MARKET INSIGHTS

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PERSPECTIVE ON THE COST OF UCITS

Fund managers only retain 41% of the total cost paid by retail investors

The cost associated with investment funds has received a lot of attention among policymakers and regulators. For example, ESMA recently stated that "retail clients continue to lose out due to high investment products costs"[1]. In the previous Market Insights, we addressed this concern by highlighting the huge opportunity cost borne by European households who keep their savings in bank accounts rather than investing in UCITS.

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In this new Market Insights, we deep dive into the costs of UCITS, focusing specifically on the fees charged by the various operators along the investment fund value chain. In this context, we distinguish between two main types of costs:

(1) the product cost for which fund managers are directly responsible, and
(2) the total cost of ownership borne by consumers, which includes the product cost as well as the costs of distribution and advice.

In most continental European countries, the distribution and advice costs are bundled in the ongoing charges paid by retail investors to fund managers before being retroceded to distributors. There, the total cost paid by retail investors reflects the total cost of ownership. The bundling of costs makes it easier to see the total amount to be paid by the client, but it is more difficult to separate and distinguish between the different charges occurring along the fund value chain. This creates a problem with cost attribution, where it is not clear how much fund management, distribution and advice drive cost levels. At times, this results in some market observers mischaracterising fees retained by fund managers, not being aware that a large part of the cost is driven by distributors and advisers.

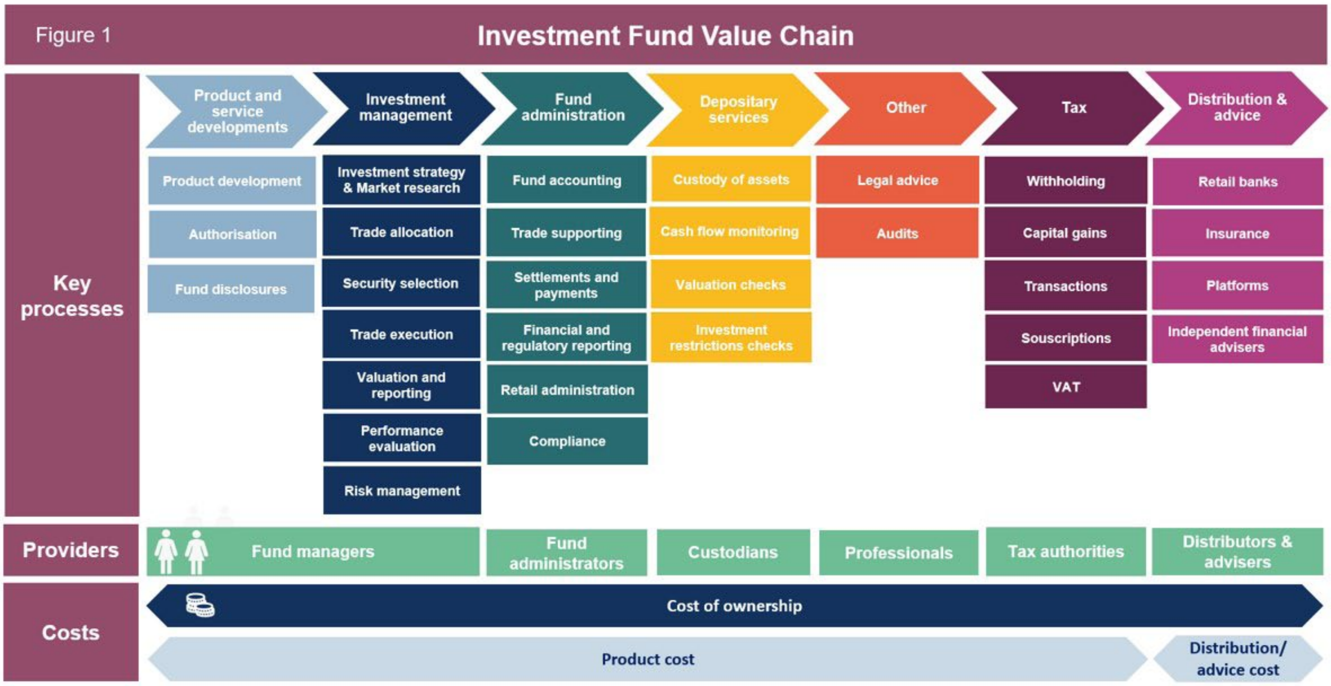
This Market Insights addresses this problem using cost data calculated by Fitz Partners, a fund research company specialised in the calculation of fees and expenses of cross-border funds at the most granular level of operations possible[2]. Specifically, we examine the different cost elements of actively managed UCITS and index-tracking UCITS, as of the end of 2020, and identify the largest 'cost contributors'. We also look at the absolute amounts paid by retail investors to fund management companies, fund distributors and other services providers.

