

Keynote Speech

BETTER FINANCE 10th Year Anniversary Event

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Good afternoon Ladies and Gentlemen,

It's a great pleasure for me to be here to celebrate BETTER FINANCE's 10th anniversary and I would like to thank the organisers for inviting me today.

The key themes of this morning's discussion concern investor protection and how to ensure retail investors' participation in capital markets, particularly in the context of the Romanian capital market.

In the spirit of this conference, I will focus on the costs and performance of retail investment products, as they are key factors affecting the protection of investors and their participation in capital markets. I will first discuss the relevance of costs in the EU legislative framework that regulates the provision of investment services.

Secondly, I will talk you through ESMA's first annual costs and performance report on retail investment products.¹ In particular, I will highlight the main results of the report, and then remark on active and passive investment. Finally, I will touch upon closet indexing and provide you with an overview of our latest guidance on benchmark disclosures in retail funds.

The importance of costs of investment products in the EU framework regulating

¹ ESMA, 2019, "ESMA Annual Statistical Report – Performance and costs of retail investment products in the EU": https://www.esma.europa.eu/sites/default/files/library/esma50-165-731-asr-performance_and_costs_of_retail_investments_products_in_the_eu.pdf

investment services

Given the importance of costs for the achievement of investors' investment objectives, it is understandable that they have received increasing attention in the legislation regulating investment services. First, a new transparency regime has been established under MiFID II in relation to information on costs and charges that must be provided to investors before and after their investment activity. This aims to provide consumers with a clearer picture of the costs associated with the investment options they can choose, enabling them to make cost effective choices, which is particularly important for long term investment performance.

A second relevant MIFID II requirement is that firms providing investment advice or discretionary portfolio management must be able to understand the nature and the features of financial instruments selected for their clients. This understanding now explicitly includes the costs and risks of these instruments. Firms must also consider costs and complexity and assess whether equivalent, but simpler and/or less costly investment services or financial instruments can meet their client's profile. ESMA provided guidance for compliance with this requirement in the recent guidelines on MiFID II suitability rules. In particular we clarified that, in order to recommend suitable investments, firms need to fully understand all the different aspects of the products that they select and need to be able to clearly justify situations where a costlier product is recommended to a client.

Finally, the new product governance regime requires investment firms manufacturing financial instruments to consider the costs charged for the relevant instrument. In particular, manufacturers must assess that financial instruments' costs are compatible with clients' objectives, that charges do not undermine the financial instruments' return expectations, and that their charging structure is transparent and is not too complex to understand.

Such provisions for manufacturers must be read in conjunction with the product governance obligations for distributors that have to obtain from manufacturers the necessary information to understand the products they intend to recommend or sell. Even when manufacturers are not subject to MiFID II, distributors must undertake all reasonable steps to obtain adequate and reliable information from these manufacturers to ensure that products are distributed in accordance with the characteristics, objectives and needs of the target market. Costs are an important part of this assessment.

Overall, these MiFID II provisions on transparency, suitability and product governance confirm

and emphasise the importance of analysing product costs, and their impact, when providing investment services to investors. This is consistent with the firms' duty to act in accordance with the best interests of their clients. This is the overarching obligation that not only applies in the MiFID II context but also in that of the UCITS and AIFMD regulatory frameworks. Indeed, the general duty to act honestly, fairly and in the best interests of investors should also have an impact on the costs of investment funds for investors and on avoiding charging undue costs to them.

ESMA's first Annual Report on Performance and Costs of Retail Investment Products

ESMA's first annual statistical report on costs and performance of retail investment products is at the centre of our investor protection mandate and a building block in the Capital Markets Union. Our report covers UCITS, retail alternative investment funds (retail AIFs) and structured retail products (SRPs). The most detailed analysis in the report focuses on UCITS, distinguishing the performance and costs of various time horizons, asset classes, retail and institutional investors, and actively and passively managed funds.

Past performance and costs of investment products have a major impact on making informed investment decisions and therefore on the value of individuals' investments. For investors to trust in EU capital markets and to make informed choices about where to put their money, comprehensive and comparable information on costs and performance of investment products across the EU is key.

