POST RDR IDENTIFICATION OF THE PRIMARY SHARE CLASS FOR THE PREPARATION OF PERFORMANCE DATA

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Executive Summary

The introduction of the Retail Distribution Review (RDR) introduced a number of challenges for the presentation of performance data, particularly in relation to ranking tables and the calculation of sector averages by the data vendors. The leading data vendors (Financial Express, Lipper and Morningstar), in conversation with The Investment Association, have been considering how best to maintain consistency and comparability of relevant performance data following the Investment Association public consultation in June 2014.

The following reflects the main conclusions that have been reached:

In the post RDR world, data indicates that the most common consumer experience is in the RDR-compliant share class offered by third party distributors, currently share classes accessed through a platform.

The data vendors will therefore base the primary on the nominated share class chosen by the fund group based on the following definition:

1. The highest charging unbundled – free of any rebates or intermediary commission – share class freely available through third party distributors in the retail market.

2. The data vendors can no longer identify the primary share class at arm's length. Therefore they will change the share classes that they use to calculate the Investment Association sector averages once they have collected and tested the data based on the nominated primary share class which firms will need to provide directly to the data vendors by 27 March 2015 using a standard template. Detailed procedures can be found in Annex One.

3. The list of primary share classes used for the calculation of The Investment Association sector averages will be made publicly available, in coordination with the leading data vendors.

4. The guidance for track record extensions remains the same as that set out in 2012:

   "Post RDR share classes should take the track record of pre RDR bundled retail share class, unadjusted for the lower fees of the new post RDR share classes."

   This guidance offers the means to deliver a consistent approach to the presentation of past performance. Use of the historic track records based on higher fees of existing retail share classes is the most cautious approach to presenting the data to investors and is typically more representative of what they will have experienced.

The Financial Conduct Authority (FCA) has been kept informed of the challenges that the industry faces with regard to this process.

Background

The Investment Association (formerly IMA) sector framework has been developed in order to allow consumers and distributors to navigate what remains a large universe of UK-distributed investment funds. From being primarily UK-domiciled funds, increasingly offshore funds are part of buyer selections and the sector classification framework has evolved to include offshore.

While there are a number of different sector classification frameworks, the Investment Association framework is one of the longest-established. It is subject to arm's length monitoring, using a third party independent monitoring company, which provides the framework with its integrity.

One of the most important ways in which the sector framework is used by the industry, including fund selectors and distributors, is to compare performance. Performance data is collected and collated by data vendors who use it to create ranking tables and calculate sector averages.

The Investment Association has not licensed a methodology for the calculation of sector average performance, believing it to be more appropriate for the commercial market to develop transparent processes. We have never stipulated, and do not believe it is our role to stipulate, precisely how individual sectors are analysed. However, we believe that, as far as possible, there should be a common basis for comparison and have sought to facilitate this by helping the data vendors identify a 'primary' share class.

Designating the primary

In the pre RDR environment, data vendors calculating the sector average were able to identify a 'primary' share class using arm's length business rules. It was the view of The Investment Association and the main data vendors that the primary should represent the most common consumer experience, which was a bundled retail share class (reflecting a combination of fund management, advice and distribution charges). Where more than one bundled share class was available, it was deemed that the most expensive should always be used. This was a protection for consumers, ensuring the choice of primary share class for inclusion in the sectors could not be 'gamed' by any firm seeking to show stronger performance.

In an environment where precise comparison of performance has always been difficult, the system worked reasonably well because there was a limited range of share classes available in the market. In the post RDR world, this has all changed. At the moment, the market has pre RDR bundled share classes and a variety of post RDR unbundled (free of any intermediary charges or platform payments) share classes, some used for direct or IFA distribution, some used for platform distribution, and some for a combination of distribution purposes.

2014 Consultation

The question of the primary share class and the extension of track records in this new world was the subject of an IMA consultation last year, which resulted in quite a wide range of views from the industry, on the timing and substance of any move away from the existing primary (the highest charging pre RDR bundled share class).

One clear conclusion unified all respondents. There is currently no obvious basis for comparison that represents the experience of the majority of investors:

- Many, albeit a diminishing number of unitholders by total funds under management, are still in bundled share classes. This can be expected to change over time.

- New investors may be buying units on fund platforms, but some of those platforms are offering share classes that are cheaper than the standard unbundled share class, based on their distribution scale in the market. Equally, some fund groups distribute direct or within vertically-integrated distribution models, where there is in effect an internal distribution fee included in that share class.

- Fundamentally, few consumer experiences of total performance will be the same because now there is an unbundling of the costs associated with management, distribution and advice, which means that true comparisons of overall cost and associated net performance (ie. that likely to be actually experienced by the consumer) can only be undertaken by those closest to the consumer in the value chain, with full knowledge of what they have paid in total.

Nonetheless, The Investment Association believes that it has a responsibility to continue to give guidance to enable there to be a common basis for comparison, with the significant caveat that such exercises are increasingly difficult.

In theoretical terms, we believe that true investment performance comparison would ultimately require a starting measure that was gross of fees, adding in the impact of different charges (fund management, distribution, etc.) within a customised illustration for a consumer, such that the full impact of all charges was readily available.

However, we accept that this 'gross of fees' performance is both challenging in practice and contrary to current regulatory thinking, for reasons that are fully understandable given that it reflects a return that is inaccessible to a consumer.

