Schroders
Costs and charges: a key part of the value for members debate

Hilary Vince
DC Strategy Manager

Costs and charges will move up the agenda this year as the industry awaits the outcome of a Financial Conduct Authority (FCA) consultation on the issue. Since April 2015, trustees and Independent Governance Committees (IGCs) have had to report annually on the level of charges and transaction costs in their default fund and the range of charges and costs in any other funds. This is also a crucial element in fulfilling another new duty: as assessment of the value for money their scheme offers to members.

The FCA consultation is part of an initiative looking at how costs and charges information can be standardised[1]. Such standardisation is much needed, given the size and complexity of much of the data that needs to be collected. It remains to be seen, however, whether the effort will provide any worthwhile information for trustees, IGCs, managers or members.

Costs and charges: non-transaction costs

The costs of running investment portfolios divide up between those that are generally accrued on a regular basis, and are therefore relatively easy to predict, and those that depend on how much the portfolio is traded. The most straightforward part of the new requirements for chairs to meet will be reporting on the former. Such costs include the fees charged by the investment manager (ongoing charge etc), custodian and auditor where the rate of charge, if not always the amount, is fixed in advance.

Costs and charges: transaction costs

The other costs of running an investment portfolio are directly related to the amount that the underlying investments are traded. These costs are largely unavoidable, but very difficult to predict. Some funds' investment philosophy necessarily involves frequent trading. For instance, growth-orientated strategies tend to change their investments more often than value-orientated approaches. Trading costs are therefore typically likely to be much higher for the former than the latter.

A number of costs fall under the category of transaction costs. The Department for Work and Pensions (DWP) provided some examples in its 2014 consultation paper:

- brokerage commission and fees;
- bid-offer spreads;
- transaction taxes (including stamp duty);
- soft commission services included in brokerage fees, e.g. research costs;
- foreign exchange commissions; and
- fees relating to stock lending or stock borrowing[2].

Measuring these costs is not always easy (and will itself add to the cost of running funds). Certain costs are easy to calculate, albeit only after the event, while others are largely dependent on what happens in the market in question at the time the "cost" is incurred. We call these respectively "explicit" and "implicit" costs:

1 Consultation paper: Transaction cost disclosure in workplace pensions, Financial Conduct Authority, October 2016
2 Better workplace pensions: Putting savers' interests first, Department for Work & Pensions, October 2014.

"Explicit" transaction costs

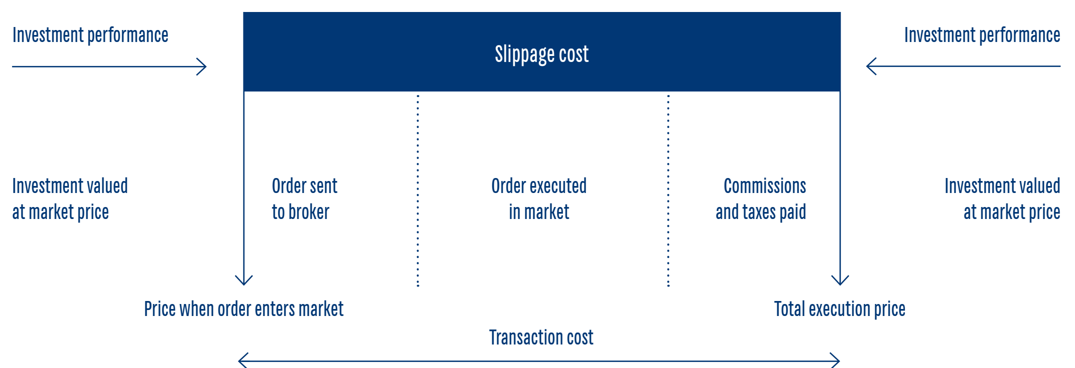
These are directly quantifiable charges which result from trading activities. Most of the examples given by the DWP above would fall into this category.

"Implicit" transaction costs

The value of an investment can be affected during the purchase or sale transaction by the movement in the market. Moreover, the transaction itself can affect the price at which it is concluded. A very large transaction can itself affect the price or spread quoted by market participants. For instance, the price actually paid for the purchase of a large block of shares might end up being higher than the figure publicly quoted before the deal, or the spread might be wider than that quoted before. This is because the other party to the transaction may decide they can demand a higher price given the limited availability of such a large quantity of shares.

Another "cost" is the result of not executing a transaction quickly or efficiently. This is often the result of the price moving between the time the trade is transmitted to the market and its being executed. It is arguably the most difficult cost to pin down. The FCA calls these "slippage costs" and is in the process of defining how they should be calculated.

The FCA proposal assumes that "there is typically a loss of value to the party that is undertaking the transaction. This loss of value is the implicit cost of the transaction." The key element here is what the FCA calls the "arrival price". This is the mid-price at the time an order to buy or sell an asset "enters the market". As this will be later than when the security's value was last measured in a client's portfolio, it will almost certainly be set at a different price. Certainly, early attempts to calculate them have not been encouraging. It appears they swamp all the other costs of transacting sales and purchases of shares, such as the spread and the commission charges. As a result, cash charges can be virtually wiped out or even become positive. It is hard to see the value of slippage as a measure of cost.



The FCA has suggested that this approach would be equally applicable to other assets, such as bonds and property. However, given the frequent absence of any continuous pricing for these assets, we would argue that slippage could result in even more extreme "costs" being recorded.

3 Consultation paper: Transaction cost disclosure in workplace pensions, Financial Conduct Authority, October 2016.
4 Investment Association response to FCA consultation paper: "Transaction cost disclosure in workplace pensions", CP16/30.
5 Occupational Pension Schemes (Scheme Administration) Regulations 1996, s. 23(1).

What should trustees and IGCs do next?

Chairs need to have their statements written and accounts published within seven months of their year end[5]. They therefore need to put themselves in a position where they can collate the necessary information, if it is available. Well in advance of the year end of their scheme they should therefore approach the managers of the various funds offered to their members. For those funds that do not form part of their default, they will need to gather information on the range of costs and charges involved. For the default, however, there is a requirement for much more detail about the actual level of costs and charges imposed on members.

The explicit costs should be relatively straightforward and available either from the managers themselves or from information they publish.

The information on "implicit" costs, however, is new and not currently collected by anyone. Investment managers will need to instal new systems to capture this data at a time when the authorities are still deciding on the rules. It may be, therefore, that chairs' statements will continue to have to state that insufficient information was available for them to form an opinion on whether costs and charges represented value for members. Moreover, even where information is available, they may be forced to the conclusion that some of the transaction charge data provides little that is useful in determining value for members. It may, indeed, be positively misleading in many cases.

5 Occupational Pension Schemes (Scheme Administration) Regulations 1996, s. 23(1).

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