Data on EU household financial assets continue to show that there is significant potential for increased participation of retail investors in EU capital markets. In the past years, while household assets have increased substantially, the various shares of asset classes remained relatively constant, with currency and deposits staying, on average at around 30% of total financial assets against 8%, 17% and 16% respectively for investment fund shares, equity and life insurance.

Costs and performance: The importance of costs of investment products

Focusing now on UCITS, let me go into more detail on the findings of the report. First, we found that the total costs of a fund represent a significant drain on fund performance, with on-going costs constituting over 80% of the total cost paid by customers and impacting retail investors to a much greater extent than institutional investors.

I think it is important to highlight that, while the report is unprecedented in detail, distribution costs have been partially accounted for, being considered only to the extent they are included in ongoing costs or entry/exit fees presented in the KIID (Key Investor Information Document).

Detailed results of the report show that:

- Net assets in equity, bond and mixed UCITS total EUR 4tn for retail investors, 59% of overall EU UCITS net asset value as from the report. Net assets of institutional investors in equity, bond and mixed UCITS account for 22% of the total UCITS net assets.

To achieve more portfolio diversification, UCITS investing in alternative assets are growing, though still marginal: less than 2% of total net asset value.

- Gross annual past performance largely follows the dynamics of underlying assets and is highly volatile across time, assets classes and fund domiciles. In 2017, equity UCITS performance is very strong at around 16% whereas performance at the 10-year horizon (from 2008 to 2017) is the weakest at 7%, due to weak equity market performance during the global financial crisis. For bond UCITS, performance has been declining significantly in recent years due to the underlying bond market performance. It is the weakest in 2017, at 2.5%, while it is the highest over the 10Y horizon at 5.3%.
- Differently, costs charged by funds are fairly constant over time, and across asset classes. For EU equity UCITS sold to retail investors the impact of costs on performance relative to gross returns hovered around 1.9ppt (the difference between gross and net returns) over the 10Y and 1Y horizon. This implies that, given the low gross performance of a retail equity UCITS over 10 years, the similar level of costs has an impact relative to gross returns of around 27% at the 10-year horizon whereas only 18% at the 1 year horizon. Hence, because costs are fairly constant over time and not as variable as gross returns, retail investors take an extra hit in case of an overall lower gross return.

We should note that costs differ across Member States. For example, differences may be due to the inclusion of distribution costs and performance fees in reported costs.

- Moreover, costs are higher for retail than institutional investors. As an example, in the case of retail investors, on average for the EU, net annual returns of equity UCITS decreased by 18% compared to gross annual returns over the 3Y time horizon, between 2015 and 2017. For institutional investors, instead, net annual returns were found to be only 9% lower

than gross returns over the same period. For bond UCITS, this reduction was around 33% for retail investors and 17% for institutional investors.

To conclude on the first statistical report, let me focus on some interesting initial findings on active and passive investment management, a topic we are conducting more work on. Differently from the US, in the EU most passive portfolios remain focused on equities. Over the last five years, the share of passive management averaged around 10% of the overall EU equity market yet being highly heterogeneous across domiciles.

In terms of type of management, results show that active equity UCITS only slightly outperform passive over the 1-year and 3-year horizons, while costs are significantly higher for actively managed funds. Consequently, net annual returns are similar across management types, at 1-year and 3-year horizons, while they are higher for passively managed UCITS at longer time horizons. This again shows the relevance of the level of costs on performance in the longer term.

The preliminary results led ESMA to further investigate the performance of active versus passive funds. This analysis includes performances of active equity funds against their prospectus benchmarks, further insight into the performance of the specific class of equity ETFs, as well as reporting on potential differences within the distribution of active funds.

So far, we have observed a slightly higher variability of active versus passive funds compared to the EU average, both in terms of gross and net performances. Focusing on top 25% active and top 25% passive performers we observe significantly better gross and net performance of actively managed funds over one year (2017). This result is in line with expectations: while on average active does not outperform passive, at least some active strategies should outperform passive strategies. However, this phenomenon needs more in-depth analysis and we will report on this in more detail in the next version of the ESMA annual statistical report.

