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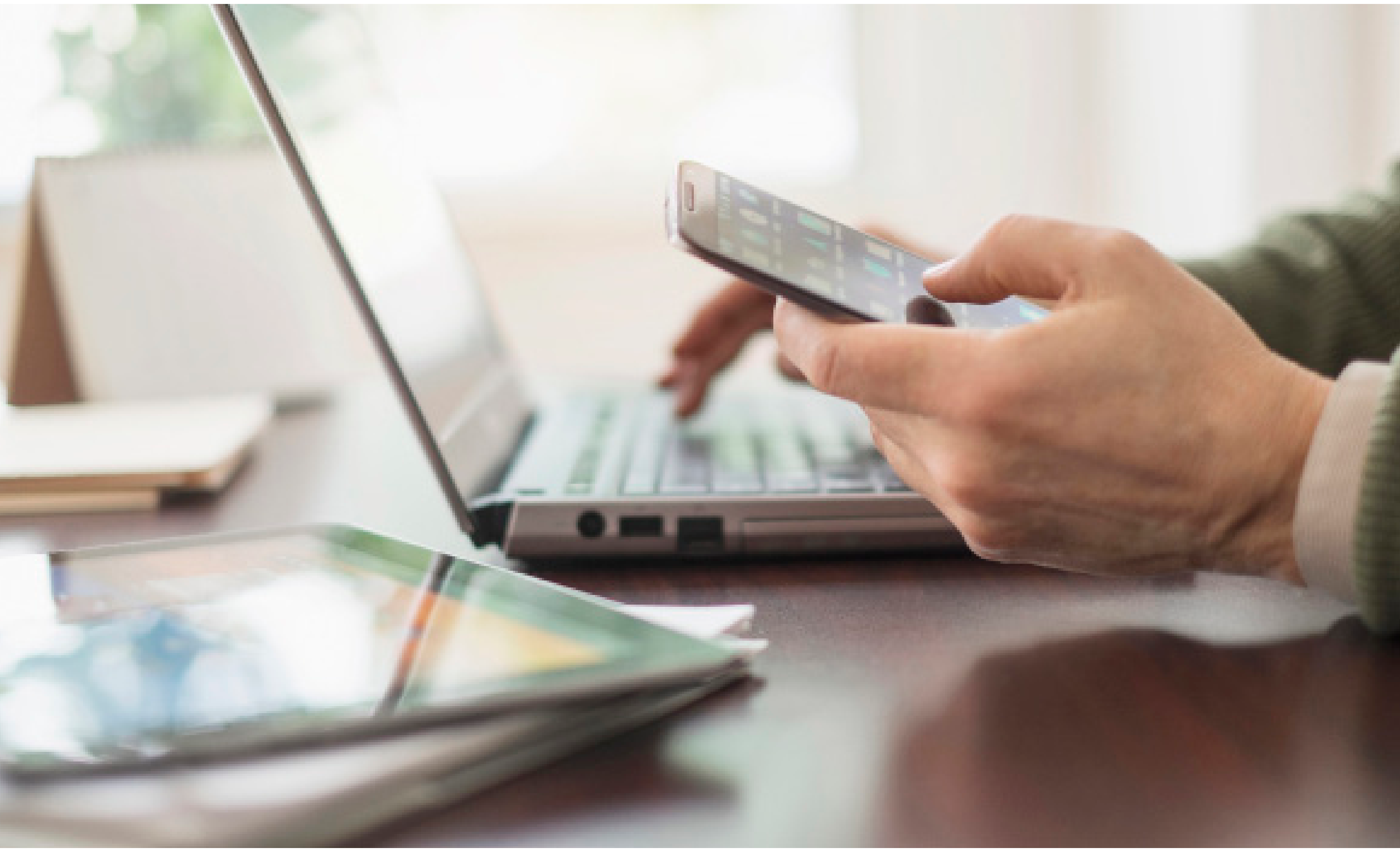
Broadridge®

Assessment of Value: Managing data & design



Ready for Next

ASSESSMENT OF VALUE

"Within the UK market there are approximately 2,345 unique funds, with approximately 11,100 share classes. This means that each fund has approximately five share classes that will need to be reviewed by the board. Such an endeavor can become almost impossible to manage without a strategy to separate those funds needing a deep dive in the review process versus those funds that can be deemed to have value."