INVESTMENT FUND VALUE CHAIN

Figure 1 shows the nature of the services offered by the different providers along the investment fund value chain. These services include product development services, investment management, fund administration, depositary and other services, tax, and distribution and advice. It is worth noting that the provision of all these services is highly regulated to ensure market integrity and investor protection. The total costs paid by the investor therefore also incorporate the costs of control, compliance and regulatory reporting requirements.

When analysing the cost of investment funds, it is common practice to report the ongoing charges figure (OCF), which expresses the total amount of the expenses of the UCITS as a percentage of its average net assets[3]. In the list of cost elements included in the OCF, the costs of distribution and advice are often, but not always, included. When distribution and advice charges are included, they are paid by the investors as part of the total bundled price and then they are retroceded by the fund manager to distributors. This is the practice commonly followed in most continental European countries. Defined in this way, the ongoing charges reflect the cost of ownership. It should be noted, however, that this cost indicator does not take into account any entry and exit fees that may be charged by the distributors to investors[4].

Distribution and advice costs can also be unbundled, meaning that these costs are externalised rather than being embedded within the fund's ongoing charges. Under this business model, investors pay for advice through a fee that comes directly out of their pocket. Unbundled share classes were traditionally offered to institutional investors or retail investors with large account balances (e.g., high-net-worth individuals). However, many UCITS now offer at least one unbundled share class intended for retail investors. The United Kingdom and the Netherlands enacted a retrocession ban that requires distribution and advice costs to be charged separately from the OCF. In such cases, ongoing charges reflect the product cost.



Source: EFAMA

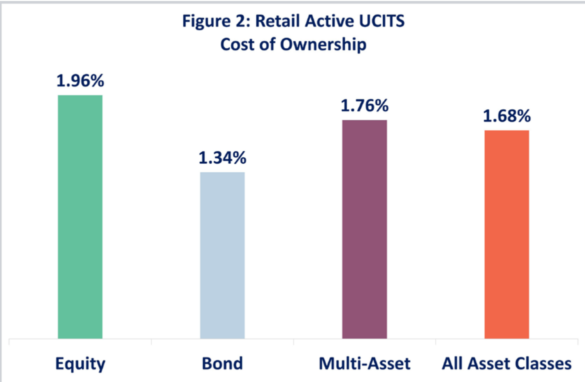
COST ANALYSIS OF ACTIVELY MANAGED UCITS

In general, the lack of consistent data on distribution and advice costs does not allow a detailed analysis of the cost of ownership of UCITS and an estimation of the share of distribution and advice costs therein[5]. It also makes it difficult to compare costs between countries where distributors are paid through retrocessions (bundled fee-based model) and countries where the costs of distribution and advice are paid directly by investors (unbundled fee model).

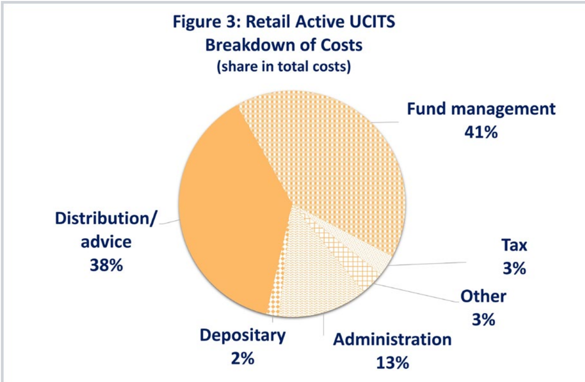
In this section, we aim at filling this data gap by providing a breakdown of the different cost elements of actively managed cross-border UCITS domiciled in Luxembourg and Ireland and offered to retail investors[6]. This analysis is based on the bundled share classes offered by the funds included in Fitz Partners' database[7]. Although the sample used covers a specific segment of the UCITS market, we believe that our analysis offers some insightful and relevant perspectives on the distribution of costs between the main providers of services in the UCITS market.

