30 October 2020

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Submitted via email: pensions.investment@dwp.gov.uk

Dear David,

CFA UK response to DWP's Consultation – Improving outcomes for members of defined contribution pensions schemes

CFA Society UK ("CFA UK") welcomes the DWP's response to their February 2019 consultation, and the opportunity to participate in this further phase of consultation. We note the expansive breadth of scope of both the February 2019 and September 2020 documents, and therefore welcome the DWP's iterative approach to exploring and consulting on these complex topics.

CFA UK is the professional body that serves nearly 12,000 leading members of the UK investment profession. Many of our members work with pension funds, either managing investment portfolios, advising on investments or as an in-house employee responsible for pension investment oversight[1].

The scope of the consultation includes a number of areas of policy which CFA UK does not have expert opinion on and therefore will not opine on. We would instead like to briefly highlight three topics and proposals raised in the consultation document and offer our views on those. We believe that these issues around the investment of UK DC schemes are of the utmost importance, and we support the DWP's efforts in developing and refining pensions legislation and guidance to promote both innovation and a general 'raising of the bar ' for investment quality in DC.

a) Value for money, net returns and encouraging consolidation

CFA UK welcomes the DWP's outline for proposed factors for determining the value for money ("VFM") offered by a scheme. We note that the FCA recently consulted on the topic of VFM as it pertains to schemes governed by IGCs in Summer 2020, and while they chose a slightly different form of words to those outlined by the DWP, there is alignment in the key themes of investment quality, good customer service and reliable systems. In our response to the FCA[2] we supported the FCA's framing, but noted that 'investment performance' needed to be understood in a nuanced way,

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[1] *More details on CFA UK and the CFA Institute are provided in Appendix I.*

[2] https://www.cfauk.org/-/media/files/pdf/pdf/5-professionalism/2-advocacy/responses/igc-vfm-to-psc.pdf

with regards to the suitability of the investment approach to the scheme's objectives and members – we believe the DWP have captured this nuance in their wording well.

We are also very supportive of DWP's move to mandate that schemes report performance net of fees; this aligns with the CFA Institute's Global Investment Performance Standards (GIPS)[3], as well as custom and practice established by MiFID in the retail investment space. We would stress, however, that net performance does not in and of itself demonstrate value for money, indeed as we cautioned in our response to the FCA, the temptation to give primacy to absolute past performance (be it gross or net of fees) is unlikely to lead to sound decision making and has been a pitfall through the history of the pension and investments industry.

Net returns constitute the most honest and intuitive representation of a scheme's performance track record – and we would argue that is itself reason enough to make this the norm for reporting purposes, without implying it adequately demonstrates VFM. Finally on this topic, we note the DWP have asked a specific question on time horizons for net performance reporting: we'd support 3 and 5 years as well as since inception (at a minimum where available), on an annualised, geometric basis.

b) <u>Look-through on costs in REITs and other investment companies</u>

CFA UK are concerned by the DWP's new guidance on look-through to underlying costs, especially as it pertains to REITs. REITs are an exemplar of why the regulators need to be circumspect about mandating that schemes look through to costs in more cases than not: the practical challenges to and implications of schemes applying this guidance are significant.

We would first observe that the distinction between a closed-ended real estate fund and a real estate commercial company, in the sense of the net economics of the investment, is arbitrary; the magnitude and indeed the type of drag or leakage of underlying asset returns to the remuneration of senior management etc. is equivalent.

Second, we believe it could be prohibitively difficult for many or most schemes to accurately get a read on look-through costs in REITs as neither counterparty have established customs and practices for this type of disclosure and measurement. Many schemes will have exposure to REITs not through a specific strategic asset allocation or direct investment, but rather simply by holding a diversified developed market cap equity index fund: it would surely be an unreasonable burden on schemes to trawl through the holdings of their equity tracker to identify those REITs that meet the definition of a closed-ended fund and then somehow extract the fee load within that structure (as a total expense ratio, which itself may not be the normative fee quotation basis for the firm operating the REIT) in order to aggregate up their total look through fee exposure as per the spirit of the guidance. We would note here also that most UK DC schemes allocate to global equity portfolios with thousands of lines of stock, including many REITs. Meanwhile, their UK exposure, and hence their ability to rely on the categorisation in the UKLA Official List, will be very limited.

We believe the unintended but inevitable consequence of this will be that schemes will effectively be compelled to seek to divest from REITs entirely, which itself could be prohibitively difficult and expensive, as it would require the creation of new funds and indices that carve out REITs for the sole benefit of UK DC schemes seeking to be compliant with the guidance.

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[3] https://www.cfainstitute.org/en/ethics-standards/codes/gips-standards

Finally, we would remark that this principle of look-through in REITs would naturally precipitate a wariness of holding equity in any listed investment company, particularly those whose primary business is investing in private markets and illiquid assets, and thus significantly undermine the wider policy aim of giving DC scheme members more access to the economic benefits of investing in private and illiquid assets.

c) <u>Performance fees and smoothing mechanisms</u>

CFA UK welcomes the DWPs efforts to make the charge cap calculation methodologies more accommodative to investing in private market fund structures and the innovative consideration given to performance fee measurement. We are strongly in favour of measures that promote more sophisticated and diversified investment approaches amongst DC schemes, and we believe that in time DC portfolios should be every bit as sophisticated as those of their DB and other institutional peers, including significant allocations to private market assets. That said, we also share the DWP's circumspection concerning performance fees and the potential for both (i) inequitable treatment amongst investors and (ii) unfair rewards for providers if they are not structured well.

