaning they are unable to perform even the simplest of calculations. This lack of literacy, paired with the ever-increasing variety of financial solutions, makes individuals feel helpless when choosing suitable products for their financial needs. In addition, most people evidently lack interest in learning about financial matters. A U.K. survey for the Financial Services Consumer Panel² found that only 33% of consumers regularly review their financial situation, and further data suggests that individuals are reactive rather than proactive in their financial matters.

Multiple but uncoordinated initiatives on financial education

This level of investor illiteracy has sparked numerous initiatives led by governments, regulators, financial institutions, the European Commission, and investor and consumer associations. Contrary to

the United States where the SEC and the government are trying to coordinate and channel investor education efforts (President George W. Bush created for the first time a President's Advisory Council on Financial Literacy in 2008), the picture looks different in Europe. An assessment carried out on behalf of the European Commission found 180 different financial literacy projects in EU mainly targeting children and young adults with a focus on money basics (opening a bank account, credit cards, debit cards, loans, debt prevention, and repayment plans) rather than on investments and savings. The European Commission promotes financial education among others through its website Dolceta. While such initiatives are positive, they remain limited due to the provision of the Treaties, where educational competency is up to the individual EU member states.

Although a mutual agreement exists among governments and associations that investor education is important, little effort has been made to coordinate and bundle the current scatter-gun approach. Investor education should be an integral part of the individual's life-cycle building of a knowledge base as he or she grows older. Selective or one-off, short-term investor education initiatives tend to increase awareness for a short period of time but lose their effectiveness in the long run.

PROPOSED SOLUTIONS

Create a compulsory financial and retirement planning education model

In order to ensure that every individual is aware of the importance and plans for his/her financial well-being in retirement, education on basic retirement planning should be enforced by the government and made a compulsory subject in high school. The focus should be on ensuring that the need for individual retirement planning is clearly understood and "bought into" and that a basic understanding of the products themselves and how they operate is provided. Since we would argue that the long-term financial well-being of the mass-market

²Source: "Towards a National Strategy for financial capability", FSA, 2003

is a critical factor to the social well-being of Europe, this should be considered as important as current core subjects and, if possible, form part of the exam curricula of tomorrow.

Education could be further deepened at university level and beyond. However, the key objective must be to ensure a basic level of understanding exists for all. A variety of teaching tools, in addition to normal classroom teaching, such as games, competitions, e-learning, bank or stock exchange visits etc., should be used to encourage pupils to actively engage with the material. Ultimately, every individual should clearly understand the savings amount required to uphold his/her standard of life and the investment vehicles available to reach this goal. This will increase in complexity as individuals move to higher education, a fact which correlates with the likelihood that their earning potential will similarly increase and their needs likewise.

Whilst we believe this should be primarily driven by the State, the design, and possibly, the execution, of such training even in high-school could be in cooperation with industry, specifically from those institutions targeting the mass retirement market.

As highlighted above, one of the challenges faced in Europe is the territory level responsibility for education. Hence there is a need for a European level mandate to ensure that a minimum level of financial education is provided across all the EU countries.

Once individuals reach working, and later the retirement age, voluntary free-of-charge courses targeted at the specific needs of the individual for retirement savings during working age and consumption at retirement should be provided through e-learning, podcasts, seminars, etc. During this working and retirement phase, the cost of investor education should be borne together by the financial industry and the government, perhaps through an "investor education fund."

It is clear that education is a long-term objective. In the short-term, state-led campaigns targeting awareness of the importance of retirement planning, similar to the AIDS awareness campaign, should also be considered to seek to provide at least some measures of understanding to the mass-market.