Figure 2 shows that the simple average cost of ownership of actively managed cross-border UCITS offered to retail investors is currently 1.68%, but this differs according to UCITS type: 1.96% for equity funds, 1.34% for bond funds and 1.76% for multi-asset funds[8].

Looking in Figure 3 at the breakdown of the cost of ownership attributable to the different service providers along the value chain, on average, 41% of the fees charged by UCITS cover the expenses incurred by fund management companies in the area of product development and investment management. This means that part of these costs is used to pay providers, for example data and research providers. A slightly lower proportion of the cost of ownership (38%) is paid to distributors in compensation for the provision of advice and for acting as the intermediary for retail investors. The remaining 21% covers administration services, depositary, tax and other expenses.

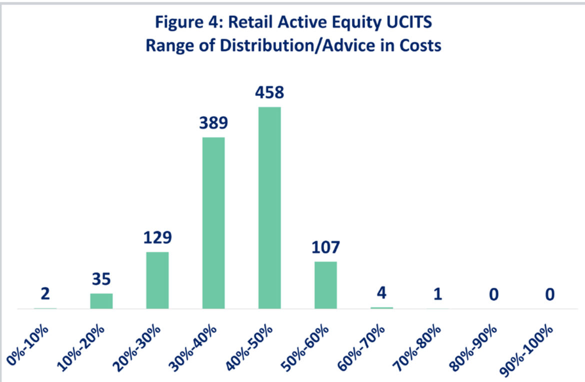


Source: EFAMA calculations based on Fitz Partners' data



Source: EFAMA calculations based on Fitz Partners' data

Figures 4 and 5 below show that compensation for distribution of retail active equity and bond UCITS can vary considerably. Most commonly, distribution and advice costs make up between 30% and 50% of the total cost of ownership. But in some cases it is less than a third and in others more than half. This variation reflects the constant and varying negotiations taking place between fund managers and distributors.



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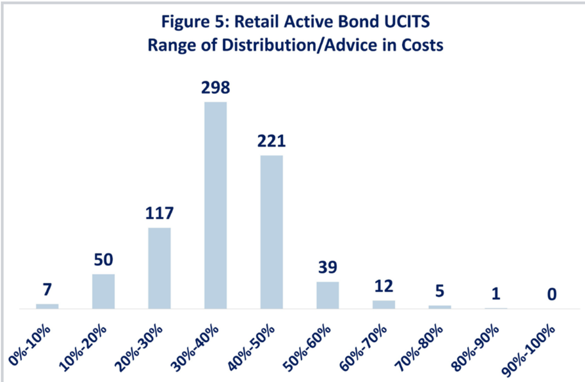
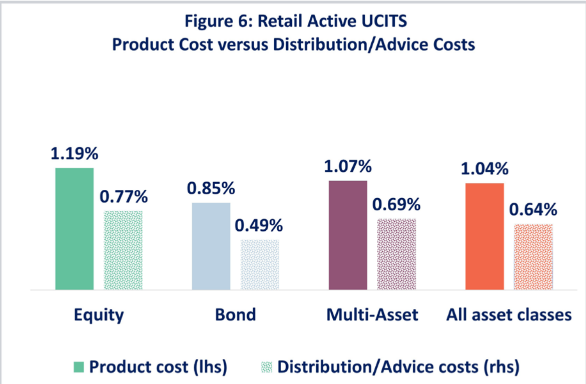


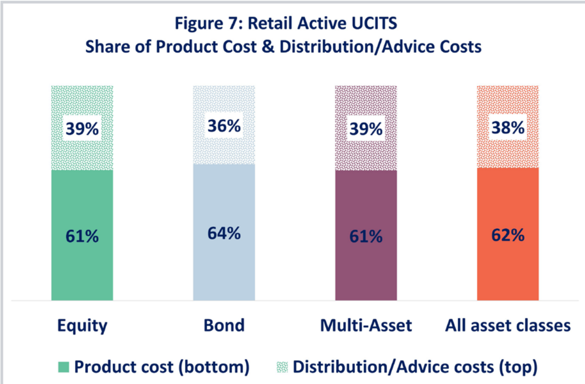
Source: EFAMA calculations based on Fitz Partners' data