Conclusion: post RDR primary share class

The conclusion we have reached in this exercise, in close conversation with the leading data vendors, is that the pragmatic solution would be to designate the following share class as the primary (Option B in the Investment Association 2014 consultation):

The highest charging unbundled – free of any rebates or intermediary commission – share class freely available through third party distributors in the retail market.

Importantly, this is no longer the most expensive RDR-compliant retail share class available in the market. This decision was not made easily and the logic for it rests on a few important points:

- In a post RDR world, there is a distinct risk that comparing different share classes will simply measure distribution method differentiation, not fund manager delivery. Comparing on a systematic basis funds that only have retail platform share classes with those whose most expensive share class is a direct offer (both RDR-compliant) makes little sense.

- It is also the case that data indicates that the most common consumer experience in terms of flows into funds is not in the most expensive RDR-compliant share classes, but the RDR-compliant share class offered by third party distributors, currently share classes accessed through a platform.

- Finally, nothing will stop any market participant calculating their own average performance figures for an individual sector using whichever share class or methodology they choose to use.

In summary, what we have tried to do is recommend a solution that provides market participants with a formula that enables them to nominate the appropriate share class to the data vendors that will be the most common basis for comparison.

Track record extensions

There is a second issue that arises in relation to changing the primary share class and this relates to comparisons over periods which extend past the launch date for most RDR share classes, typically 3/5/10 years. Many RDR share classes were launched at the end of 2012 which means that post RDR share classes have just over 2 years of performance history. Comparisons over longer time periods, therefore, will not be possible unless the performance history is extended using another share class.

As far as possible and similar to the case with identifying a common primary share class, it is logical that there should be a common basis for comparison if track records are extended.

With respect to track record extensions, it is the case that FCA rules provide some flexibility to individual asset managers in choosing how they present simulated past performance data, including for post RDR share classes. However, it is important that the industry adopts a consistent methodology for presenting the information.

With this in mind, we have decided, in tandem with the leading data vendors, to reiterate the guidance set out in 2012 that:

Post RDR share classes should take the track record of pre RDR bundled retail share classes, unadjusted for the lower fees of the new post RDR share classes.

This guidance offers the means to deliver a consistent approach to the presentation of past performance. In addition, use of the historic track records based on the higher fees of existing retail share classes is the most cautious approach to presenting the data to investors and is typically more representative of what they will have experienced. Using synthetic track records that exclude adviser charging could mislead consumers into believing the industry has delivered better performance than it has.

While this seems the most logical and sensible approach to achieve consistency and comparability, we note the following:

- There can only be one track record assigned to a share class in the data vendor systems and therefore those that have converted an institutional share class into their RDR share class will already have an historic track record based on these lower charges.

- Some firms may choose not to use the simulated data as there is no regulatory requirement to provide simulated past performance, and this is their prerogative. This would, of course, affect the information used in comparison tables and may mean the primary class has no performance record over longer periods and so miss out on being ranked in those tables.

We cannot see a way around these problems but acknowledge that it will cause some inconsistencies to comparisons over longer timeframes.

It should be pointed out that under COBS 4.6.6 a firm must ensure that information which contains simulated past performance carries a prominent warning of that fact. The data vendors are able to indicate to their data clients where track records are simulated so that these clients can meet their regulatory requirement to disclose this information. This should provide a degree of transparency on those funds that have extended track records and those that have not, although in some cases the launch date of the fund will be the same as the launch date of the RDR share class and no historic performance data will exist.

The FCA is aware of the issues with which the industry is dealing on both track records and the wider post RDR performance comparison question.

In summary, The Investment Association has tried to limit variations in approach through the guidance set out above.

Transparency of process

Working with the leading data vendors, The Investment Association will make publicly available the list of primary share classes being used for the calculation of the Investment Association sectors. We also expect any data vendor calculating averages based on the sectors to make available its methodology.

Next steps

We set out the mechanisms for how this proposed new primary share class will work in Annex One of this paper.

Annex One: Procedure for initial nomination of the primary share class and extending track records

Firms should use the template provided to nominate the primary share class for each fund that is classified to an Investment Association sector. The blank template will also be made available on The Investment Association website.

The template sets out the definition of the primary share class and a flow diagram to help the identification process.

For those share classes where a track record extension is required, the code (ISIN) should be provided of the donor share class.

<u>The document should be returned to the leading vendors</u> – a list of email addresses to which the completed forms should be returned, is provided on the template. Where firms use other data providers or other providers wish to collect the information, the template may be used to provide the information independently.

It is intended that the data collection teams at the leading vendors will contact their clients through their normal procedures at the same time. Enquiries should be addressed to the data vendors.

<u>Firms have until Friday 27 March 2015 to confirm their details to the leading vendors – Financial Express, Lipper and Morningstar.</u>

Further Steps

- There will be a period in which the leading data vendors will liaise with each other in order to check for any inconsistencies or anomalies that appear in the submissions and seek to resolve them with the firms.

- The Investment Association will publish the primary share classes and their ISINs on the website when the list is agreed by the data vendors.

- The leading data vendors will, as soon as practicable, conduct a private pilot study for The Investment Association based on the new primary share classes that will include rankings and sector averages data on one or two sectors.

- Subject to the results of the pilot test, a final implementation date will be announced for the changeover from the existing primary share class to the new nominated primary.

- Once the initial list is established, ongoing collection of the nominated primary share class for newly classified funds will be through the Investment Association classification process. Information on the nominated share class and any donor share class will be passed on to the data vendors with confirmation of the classification of the fund.

- The leading data vendors will liaise with each other on an ongoing basis to compile a consistent list of primary share classes which will continue to be published on The Investment Association website.