An integrated model for investor education

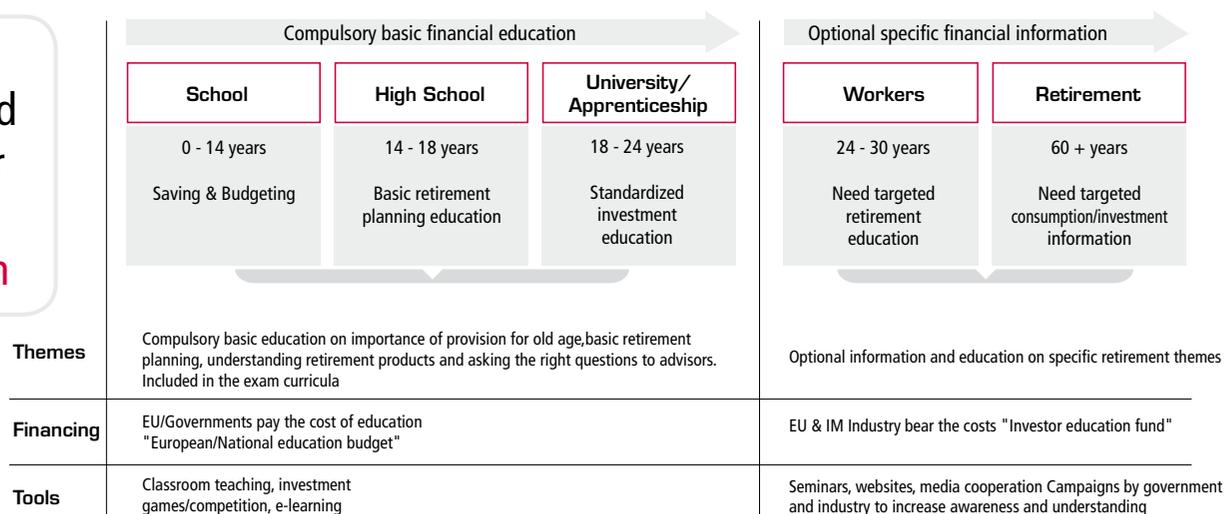


Figure 6



Investor Advice

From the client's perspective, investor education is an integral part of securing an ideal retirement vehicle, but questions abound regarding just how far "Joe the plumber" or even "Joe the architect" has an interest in and the readiness to understand financial investment. Hence, an important part of the value chain is to have good advice, ensuring that investors receive the right product for their specific needs.

CORE CHALLENGES FOR THE EUROPEAN FUND INDUSTRY

Lack of basic qualification in many territories

The current landscape within the EU shows a fragmented picture as to the level of sophistication of financial advisors; from highly educated financial planners, who have been through rigorous and extensive training, to persons hired from non-banking sectors with no prior financial education and set to "advise" customers after short product training. Customer advice, especially for non-HNWI, is mostly without understanding the financial life-cycle of the investor. To make things even more difficult, advisors using open architecture face the dilemma of choosing from thousands of products, making it impossible for them to have an in-depth screening and understanding of all available products in order to make the best choice for their customers.

Conflicts of interest undermining quality of advice

One of the major challenges facing investor advice today is recognised as the conflict of interests arising from the revenue model prevalent in many jurisdictions, where advice remuneration is linked to specific product sales. Such revenue schemes will either incentivise sale or churn of client holdings, not necessarily in the client's best interest. MiFID is a critical piece of regulation aimed at tackling such conflicts

either through product selectivity or transparency requirements, but the implementation of MiFID has been patchy and has not resulted in a demonstrable shift in behaviour.

PROPOSED SOLUTIONS

Develop a financial healthcare model

In order to address this conflict of interests and provoke investor confidence, it makes sense to take a holistic view of investor advice. Just as a physician is responsible for the health of the patient, the financial advisor is (or should become) responsible for the financial health of individuals and families, which is of key personal and social importance in Europe today.

EU-wide harmonised certification and professional codex

Financial advisors should have a clear EU-wide harmonised certification for their profession and a clear professional codex for safeguarding the clients' financial interests and health above all else, whether they are independent advisors or employees of an institution, such as a bank. Anyone with no prior certification should not be allowed to act as an advisor for retirement savings. Eligibility to act as an advisor should be subject to rigorous harmonised guidelines, with specific modules for the country where the profession will be exercised, and the codex should be upheld under all circumstances.

Transfer of investor to specialist when necessary

Even though physicians receive a long and profound education, they transfer the patient to a specialist in case of particular sickness. Given the complexity and variety of financial products and solutions, financial advisors should be ready to transfer their customers or ask advice of experts when lacking specialisation and any business model which emerges should encourage such behaviour.