EFAMA
European Fund and Asset Management Association

Using the breakdown of average costs shown in Figure 3, it is possible to calculate the product cost as the sum of the costs of fund management, administration, depositary and other professional services, and tax. Figure 6 shows that the annual average product cost of an actively managed retail UCITS is 1.04%, with distributors being paid an additional 0.64%. As shown in Figure 7, this means that the share of the product cost in the total cost of ownership of UCITS averages 62%, compared to 38% for the costs of distribution and advice. The share of the costs of distribution and advice is the highest for equity and multi-asset funds (39%) and the lowest for bond funds (36%)[9]. Figures 8 and 9 show the fee retained by fund managers to develop, manage and administer their funds, and the share of this fee in the cost of ownership of the different types of funds, respectively.



Source: EFAMA calculations based on Fitz Partners' data



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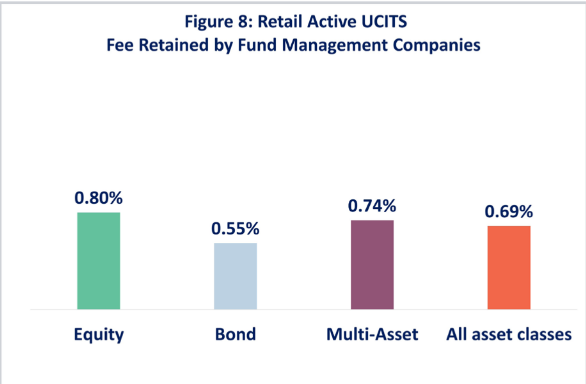

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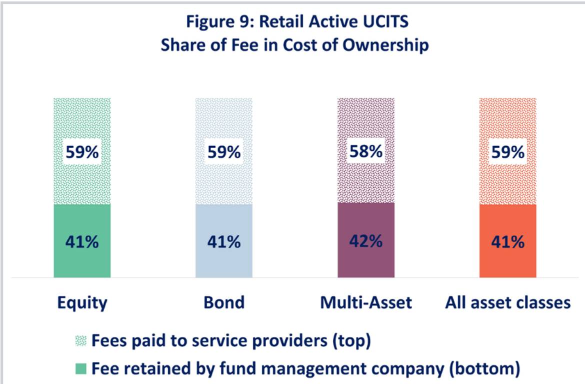
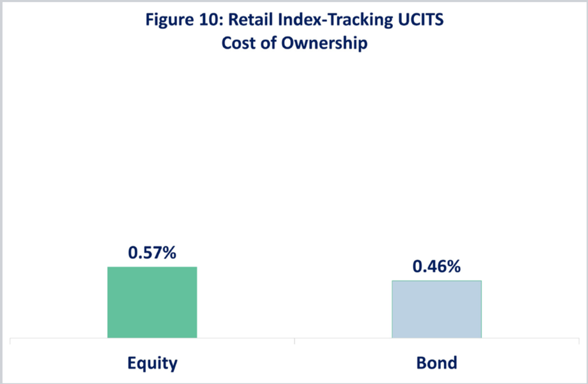


Source: EFAMA calculations based on Fitz Partners' data

COST ANALYSIS OF INDEX-TRACKING UCITS

A similar cost analysis can be done for index-tracking cross-border UCITS. The results are summarised in Figures 10-15 below. ETFs are not covered in this analysis, as they do not have bundled share classes.

Unsurprisingly, index-tracking UCITS have, on average, lower costs than actively managed funds because tracking an index implies fewer interventions by the fund manager. The costs of distribution and advice of index-tracking UCITS are also lower in absolute terms. However, through retrocessions, distributors of index-tracking UCITS are paid the same percentage of the ongoing charges as that received from offering actively managed UCITS (38%).



