VALUE FOR MONEY

A Framework for Assessment[1]

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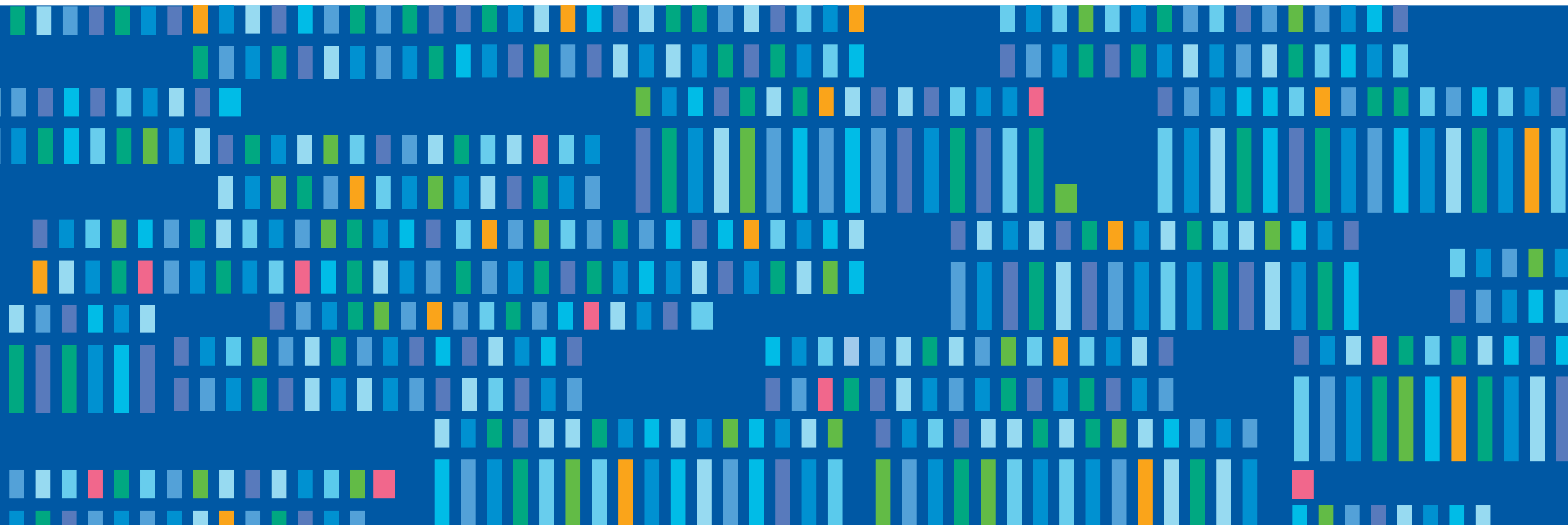

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Executive summary

- Value for money ('VFM') is an area of growing regulatory interest, particularly where there are potential information asymmetries between asset managers and clients.

- A number of regulatory requirements exist in relation to VFM, for example requiring DC pension scheme trustees, insurance Independent Governance Committees, and the Boards of UK Authorised Funds to make regular assessments of value. While these requirements are similar, they are not entirely consistent and could benefit from some harmonisation.

- We argue that a framework for assessment of VFM should include:
    - I **Costs and charges** - noting there are often several different types of charges
    - II **Output, defined as risk and return** - with a focus on the long-term
    - III **Quality and service** - other features and benefits desired by the client, including issues such as the quality of governance and the sustainability of the investment approach

- VFM is an established concept in other sectors, especially in the area of public sector spending and the activities of non-governmental organisations, who have to account for efficient use of public funds. Frameworks from these sectors form useful comparators for considerations in the asset management industry.

- We do not believe these elements can be combined in a single metric - rather they form a consistent framework of factors that should be evaluated alongside each other.

- VFM should not be just about lowest cost, but rather consider the long-term investment output received, both risk and return, and the wider set of benefits received.

- Different clients will have different needs and different preferences for the mix of benefits and services they receive. In this sense, VFM is in the eye of the beholder and asset managers should engage in an early and ongoing dialogue with their clients to ensure their clients' objectives are being identified and met.

Introduction

There is an increasing focus on value for money in the investment industry. In the UK and elsewhere, regulators and government have challenged financial services firms to demonstrate how they are delivering value to clients. The FCA's Asset Management Market Study, Retirement Outcomes Review, and Investment Platform market study, amongst others, have all identified concerns about value for money ("VFM") or related issues.

Assessment of VFM is key focus for financial services regulators particularly in situations where there may be information asymmetries between asset managers and clients, or other weaknesses in clients' purchasing abilities, for example due to complex distribution channels.