E-diagnostics / E-advice

With the successful penetration of the internet in the majority of households in the western countries, the web has become an accepted channel for business and individuals search for all types of advice from experts and peers. The health industry has already reacted to this where patients are able to have an e-diagnostics on the internet by inputting their symptoms and even an e-prescription from a doctor on the web. Certain firms have also launched equivalent initiatives for financial products, however, as with medicine, financial advice remains ultimately a face-to-face business. Given that the next generation of investors will be even more technology and internet savvy, investors should at least have a choice to receive a diagnostic of their financial health at retirement by answering guided questions on the internet and then visit the advisor for certain products/objectives. It could also be envisaged that a "financial prescription" is provided directly via the web through a certified financial advisor.

Advice based fee model

As in the field of medicine, business can flourish with the product providers "putting" their solutions to client needs. However, this needs to operate within an appropriate framework where the advisor is the guardian of client's interests and is duty bound to act first and foremost in the client's best interests in a "professional environment". Just as in the health industry the doctor's main revenue is not derived from the Pharma producers, the major earnings of advisors for retirement products should not stem from the asset managers.

An advice-based fee model, where the customer would pay a fee for independent advice and the advisor would not receive any commission from the manufacturer (as proposed by the FSA in their "Retail Distribution Review" dated November 2008) is the ideal solution that can do away with the conflict of interest of the advisors.

Advice made available to every individual

Retirement planning involves the entire population and is important for the individual's general financial health in old age. However, even within the mass market, people at different income levels will require advice with different levels of sophistication. The low-income segment of the population will have fewer savings to invest for retirement, so it will have a lower need for sophisticated advice. The level of sophistication will increase for individuals and families with average and above-average incomes. Within the context of the "Financial Health Model" outlined above, we believe that financial advice should receive equivalent support from the society to ensure the affordability of independent financial advice, at the least for low-income families. Just like basic medical treatment is ensured even to the poorest of individuals by the governments within the EU, financial advice should be made available to every individual independent of his/her wealth. Such a model should offer basic advice and provision on retirement needs including saving to buy a house and debt management and other financial needs. It should also be followed on a periodic basis allowing re-alignments according to changes in the situation of the investor (similar to people consulting a doctor when they get sick). However, application of this model needs to vary as to the income level segment of the population. For example, a product with built-in retirement solutions could be offered to the low-income portion of the population and little advice would be required.

However, people with average and above-average income levels would require more tailored retirement solutions, which could be achieved by selecting different eligible products as building blocks. Levels of access to such advice would need to be managed and a means of funding would need to be designed. However, many of the current models for basic access to doctors that exist today in Europe would, we believe, provide a good

starting point for the construction of sound retirement advice for the mass-market on an ongoing basis. It is arguable if independent advice, especially for the low income portion of the population would be economical for the advisor. As mentioned above, this advice would be by far less intensive, however, advice for this portion of the population could also be carried out by non-profit state supported organisations.

Figure 7







Fund Governance

Over recent years the goal of protecting investor interests has led to discussions on fund governance taking a front seat with regulators and within the industry. However, instead of a clear and harmonised set of rules, what we see are different laws stating fragmented guidance, “corporate” governance regulatory regimes, and a set of national and European codes of conduct self-imposed by the industry. The only degree of harmonisation lies in the UCITS directive’s basic focus on investor protection and related responsibilities dictated therein. Despite this, there have been few issues of any significance arising from the fund industry in Europe. However, to ensure proper safeguards exist for investors in retirement products, it is crucial to establish a clear framework for protecting their interests. In order to achieve this, there are core challenges to be addressed.

CORE CHALLENGES FOR THE EUROPEAN FUND INDUSTRY

Focus on managing inherent conflicts

Fund governance, in protecting investor interests, should ensure that conflicts of interest between the fund and the manager, employees, and any other stakeholders are identified and prevented, but this remains a challenge. Even in the U.S. where consistent and regulated governance with the focus on independent directors has been at the forefront of the retail fund industry, this challenge remains very real today. “The statute that governs our industry, demands that mutual funds be organised, operated, and managed in the best interests of their shareholders rather than in the interest of their advisers and underwriters. Yet for all of the Act’s noble intentions, that’s simply not the principle under which our industry operates today.”³

No clearly defined fund governance framework

Mutual funds generally operate under “corporate” governance regimes designed for the corporate and/or different voluntary codes of conduct. Furthermore, different fund legal structures existing within the market have different governance forms, making it more difficult to achieve a harmonisation within the industry. As such, mutual funds or FCPs, which have no legal personality, have only a board at the fund management company level whereas investment companies have a board at the fund level (since they are a corporate legal structure) and at the fund management company level, as well. Often the split of roles and responsibilities between those charged with fund governance and those responsible for management companies is not fully understood by the members, who are also often the same people. There is also overlap between structures which adds unnecessary costs that investors must pay.

