CRYSTAL CLEAR
THE QUEST FOR COST TRANSPARENCY
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Investment managers occupy a privileged position of being trusted with people’s money. As part of that responsibility, it is crucial that clients and the pension scheme members they serve understand both how their money is being managed and what the costs are.

A number of factors are driving momentum towards improving cost transparency and empowering Trustees and Governance Committees to ensure greater clarity from their asset managers and pension providers.

Uncovering the Layers

For too long, uncovering details of pension product costs has been akin to removing the layers of an onion. The quest for improved simplicity and visibility on costs has taken on new urgency over recent years with helpful new regulations and guidance. These have put a much-needed focus on costs and provide direction to help make the value of pension products easier to compare and evaluate.

Since 2014, a wave of papers, initiatives and studies has been produced by the government and regulators. The overarching aim is to ensure members receive the greatest value for money by providing pension schemes with greater clarity on the fees paid.

In short, DC trusts and insurance companies are required to calculate the transaction costs incurred on their funds and assess the extent to which those transaction costs represent good value for money. From the beginning of 2018, asset managers and pension providers will be required to disclose transaction costs for the funds under their management. Until then, Trustees and Governance Committees are faced with the challenge of obtaining information from providers to help them assess value for money.

Transaction Costs Explained

Funds incur transaction costs when securities within the funds are traded. Fund managers make trades when:

- Money flows into or out of funds
- Investment decisions are made and portfolios need to be rebalanced

Transaction costs can be both explicit and implicit.

Explicit Costs

Explicit costs are measurable and can be objectively calculated.

Implicit Costs

Unlike explicit costs for which the fee paid is tracked and is clearly visible, implicit costs are subjective. They are measured as the difference between the transacted price and the “benchmark” price. The difficulty lies in how this “benchmark” price is defined.

The Financial Conduct Authority’s (FCA) consultation paper, “Transaction cost disclosure in workplace pensions”, proposes the slippage cost approach to calculate implicit costs.

The FCA has proposed that these slippage costs can be calculated by comparing actual asset prices with the value of the asset immediately before the order to transact entered the market.

Examples of explicit costs are:

- Broker commissions — intermediaries charge fees for buying and selling securities. Broker commissions include exchange fees, settlement fees and clearing fees
- Taxes and levies — taxes and levies are charged by regulatory bodies and exchanges. For example, when UK shares are bought, a tax of 0.5% on the transaction is usually paid for Stamp Duty Reserve Tax (SDRT)


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Other Costs

Securities/stock lending — a securities lending transaction involves a fund making a short-term loan of assets it owns in order to increase returns to investors.

Anti-dilution — when money flows into or out of a portfolio, the manager will need to undertake transactions to meet those flows. Funds use mechanisms called “anti-dilution” to pass the transaction costs associated with these flows to those putting money in or taking it out. This prevents the fund from becoming diluted.

Benefits received by the fund from this mechanism must be removed from transaction costs. These anti-dilution effects often take the form of bid-offer spreads.

Calculating Transaction Costs

Broker commission + Slippage costs + Taxes and levies + Stock lending costs (if applicable) - Anti-dilution benefits = Transaction costs

Source: SSGA, 2017. For illustrative purposes only.

Costs in a DC Context

Many default fund arrangements include allocations to multi-asset funds. These can invest in a number of underlying funds themselves, adding to the complexity of calculating costs. A simple weighted-average calculation of transaction costs for the underlying component funds may not be suitable when the asset allocation evolves over the course of the year.

The FCA is expected to provide further guidance on the disclosure requirements for multi-asset funds and Fund of Funds in the second half of this year.

Achieving Consistency

While it may not be clear how to calculate transaction costs for multi-asset funds, Trustees and Governance Committees can ask the managers of the underlying funds to provide the necessary information.

The FCA’s proposed approach aims to introduce consistency across the industry. This will aid Trustees and Governance Committees in assessing value for money. They should aim to have a set of transaction costs from their providers that they can benchmark against comparable funds and test whether members are receiving good value for money.

Commitment to Transparency

In a challenging investment climate, driving efficiency in every aspect of fund management is particularly crucial. At State Street Global Advisors, we embrace transparency — investors are entitled to it. We welcome the introduction of a new consistent framework for transaction costs disclosures and the obligation on managers to provide the necessary information and data.

Key Questions to Ask

1. What were the transaction costs for the underlying funds over the past 12 month period?
2. What are the bid-offer spreads of the underlying funds?
3. What are the asset manager’s processes and controls for minimising transaction costs?
4. Question for your consultant — how do the transaction costs for the funds compare with competitor funds?

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