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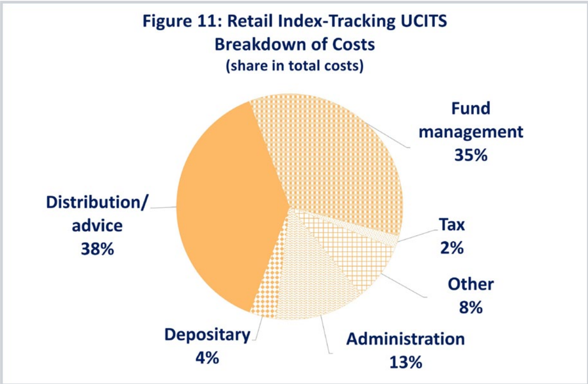

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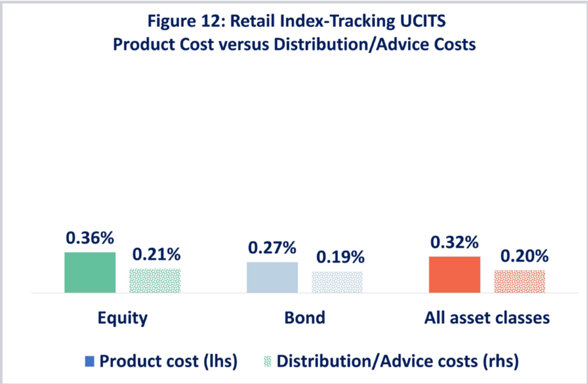

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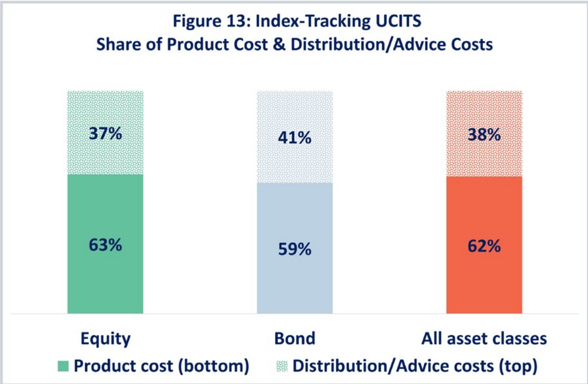

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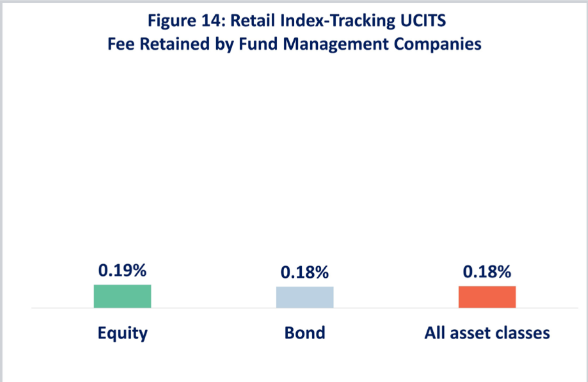

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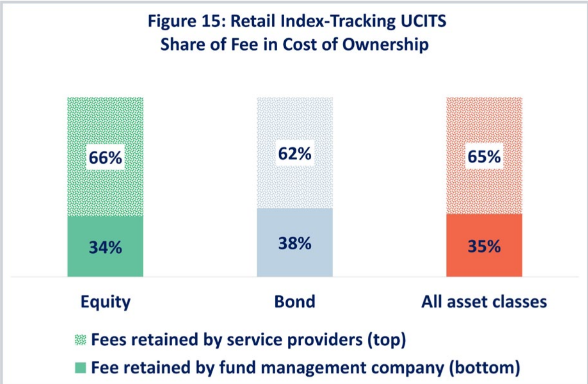