Outside the well regulated UCITS regime, there is little structure around governance at all. It is important that any shift in governance requirements for long-term investment vehicles ensures a consistent framework regardless of the product type.

PROPOSED SOLUTIONS

Strengthening the fund governance framework for retirement products

Recognition that retirement investment vehicles are systemically vital to the future financial health of Europe, in addition to the fact that they do not face the same governance challenges as listed corporate, are pre-requisites in taking steps to promote a consistent and clear governance framework.

There is an inherent need to clearly define the roles and responsibilities of the players in the current governance model. Within this context, governance principles and mechanisms should be established around the following core principles:

1. The promoter of retirement vehicles should assume an institutional responsibility beyond that of “brand protection” which exists today. This institutional responsibility should be targeted at meeting the objectives agreed with the investor as well as conducting business “properly” and pro-actively managing inherent conflicts.
2. Legally defined responsible entities such as the depository, the auditor, or external specialists such as independent directors should be charged with additional oversight and reporting in case inherent conflicts are not handled by the promoter.
3. Any such oversight and reporting should be developed and consistently applied at the EU level and not left to the individual member state’s discretion. The framework should also apply to all long-term savings products in order to allow for a level playing field.
4. An “investor representative” registered with the State and empowered with specific additional scope for protecting investors’ interests should also be considered for retirement vehicles. This representative would thus also manage the States’ “systemic” interests in the funds operations.

Care should also be taken that such oversight does not dilute the “ownership” of the product by the promoter as has been argued to be the case within the full-blown independent board model seen in the U.S. An effective governance framework is one which clearly defines the role of various parties having an eye on the one-hand to ultimate “ownership” of the product and its delivery on the objectives and on the other to ensuring conflicts are properly managed and business is conducted properly. Care should also be taken that such oversight does not dilute the “ownership” of the product by the promoter as has been argued to be the case within the full-blown independent board model seen in the U.S. An effective governance framework is one which clearly defines the role of various parties having an eye on the one-hand to ultimate “ownership” of the product and its delivery on the objectives and on the other to ensuring conflicts are properly managed and business is conducted properly.



Fund Costs

Mutual fund fees are vitally important to the investors' return. For example, on an investment held for 20 years, a 1 percent annual fee will reduce the ending account balance by 18 percent. The amount, breakdown, and ambiguity of these fees are a major source of discontent among investors and regulators alike.

CORE CHALLENGES FOR THE EUROPEAN FUND INDUSTRY

Failing transparency of fees

In contrast to the United States, where the SEC has harmonised the definition and communication of fund fees towards investors, no single definition of the Total Expense Ratio (TER) – the annual cost effectively paid by the investor – exists in Europe. In addition, most of the TER that is communicated by the funds does not include transaction costs, which may have a significant impact on the overall cost of the investor. This additional cost is especially applicable to long-term investors in funds with high portfolio turnover rates. This failing harmonisation and transparency makes it difficult to identify the nature of underlying fees or the actual costs for the investor and make fee comparison between funds highly challenging.

A major portion of fees paid by the investor is neither for the performance nor the operation of the fund, but for fund distribution. These are "sales commissions" that are paid to distributors for selling or "advising" the funds. In fact, distribution fees account for an average of 64% of the TER in Europe⁴. Another significant portion of fund fees is used for the active portfolio management of the fund. Currently, however, there is no clear relationship between the management fee and the risk-adjusted returns. Since even though performance fees exist, it is very rare that they are linked to the

risk adjusted return (RAR) of the fund. Such a model also serves to incentivise asset managers into taking higher risks to achieve higher returns either through performance fees or simply by making the fund more attractive from an absolute performance perspective.