In the first two papers in our Assessment of Value (AoV) series, Broadridge presented the data necessary to evaluate a fund's value as well as providing practical perspective around the performance evaluation that will take place as part of the AoV process. Over the past several weeks as we have been talking with clients and others within the asset management arena, the most common concern we have heard is how do we make all the data we have available relevant and useful during the AoV review. As we noted in the first paper, there will likely be an evolution over the first several years of implementation that will impact what a board looks at, as well as how materials are presented. The first year will inevitably be a larger process as everyone involved decides what to include, how to manage the process, and learns and understands the materials. The fund industry does not suffer from a lack of data with major players like Fund Express, Lipper, and Morningstar all collecting significant amounts of cost, performance, and holdings data on funds. The challenge boards will face this year is how to select what data to include and how to make that data useful during the AoV process.

Within the UK market there are approximately 2,345 unique funds, with approximately 11,100 share classes. This means that each fund has approximately five share classes that will need to be reviewed by the board. Amongst the approximately 200 fund companies that are part of the AoV process each board will, on average, review 55 share classes annually as part of their work and, at a minimum, consider 25-30 data elements per fund within a report (and likely more!). The scale of work required of independent non-executive directors (i-Neds) and affiliated directors may scale dramatically larger depending on the size of a fund company. Such an endeavor can become almost impossible to manage without a strategy to separate those funds needing a deep dive in the review process versus those funds that can be deemed to have value without spending as much time on the review.

THE FOUNDATION FOR ASSESSMENT OF VALUE

Qualitative Analysis	• A holistic report that provides overview of funds and complex looking beyond a single ranking • Provides boards insights into why a fund ranks how it does
Executive Summary	• Provides overview of complex by asset class and macro-level data on costs, charges, and performance • Allows the board to identify funds with low relative rankings
Fund Report	• Fund report ranging starting at 1 page + • Highlighting quantitative data outlines in AoV rule including: cost components, performance, and risk measures
Peer Groups	• Comparison groups for charges, performance • Groups created to address economics of scale, comparability of performance and charges • Need to create meaningful groups for benchmarking

MANY QUESTIONS TO ANSWER BEFORE STARTING

Where do we start with the value review process? Is it deciding which data should be included? The format of displaying data? Which data should be used for primary and secondary evaluation? Or is it all of the above? What about the value of the entire fund company, or a specific asset class, versus the value of individual funds? All of these criteria may be used in helping to evaluate value.

A solid foundation for reporting is critical. That foundation starts with the comparisons being used to evaluate a fund, moves to the content and display for an quantitative analysis and finally moves to a qualitative analysis that explains the why. In order to make the process manageable, Broadridge typically works with each fund company to determine primary data to evaluate each fund and then determines a design that works best with those primary factors and the unique needs of each board to create a report. In addition to reports on individual funds, Broadridge typically creates a two-part executive summary that allows for a quick analysis of the overall fund company and individual funds.

So how do we decide the primary data to be used to evaluate a fund's value? From a quantitative perspective, cost and performance data are two major factors to look at. On the cost side the Ongoing Charges Figure (OCF) for the current fiscal period is a logical starting point to evaluate value. While we typically include historical cost comparisons in reports Broadridge feels the current data is the most relevant as it incorporates any changes the fund company may have made and it is what the current investors pay.

Unfortunately, performance is a bit tougher to determine the right primary factor or factors. On the performance side it is very easy to quickly fall into the paralysis by analysis box if there are too many "primary" factors. During the AoV process you can look at multiple time periods, with one-, three-, and five-year time periods being common. In addition to multiple

Figure 1
Percent of Funds That Beat Their Benchmark, Select Periods Ended 30/06/19

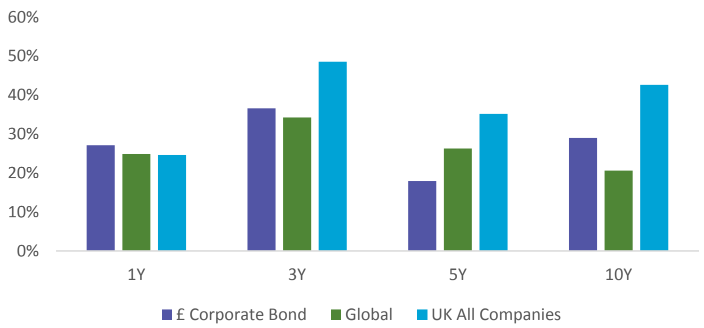
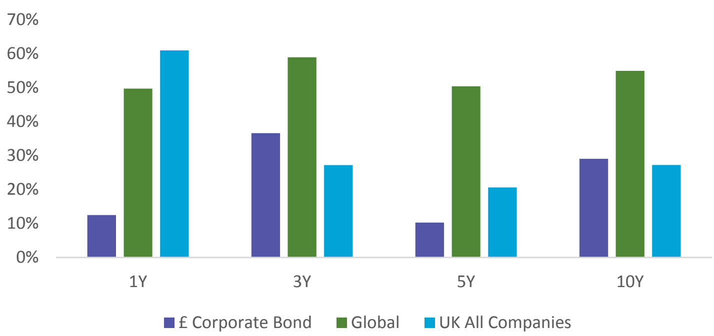