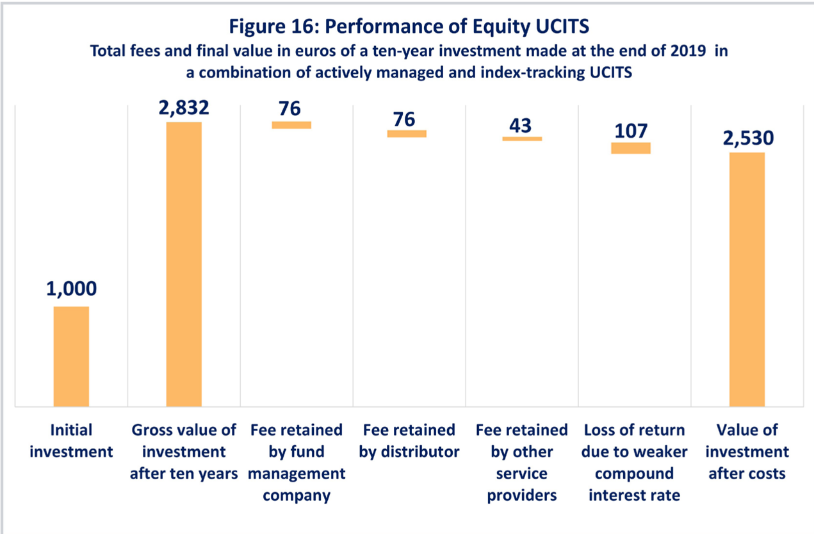
Source: EFAMA calculations based on Fitz Partners' data

The lower cost of index-tracking funds leads some stakeholders to argue that it is difficult for actively managed funds to outperform passive funds in average net terms. In response to this point, we have shown in a previous Market Insights that this is not necessarily the case for all active funds, as many active funds outperformed passive funds in net terms.

This latter observation highlights the important role that advisers can play in helping individuals find the best investment products and achieving optimum diversification, taking into account the investor's current situation and goals while targeting the expected returns. Given the very wide variety of investment products available and the low level of financial literacy across countries, distributors and advisers can play a significant role in addressing investors' needs in this area, including by selecting the best actively managed and index-tracking UCITS.

A REAL-LIFE COMPARISON BETWEEN COST AND BENEFIT

The fee paid by an investor can be put into perspective by considering the long-term benefit of investing. Based on data published by ESMA, Figure 16 shows that the total value of an investment of €500 in an actively managed equity UCITS and €500 in an index-tracking UCITS made at the end of 2009 was, on average, €2,530 ten years later, taking into account the impact of all costs[10]. The net return (€1,530) can be compared to the total fee retained by the fund manager (€76), the distributor/advisor (€76) and the other service providers (€43)[11]. But the net value of the investment is also lower than its gross value because the fees paid by the investor reduce the amount that can be reinvested each year, thereby weakening the power of the compound interest. Hence, only part of the difference between the gross and net value of the investment is actually paid to the service providers along the value chain, i.e., €195 in the scenario considered here.



Source: EFAMA calculations based on Fitz Partners' data

This real-world example of the kind of investment available to European citizens shows that the cost of UCITS and financial advice is small in relative as well as absolute terms. Paying a total of €76 over ten years, or €7.6 per year on average, to receive professional investment services cannot be considered as unreasonable or excessive, especially in light of the net rate of return that the investment brought, i.e., 153% after total costs. The same is true for the total fee paid to the distributor/adviser (€76) over a ten-year period, bearing in mind that this usually involves face-to-face meetings with clients to understand their risk appetite, financial objectives and financial position.

To put these costs further into perspective, a subscription to a digital music, podcast, and/or video service such as Spotify Premium costs at least €9.99 per month, or €1,199 for ten years.

CONCLUDING REMARKS

This study finds that the average cost of ownership of actively managed cross-border UCITS is 1.68% for retail clients using advice-based distribution channels. On average, 38% of this fee (0.64%), is paid to distributors through retrocessions, which means that the average product cost of this type of UCITS is 1.04%. Out of the total fee paid by the investor, the fund management companies retain only 41% to cover their expenses in the area of product development services, investment management and fund administration. Index-tracking UCITS have, on average, lower costs than actively managed funds, but distributors of index-tracking UCITS and active UCITS are paid the same percentage of the ongoing charges (38%).

These findings allow us to put the fees charged by fund management companies into perspective, as they show that distribution and advice costs represent a sizeable part of the total cost borne by investors. We believe that this dimension of the functioning of the fund market should receive greater consideration from policymakers when discussing UCITS costs. Indeed, fund managers can only be held accountable for the costs for which they are directly responsible. In this context, we hope that ESMA will be able to strengthen its Annual Statistical Reports in the future by distinguishing between the different cost components of UCITS and focusing on the value of the solutions and services investors receive from the different operators along the investment fund value chain.