PROPOSED SOLUTIONS

Harmonise definition and disclosure of fees

The current traditional fee structure needs to be reviewed when considering a client's expectations, especially within a retirement investment.

First, there should be a clear and harmonised definition across the industry for calculating the total fees paid by the investor (the nature and destination of fees). These fees should be reported in an investor-friendly format so that the client understands the price he/she is paying for the investment. For example, "how much in total annual fees would an investor pay for a fund in which he/she invested €10,000?" as done in the US.

A significant and often hidden piece of fund costs is related to transaction fees. The nature of the eligible funds for retirement is that they will have a relatively predictable capital flow together with – by definition – a long-term investment horizon. In a retirement investment vehicle, it might be expected that transaction fees are significantly less than in today's standard UCITS fund. This may not always be the case but in any event, we believe that any disclosure of fund fees should incorporate the costs borne by the investors due to portfolio turnover as without this we only see part of the picture. Anecdotally, the now infamous Madoff schemes charged zero management fees on assets managed with Mr. Madoff simply relying on the "transaction fees" incurred (or not as ultimately proved to be the case).

⁴Source: CRA Analysis for the European Commission

Align investor and asset manager interests

In order to align the interests of asset managers and investors the industry must be properly incentivised to deliver retirement products of quality. Incentives for retirement savings products should be linked to the risk-return objectives within the investor timeframe (“objective fees”). As opposed to performance fees that target outperforming a certain level of return, “objective fees” should be determined in line with final and intermediate risk-return objectives. If providers are able to construct such fee schemes linked to the achievement of the objectives rather than simply the managing of assets, then we could arrive at a remuneration model that is both in the interests of investors and providers alike. Having said this, to provide the necessary safeguards for relative capital protection as indicated above, there may also be a part individual States (or the EU) need to play to ensure that the financial institutions are supported as needed to build and maintain the appropriate suite of products.

As stated previously, it is important that the right incentives exist for industry to design and maintain quality products in the retirement space. With a combination of the state incentive and facilitated low/no-cost distribution models described above, it is believed that for such vehicles a dramatic decrease in ongoing costs should be achievable as absolute asset levels should be significant.



Product Design

Education, advice and governance mechanisms work only to the point that available products are suitable to investor needs. There are more than 51,382 mutual funds (UCITS and non-UCITS) in Europe. This is by far more than the need of a population of 493 million with an investment pool of €7,910 billion. By comparison, there are only 8,029 mutual funds in the United States for a population of 307 million and an asset base of €8,648 billion⁵.

CORE CHALLENGES FOR THE EUROPEAN FUND INDUSTRY

Product proliferation

So far product proliferation has been effective in collecting investor capital. New fund launches are supported by high marketing spends and lucrative incentives for distributors during the launch phase in comparison to existing funds. However, a part of the money in new fund launches often stems from the sale of existing funds. This churn pushed by distributors is at a disadvantage to many investors because they pay higher fees through multiple loads, decreasing the return on their investments. It also poses a challenge for asset managers because, rather than being able to manage a steady long term asset base, they need to additionally cope with the volatility of flows.

The dislocation of fund managers and investor interests motivates the managers to design funds that gather assets, rather than achieve the investor's objectives. Managers are paid to maximize the assets within the funds and have little direct incentive for accomplishing the investor's goals. In turn, this facilitates product proliferation because it is easier to increase assets by advertising rather than by seeking gains through achieving the investor's objectives. Hence, the fund industry finds itself in a perpetual (some would say "vicious") circle that launches new funds in order to hinder the attrition of its

investor base but simultaneously damages investor confidence due to lowered returns.