Figure 2
Percent of Funds That Beat Their Benchmark, Annually

Figure 3
Percent of Funds More Risky (Beta) Than Their Benchmark



time periods, performance can be evaluated versus a benchmark, versus a competitor group, and at point-in-time or rolling time periods (monthly, quarterly, or annually). To define a primary performance metric Broadridge recommends using each fund's recommended holding period (RHP). While a fund's longer-term or more recent performance may tell a slightly different story, using the RHP as a primary criterion aligns with what we expect investors are wanting and ties into other regulatory requirements for reporting purposes. The next question is do you use a point in time evaluation i.e. five-year performance as of 30th June, 2019, or do you look at rolling performance periods over the past five years? The final question when evaluating performance is do you evaluate performance against a fund's benchmark (typically a broad-based market index) or versus a competitor group, an IA Sector, or does the board look at both? Unfortunately, the FCA has left this question open in the release of the value assessment rule so each fund company and board must make this decision on their own.

The charts to the left demonstrate how the choice of time periods may have a substantial effect on one's view of benchmark-relative performance. For example, in Figure 1 the vast majority of funds failed to beat their benchmark over five years, which may lead one to believe that the average fund simply couldn't beat its benchmark at any point during those five years. In Figure 2, however, annual performance reveals that funds typically beat their benchmark in 2017 and, in the case of funds in the UK All Companies sector, in 2015 as well. Conversely, it may seem remarkable that 35% of UK All Companies funds beat their benchmark over five years when only 14% did so in 2016.

Any analysis of benchmark-relative performance is better served with a view of risk. Here, note that managers often adjust how much risk they take—it's rarely a static figure. A fund may underperform its benchmark when its manager is less inclined to expose investors to volatility or the manager intends to permanently shield investors from a portion of the market's volatility.

Broadridge's research indicates that results looking at rolling performance consistency versus point in time periods make little difference. We found that for funds performing equal to their benchmark for a five-year return period 49% of funds

had outperformed their benchmark on a rolling monthly basis and 51% had not outperformed their benchmark. Overall as funds outperformed their benchmark for the five-year return period they had fewer months where they had not beaten the benchmark, and across the board if a fund outperformed its benchmark for the five-year period then more than half the time it beat its benchmark for the individual rolling monthly periods.

Beyond performance comparisons to benchmarks Broadridge typically works with fund companies to review a set of competitors. It is a challenge for a fund to beat an index for many reasons including the inability to identically match/invest in the underlying securities, the need for liquidity with funds to meet redemption demands, and the impact of costs to manage a fund that an index does not have. By looking at a set of competitors in the performance review the board can gain an understanding of the efficiency a fund company has in managing its product.

As we highlighted in our second whitepaper related to AoV, performance should also be reviewed through the lens of relative risk, whether that be relative to other funds, against a benchmark, or both. While there is no "right" answer as to which risk measures to use in the review, Alpha, Beta, Sharpe, Information Ratio, and Standard Deviation are all common. As a starting point looking at risk measures for the time period of the RHP is a reasonable starting point to determine if a fund's actual risk profile seems to correspond to the risk profile outlined in regulatory filings.

CONCLUSION

When determining primary factors for evaluating a fund's value the options and tools clearly are endless. In order to keep the process manageable Broadridge typically works with clients to look at an OCF, total return performance, and a few risk measures. Limiting an initial analysis to three primary areas of content that provide a comprehensive look at costs, performance, and risk allows the board to filter funds that quantitatively are doing well into one review process and to move funds with question marks to a process that allows a deep dive if needed. From a quantitative perspective funds that rank in the fourth and fifth quintile for costs, comparative performance, and returns versus benchmark should have further evaluation. Questions for these funds may be answered through a qualitative explanation or may require further data such as a review of risk measures for various time periods, the inclusion of performance attribution, or bringing in additional measures. It is our belief that too many metrics will cause confusion and ambiguity in evaluating a fund's value. As a starting point keeping criteria limited and concise will allow the board to distinguish between products that are truly unique and those not providing value.

Comments and questions from readers of this white paper are welcome. Additionally, if you would like to have more detailed data presented related to your funds we can incorporate that into a study. Please direct any feedback to:

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