We also find that an investment of €1,000 made at the end of 2009, in equal proportions, in an actively managed retail equity UCITS and an index-tracking equity UCITS has led, on average, to a net value of €2,530 after ten years. To benefit from this performance, the investor would only have paid a total of €76 to the fund management company, €76 to the distributor and €43 to the other service providers.

These fee levels are important to consider when discussing possible changes to the current European regulatory framework to foster the participation of retail investors in capital markets. Indeed, experiences in countries that have chosen to move towards an externalised fee-for-advice model show that there are no guarantees that this model will decrease the cost of advice and total cost of ownership. The evaluation of the impact of the Retail Distribution Review and the Financial Advice Market Review published by the Financial Conduct Authority (FCA) in the UK in December 2020 is a case in point. The FCA found that an adviser usually charges 2.4% of the amount invested for the initial advice and 0.8% per annum for ongoing advice. Transposed to the investment scenario discussed above, an investor in the UK would pay on average a total of €143 to obtain financial advice for ten years; this amount can be compared to the costs of distribution and advice mentioned above (€76, or €94 if the distributor charges 2% of the amount invested for the initial advice). This comparison shows that moving away from a bundled fee-based distribution model towards an externalised fee-for-advice model would not necessarily reduce the total costs of distribution and advice.

We, therefore, caution the Commission against any hasty decision to dismantle the existing EU distribution model, without making a careful and holistic assessment of what impacts an inducement ban could have. In particular, the effects of such a ban on the overall amount paid by retail investors and its impact on the provision and use of advice should be assessed, taking into account the different market structures and consumer habits across Member States. We consider indeed that investment advice is paramount to increasing retail participation in the European capital markets, alongside improved disclosures and increased financial literacy.

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FOOTNOTES

[1] See in particular the following ESMA's press release.

[2] Fitz Partners assists its clients by providing fund expense calculations and fee benchmarks, allowing fund operators and their boards to conduct detailed and accurate reviews of funds operating costs. All Fitz Partners' expense calculations are based on audited fund documents.

[3] The OCF includes all the expenses levied on the fund's assets, except the subscription and redemption fees paid by the investor and the performance fees.

[4] Fund investors in Europe at times pay entry and exit fees to fund distributors in addition to the fund's ongoing charges. These fees vary between types of funds, share classes, markets and individual distribution arrangements. For this reason, there is no data available on the fees actually paid by investors. Although allowable entry fees often range from 3% to over 5%, the actual amounts charged in practice are often much lower when not entirely waived. The impact of these fees on the funds' net performance gets smaller as the holding period lengthens.

[5] In its 2021 Annual Statistical Report, ESMA acknowledged the importance of distribution costs and explained that "they are not included as a specific cost as we are not able to identify such fees."

[6] To our knowledge, the only other study providing an estimation of the distribution cost is a study published by EFAMA in 2011, which was based on proprietary, confidential information provided to consulting firm (Strategic Insights) by a number of EFAMA corporate members.

[7] Fitz Partners' database covers an estimated 72% of the assets of UCITS domiciled in Luxembourg and Ireland. Our study covers a subset of this universe by focusing on the share classes of 2,106 equity, bond and multi-asset UCITS charging and disclosing distribution fees in their audited financial accounts.

[8] The asset-weighted average cost of ownership is slightly lower: 1.87% for equity funds, 1.29% for bond funds and 1.68% for multi-asset funds.

[9] As shown in Figure 6, the average cost of distribution and advice is 0.77% for equity funds, 0.49% for bond funds and 0.69% for multi-asset funds.

[10] We have assumed that both active and passive equity UCITS yielded the annual gross performance calculated by ESMA for equity UCITS over the 2010-2019 period, i.e., 10.97%.

[11] Assuming that the distributor would charge 2% of the amount invested for the initial advice, the value of the €1,000 investment would have been equal to €2,479, i.e., €51 less than in a situation where no entry fee is charged.

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Besides fostering a Capital Markets Union, consumer empowerment and sustainable finance in Europe, we also support open and well-functioning global capital markets and engage with international standard setters and relevant third-country authorities.

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