One-size-fits-all approach

Investment funds were originally designed to target long-term investors, but along with the increasing sophistication of the market, various investment fund strategies have evolved that pursue not only long-term, but also short-term trading strategies. Nevertheless most funds are still communicated and labelled as being suitable for all investors, ranging from the man in the street to high net worth or to institutional, including asset allocators. Investors can hardly differentiate between funds that are suitable for the long-term or those that have a short-term investment approach. The importance of aligning investor interests, not only as to asset allocation but also to his/her objectives and time horizon, has become evident during the recent crisis; during which the short-term liquidity needs of certain investors conflicted with the long-term investment horizon of others resulting in some significant issues for certain funds. The opportunities for generating value from pure product offerings are diminishing as the one-size-fits-all approach is not suitable for investors. "For clients, the possibility to choose between different product strategies is, on its own, not usually a solution to their specific problems. So the importance of solutions tailored to individual needs, i.e. 'absolutely client-oriented' products, is growing in the field of asset management."⁶

The crisis has also demonstrated that funds that are restricted by their investment strategies to have a minimum or maximum allocation within an asset class are robbed of the ability to act more flexibly, especially in times of crisis when rigid strategies can be disadvantageous for the investor. The fund's goal should be to manage an objective not a strategy.

⁵Source: EFAMA, ICI act Book 2008

⁶Source: "Global Trends in Asset Management: Growth Driver Demographic Change", Horst Eich, CEO of Allianz GI Germany

Mismatch of liquidity needs to portfolio strategy

By its very design, UCITS must provide ongoing liquidity for investors who want to redeem. However, investors with different investment time horizons have varying liquidity needs, and the mutual fund's provision for this liquidity comes at a cost. Typically, a certain amount of investor capital is set aside for such purposes. If, however, the redemptions are higher than the available liquidity, the fund has to liquidate its assets in order to pay its investors and a similar dislocation occurs for subscriptions. Hence, long term investors with a much lower need for ongoing liquidity have to bear the cost of the fund's non invested capital, as well as trading costs and other dilutive effects and eventually face lower returns (due to the need to liquidate or add to the mutual fund's portfolio on an ongoing basis). Ultimately fund managers need not only to manage the assets which is their specialism, but also the liability side, which is not their primary focus and which naturally results in the disruption of the funds strategy; as well as additional costs and levels of non-invested capital as indicated previously.

PROPOSED SOLUTIONS

There are, we believe, two primary product solutions for the retirement space. The first relates to a dedicated pension product where the objectives of the retiree are established at the scheme level and managed accordingly. Such schemes would invest into assets as determined to be appropriate by the scheme sponsor and which may include direct investment or investment into underlying funds or similar vehicles with a view to specifically meeting the core objectives of the investor. Such a product is better aligned to the current pension fund models which exist in many jurisdictions today, whereby investors pay into the scheme to reach their objectives. The decisions on the allocation of the capital to the underlying eligible products are taken at the scheme level. Hence in this case, the education and advice model discussed above would be targeted at the scheme rather than

the product level i.e. investors would need to understand how to reach their target through such schemes and advice would be targeted to find the optimal scheme for their needs. The state-registered "investor representative" discussed above would also be embedded within the governance framework of the annuation scheme. However, this solution deals with the current pension fund regime and is not the topic of this paper.

Alternatively, the mass-market investor would subscribe to a retirement plan which would use as its foundations investment into one or a range of underlying UCITS which meet specific objectives for the investor. We believe the time has come to strengthen the mutual fund development process by putting the investor first, developing specific retirement products, which align risk management, fees, and reporting requirements to the long-term aim of such products.

Develop a clear definition and labelling of eligible products for retirement

The retirement investment objective of an investor is not to outperform a benchmark but to achieve his/her needs of capital at retirement. As such, we agree with the INVESCO Think Tank's recommendation to create a label that can clearly identify core long-term UCITS. However, we would go further in saying that, the characteristics of eligible products for retirement should be defined by the regulator, clearly labelled and investments for retirement only allowed in such products. The features of such products should be reviewed as to their suitability to achieve the retirement goals and should also be aligned with the governance objectives, advice and educational models that have been previously discussed.

Such eligible products would either be used as building blocks to meet the retirement needs of the investor or have built-in retirement solutions. Funds designed as building blocks would remain aligned to the fundamental strategy whereas the funds with built-in solutions would offer the investor an all-in-one product to meet his/her basic retirement needs.

In addition to the UCITS IV directive which should help reduce product proliferation, we believe that such retirement products will not add to the product proliferation in the long-term for reasons specified below:

- ◆ Focusing on long-term needs and alignment of investor and provider interests would reduce the demand for launching new products in this segment due to the limitation of short-term churn of such products and the need to achieve critical mass.
- ◆ Many of the current UCITS products would be used as building-blocks within this segment.