UCITS benchmark disclosure

My earlier remark on our finding that, in the case of UCITS, the total costs of a fund represent a significant drain on performance, especially for active equity funds, has also another dimension. Indeed, this draws attention to the strategies employed by investment funds that describe themselves as being “actively managed”, compared to those describing themselves as “passive” or “index tracking”. I want to focus particularly on the closet indexing issue, also known as index hugging, which refers to the practice of fund managers claiming to manage

portfolios actively when in reality the fund stays close to a benchmark.

It is a key part of ESMA's role to try to ensure that investors are treated fairly across all Member States, especially in a single market where cross-border distribution of funds is widespread. If there are already concerns on the overall impact of charges on the performance of active funds, these are even exacerbated in the case of index huggers. Indeed, these are not only likely to be charging unduly high fees, but they are also failing to deliver the service to which they committed themselves in their offering documents. Therefore, ESMA undertook various activities aimed at tackling closet indexing.

Our work in this field has progressed over the last 3 years, both on the supervisory convergence side and on the policy side. Since the publication of the statement on closet indexing, in February 2016, ESMA engaged with NCAs on a bilateral basis, requested NCAs to take follow-up investigations and hosted a supervisors' workshop. This is an ongoing activity for ESMA.

To complement our efforts on supervisory convergence, we also engaged in further policy work to ensure consistent and enhanced benchmark disclosures in the UCITS KIID. This led to the recent publication of an updated version of the UCITS Q&A document providing further guidance on benchmark disclosures. I would like to highlight some key features of these new Q&As.

The new Q&As underline the importance for all UCITS funds to disclose clearly whether the fund is managed actively or passively. Our objective is to ensure that funds are clearly disclosing whether their strategy is 'active' or 'passive', which is why we recommend including not only these specific terms, which are usually more familiar to retail investors, but also any additional wording to ensure the meaning of these terms is clear to them.

A pivotal aspect of the new Q&As concerns the adoption of a broad definition of 'benchmark referencing' UCITS. As you probably are aware, these UCITS have to publish their past performance against the relevant benchmark. We clarified that a 'benchmark referencing' UCITS is one where the benchmark plays a role in its portfolio composition and/or performance objectives and measures. This includes, for instance, UCITS using a benchmark index as a universe from which to select securities, even if only a minority of securities listed in the index are held in the portfolio and the weightings of the UCITS' portfolio holdings diverge from their equivalent weighting in the index.

This new approach – which withdraws a previous Q&A on disclosure of past performance – leaves the share of UCITS which would not be defined as managed in reference to a benchmark to be relatively small. For this reason, the Q&As explicitly allow UCITS management companies some time to implement these changes as we expect that a significant number of KIIDs are affected by these recommended practices – although they reflect supervisory practices that are already applied in certain EU jurisdictions.

This new policy approach has benefited from the input provided by various stakeholders, including retail investors' representatives. I'm mentioning it to this audience as I'm conscious of BETTER FINANCE's contribution to the closet indexing debate, especially in its press release of June 2018², which highlighted potential improvements in the ESMA Q&As to address issues related to closet indexing.

We expect that this policy work will raise the bar significantly in respect of enhancing investor protection in UCITS, facilitating a consistent interpretation of the provisions on benchmark disclosures across Member States. Moreover, the reduced level of discretion allowed to fund managers in terms of when to disclose performance against a benchmark is likely to reduce the possibilities of adopting closet indexing strategies. Moreover, the obligation to show past performance of the benchmark should allow investors to better evaluate investment choices of active funds against passive funds.

Conclusion

Ladies and Gentlemen, ESMA truly believes in a proactive approach to enhancing retail investor participation in capital markets and that investor protection is key to achieving that. Against this background, it is continuing to pay close attention to costs as an important factor in improving the services and products for retail investors.

I am convinced that the supervisory community, both at an EU and national level, as well as all stakeholders involved can collectively work on a better understanding of costs and performance, more transparency, and ultimately a better deal for retail investors. Therefore, we are committed to use fora like this Better Finance event, to continue the dialogue on costs and performance.

² http://betterfinance.eu/fileadmin/user_upload/documents/Press_Releases/en/Other_investors/PR_-_Benchmark_Disclosure_Compliance_Research_-_040618.pdf