However, there are two distinct challenges that regulators, schemes and the fund management industry must solve in order to bring strategies that charge performance fees into the investible universe of DC:

1. The affordability of the fees under the charge cap at an absolute level
2. The equitable apportionment of those fees to members investing at different times and over different horizons.

While we commend the DWP and regard the level of engagement with this issue by all stakeholders as encouraging, we believe that the proposals will not yield material changes in the way that DC schemes do, or feel that they can, invest in practice. Notwithstanding the handful of cases that the DWP have identified in the venture capital space, performance fees are pervasive across venture and private equity (as well as the higher returning segments of other private markets, be it mezzanine debt or core-plus infrastructure), and as respondents have noted, many funds are oversubscribed, so we think it unlikely that market pricing will change radically in the near future[4].

We think the DWP needs to consider more radical policy reform if it is to achieve a meaningful change to the status quo for DC investing, and equally the investment management industry needs to reform with it. We believe the proposed multi-year performance fee measurement and other proposals appropriately acknowledge the problems at a conceptual level but do not solve them at the practical level.

In terms of the absolute level of the charge cap and the absolute level of performance fees, we need to recognise that most schemes cannot and will not use 'headroom' in the 75bps cap to charge their members a variable fee based on performance; most schemes are operating on tight fee and competitive constraints and will only realistically allocate to a fund with significant performance fees if the regulator carves out some or all of that variable component from the charge cap (for certain

[4] We would caution against sampling the entire gamut of private markets funds for evidence of a shift in pricing: infrastructure equity and direct lending for example may or may not feature a performance fee, depending on the risk/return targets and strategies of the funds. Meanwhile private equity funds, especially venture capital funds, almost always have a '2-and-20' model.

asset classes). We believe this approach aligns well with impetus for trustees to prioritise value for money over simply cost: the hurdle rate and the magnitude of the performance fees can be set to ensure the manager is only fairly remunerated when they have successfully deliver asset class appropriate returns. Absent this reform, DC members simply will not get to access the returns from these asset classes at all.

In terms of equity between members, we unfortunately cannot recommend any simple solution, but rather acknowledge that further work and innovation is required; although we would note some ideas for innovation[5] that could in combination begin to address (but never completely solve) this issue:

- Multi-year fee accrual, as proposed by the DWP
- Vintage diversification – so no one member or member contribution is overly exposed to one part of the J-curve or another
- Negative performance fees, or contingent compensation: where either a capped performance fee is smoothed across the life of the investment or a performance fee reserve fund is established, with a rebate to the scheme/members where the hurdle rate performance fails to materialise over the longer-term.

Ultimately however, inequity is an inherent feature of DC investing and therefore schemes will need to recognise and accept that like performance itself, performance fees cannot be perfectly smoothed across members and cohorts.

Yours sincerely,

Will Goodhart,
Chief Executive
CFA Society of the UK

Andrew Burton
Professionalism Adviser
CFA Society of the UK

and for overview from the CFA UK Pensions Expert Panel and the CFA UK Professionalism Steering Committee

[5] Please see CFA UK's recent paper on "Innovations in Retail Fund Fees" (https://www.cfauk.org/-/media/files/pdf/pdf/5-professionalism/3-research-and-position-papers/innovations-in-retail-fund-fees.pdf)

Appendix 1: About CFA UK & the CFA Institute

CFA UK: serves nearly 12,000 leading members of the UK investment profession. Many of our members work with pension funds, either managing investment portfolios, advising on investments or as an in-house employee responsible for pension investment oversight.

- The mission of CFA UK is to build a better investment profession and to do this through the promotion of the highest standards of ethics, education and professional excellence in order to serve society's best interests.
- Founded in 1955, CFA UK is one of the largest member societies of CFA Institute (see below) and provides continuing education, advocacy, information and career support on behalf of its members.
- Most CFA UK members have earned the Chartered Financial Analyst® (CFA®) designation, or are candidates registered in CFA Institute's CFA Program. Both members and candidates attest to adhere to CFA Institute's Code of Ethics and Standards of Professional Conduct.
- For more information, visit www.cfauk.org or follow us on Twitter @cfauk and on LinkedIn.com/company/cfa-uk/.

CFA Institute: is the global association for investment professionals that sets the standard for professional excellence and credentials.

- The organization is a champion of ethical behavior in investment markets and a respected source of knowledge in the global financial community. Our aim is to create an environment where investors' interests come first, markets function at their best, and economies grow.
- It awards the Chartered Financial Analyst® (CFA), and Certificate in Investment Performance Measurement® (CIPM) designations worldwide; publishes research; conducts professional development programs; and sets voluntary, ethics-based professional and performance-reporting standards for the investment industry.
- CFA Institute has members in 162 markets, of which more than 170,000 hold the Chartered Financial Analyst® (CFA) designation. CFA Institute has nine offices worldwide and there are 158 local member societies.
- For more information, visit www.cfainstitute.org or follow us on Twitter at @CFAInstitute and on Facebook.com/CFAInstitute.