Reduced liquidity requirements for retirement products

In order to manage the mutual fund in the best interests of investors, products should be designed to protect investors in eligible products from incurring the liquidity premium associated with the current UCITS model. Liquidity requirements for such products should be reduced by restricting early and daily redemptions, while still allowing for regular periodical payments towards the fund. The fee structure should also be adapted accordingly (high redemption costs for early termination, except in the case of force majeure).

In today's UCITS, certain funds already incorporate swing pricing or dilution levies to try and protect the fund and its long-term investors from the cost of ongoing capital flows. These mechanisms are one approach to the issue but for such vehicles other aspects could be considered, including the possibility of limiting liquidity requirements in the first instance. We believe the classification as an eligible product for retirement should require the existence of such mechanisms.

Integration of crisis management tools and long-term risk measurement

Retirement vehicles should maintain basic risk objectives, such as diversification, but also maintain the flexibility needed to enable long-term portfolio construction. In addition, new measurements for such vehicles should be introduced in order to evaluate risk in terms of not achieving the investor's objectives within the investment timeframe. These measurements should not only calculate the probability of not achieving the objective, but should also evaluate the percentage by which the objective will be missed.

In order to protect investor capital in times of market failures and shocks, crisis management tools such as counter-cyclical hedges or specific triggering mechanisms should be integrated within eligible products with built-in retirement solutions. However, care should be taken to avoid causing systemic risk as a result of all funds acting in the same manner at a time of market crisis. Further, the use of such "hedges" would change as the fund evolves along the targeted time horizon and will differ depending upon whether the fund itself has a specific target date built into its objective or whether it is designed for the long-term on an ongoing basis.

Focus on objectives not asset class

Funds today are constructed with a specific investment strategy in mind which is then sold to investors as part of their asset allocation. For long-term vehicles, one could question the relevance of a fund which has as its mandate investment in – for example – U.S. Large-Cap stocks where the actual objective of the investor is more likely to be belief in the long-term characteristics of the U.S. Large-Cap segment based on perspectives of today. A fund may be arguably better designed through identification of the fundamentals of why



U.S. Large-Cap makes sense for an investor segment and to define such fundamentals as the base objective – i.e. investing in assets that display the current characteristics of U.S. Large-Cap rather than restricting a retirement product to a specific segment based on what is true today. From a customer-centric perspective, the product would then be designed better to meet the financial objectives of the investor rather than to adhere to a fixed strategy (e.g. sector strategy etc.). We believe that the fund industry should shift focus from benchmarks to investors' time and risk objectives when developing long-term solutions. As José-Benjamin Longrée, Member of the CACEIS Executive Committee, CACEIS Investor Services put it, "It's time to beat time not the benchmark."

In such a scenario, the funds available for investment would comprise a range of products which both cater to the "automatic asset allocation", which one might see in target date funds for example, and the specific funds targeting very particular objectives from a risk/return perspective. All such funds would become eligible due to their focus on the retirement needs of the investors, the appropriate governance framework and the level of advice provided would differ depending upon the needs of the investor but only within the constraints of eligible underlying product.

Consumption element and guaranteed payout

Eligible products with built-in retirement solutions could have an integrated consumption element as part of the product/scheme attributes, since after the retirement date, the investor will require a lifelong steady income replacement for consumption. Since risk tolerance on capital loss or relative capital loss (i.e. vs. inflation) is presumed to be highly sensitive, these products/schemes should also be designed to guarantee a minimum payout relative to inflation in order to protect the investor from falling into poverty during retirement. The need for this facility could be arguable

for some of the more tailored retirement products, however, is seen as critical for low and middle-income individuals where the product might be their only source of income post-retirement.

Investor reporting and transparency tailored to retirement products

Communication of retirement vehicles should be easily comprehensible to ordinary investors representing the majority of the mass market. Furthermore these products should all have the same reporting and transparency requirements in order to allow a level playing field. The KII set through the UCITS IV Directive will already go a long way to improve the transparency of UCITS funds in order to enable investors to make informed decisions. It is critical that any other vehicles designated as "eligible" will have equivalent reporting objectives.

Reporting to investors for retirement vehicles should reflect their nature and the related liquidity constraints that have been built into the product. As such, the cost of daily NAV reporting, monthly fact-sheets etc. arguably produces little in the way of concrete benefits to the investor of retirement products. Reporting should be tailored to the specifics of the fund; however, one could consider that it is limited to quarterly statements with targeted reporting on key metrics linked to the underlying investor objective. As such, the disclosure of factors such as top 10 holdings or performance over benchmark is likely to be irrelevant. However, an assessment of the evolution of the fund vs. plan together with an extrapolation focused on the fund objectives would be valuable. Such assessment could also be the subject of independent scrutiny within the established governance framework to provide investors with additional comfort over their financial position and future. Additionally, commentary as to how the assets correlating to the objective defined have evolved (as opposed to how has the market performed) would also arguably be more relevant to the reader.

Conclusion

This is a critical time for policymakers and the industry to reinforce the confidence in long-term saving products, especially for retirement planning. The steps taken in the future will have to be in tune with investor needs, and (we hope) the themes and measures discussed within this report will foster a discussion to address the scepticism of investors towards product producers and intermediaries on these issues.

Regulators and the industry have been pushing certain themes during the past few months:

- ◆ The FSA introduced a move from a commission-based fee model towards a fee-based advice model for independent advice and more transparency in fees received by the intermediaries;
- ◆ In March 2009, the IMA CEO Richard Saunders, when talking about the challenges facing the IM industry in a world of personal accounts, identified the following key challenges: greater visibility of the industry to the investor through defined contribution pensions, unit-linked, and other fund-like products; investor education; and the default fund's investment strategies;
- ◆ The EFAMA released a report on "Rethinking Retirement Income Strategies: How Can We Secure Better Outcomes for Future Retirees";

- ◆ The EU Commission committed to creating a level playing field for product disclosures and sales processes for all packaged retail investment products, such as investment funds, insurance-based investments, and the various types of structured products;

These are encouraging developments in the right direction; however, the EU should completely take over the policy agenda in this sector to allow a harmonisation across Europe and that the discussions and efforts should be channelled and holistic measures taken on long-term savings, especially for retirement planning, in order to achieve the highest effectiveness and results for the retail investor in Europe.



Ideal Fund
Reengineering the fund value proposition

Figure 8

Summary of
the key
recommendations
proposed
in this report

Reengineering the LT fund value proposition around 5 dimensions

Today

Poor financial literacy and lack of interest

Commission based fee model creates conflicts of interest for advisors

No clearly defined governance framework

Product proliferation

One-size fits all approach

Lack of transparency

Education

Integrate financial education model

- Compulsory retirement planning education at school and University
- Voluntary free-of-charge courses on specific financial needs at working age
- Cost of education born by the Government during school & university. Thereafter together with the industry
- State-led campaigns to increase the awareness of the importance of retirement planning

Advice

Develop a financial healthcare model for retirement

- EU-wide harmonised certification and professional codex
- Transfer of investor to specialist when deemed necessary
- E-Diagnostics / E-Advice
- Advice based fee model
- Financial advice available to every individual independent of his/her wealth

Governance

Strengthen the fund governance framework for retirement products

- The promoter of retirement vehicles should assume an institutional responsibility
- Additional oversight and related reporting direct or via intermediaries
- Framework should be developed and consistently applied at the EU level and to all long-term savings products to allow level playing field
- Appointment of a state-registered individual

Fund Costs

Review current fee structure

- Harmonise definition and disclosure of fees for all retirement savings products
- In addition to covering the operational and opportunity costs, fees should be linked to the achievement of the investors' objectives: "objective fees" for retirement products

Product Design

Prioritise investor objectives within the fund development process

- Develop a clear definition and labelling of eligible products for retirement
- Reduce liquidity requirements for retirement products
- Integrate crisis management tools, guaranteed payout and consumption elements to products with built-in retirement solutions
- Align investor reporting with investors' needs and expectations

Tomorrow

"Well-educated investors who receive appropriate advice with access to an industry with a sound governance framework and which provides them the right product at the right price with the right level of transparency."



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