The ability of clients to assess VFM should help to increase trust and improve the reputation of the investment industry. The challenge is in defining a framework to do so. VFM is, in some senses, in the eye of the beholder - different clients will have different preferences for the mix of benefits and services they receive, and they may weight things differently.

In this paper, we outline a suggested VFM framework as having three main elements:

> **I Costs and charges**
> The level of costs and charges incurred by clients forms a fundamental part of the VFM assessment, but should not be the sole element. We discuss the nature and range of costs and now they should be assessed in context and reviewed alongside other factors.
>
> II **Output: Risk and Return**
> The key output of the investment process is the return and risk experienced by the client. We argue that both risk and return need to be considered and the focus should be on the long-term in line with the investor's objectives.
>
> **III Service and Quality**
> There are various services and features provided by the investment industry beyond simple risk and return, and that may be a factor in the assessment of VFM. The services and features that are of value will differ across clients as will the premium they think is reasonable to pay for them.

We think these three elements can form a consistent framework for the VFM assessment. We do not think it is feasible to sum them in a single metric, rather they should be viewed alongside each other. It is important not to equate VFM with lowest cost in isolation.

The level of cost needs to be viewed in relation to the risk and return profile delivered and to the wider level of service and quality, including features such as good governance and sustainability. The focus should be on the long-term in line with the client's objectives.

This paper aims to provide a framework to guide asset managers and clients in assessment of VFM. Some CFA UK members will be in the position of reporting the value they have provided to clients in their investment management services, while others will be making evaluations of value from their perspective as clients of the investment manager, or advisers to the client.

The framework focuses principally on investment management services, but acknowledges that many clients consume these services as part of a bundled proposition, for example with administration or platform services.

It is not intended to be a technical guide about how to comply with any specific VFM regulatory requirement. The Investment Association is a good source of such guides, in addition to the guidance provided by the regulators themselves.

Regulatory requirements on VFM

Assessment of VFM has become a key focus for financial services regulators. The table below provides key examples applying to different product types and client groups in the UK. The first two requirements relate to bundled pension scheme products while the latter applies to UK authorised funds. It is notable that the requirements are similar, but not identical and there might be merit in creating more regulatory consistency.

FIGURE 1

Focus	UK Trust-based DC Pension Funds	UK Insurance Company Workplace Pension Schemes	UK Regulated Funds
Regulation	Occupational Pension Schemes (Charges and Governance) Regulations 2015	FCA COBS 19.5	FCA PS 18/08 and proposed changes to FCA COLL 6.6
Responsible Party	Trustees	Independent Governance Committee (IGC)	Board of the Authorised Fund Manager (AFM)
Assessment	Good value for members	Value for money for relevant policyholders	Overall value delivered to unitholders
Requirements	The trustees or managers of a relevant scheme must, at intervals of no more than one year— (a) **calculate**— (i) the charges; and (ii) in so far as they are able to do so, the transaction costs, borne by members of the scheme; and (b) **assess the extent** to which those charges and transaction costs represent good value for members.	The IGC will assess the ongoing value for money for relevant policyholders delivered by relevant schemes particularly, though not exclusively, through assessing: (a) whether default investment strategies within those schemes: (i) are designed and executed in the interests of relevant policyholders; (ii) have clear statements of aims and objectives; (b) whether the characteristics and net performance of investment strategies are regularly reviewed by the firm to ensure alignment with the interests of relevant policyholders and that the firm takes action to make any necessary changes; (c) whether core scheme financial transactions are processed promptly and accurately; (d) the levels of charges borne by relevant policyholders; and (e) the direct and indirect costs incurred as a result of managing and investing, and activities in connection with the managing and investing of, the pension savings of relevant policyholders, including transaction costs;	An authorised fund manager must conduct an assessment at least annually for each scheme it manages of whether the payments out of scheme property set out in the prospectus are justified in the context of the overall value delivered to unitholders. **Minimum considerations** **Quality of service:** The range and quality of services provided to unitholders. **Performance:** The performance of the scheme, after deduction of all payments out of scheme property as set out in the prospectus. Performance should be considered over an appropriate timescale having regard to the scheme's investment objectives, policy and strategy. **AFM costs:** In relation to each charge, the cost of providing the service to which the charge relates, and when money is paid directly to associates or external parties, the cost is the amount paid to that person. **Economies of scale:** Whether the AFM is able to achieve savings and benefits from economies of scale, relating to the direct and indirect costs of managing the scheme property and taking into account the value of the scheme property and whether it has grown or contracted in size as a result of the sale and redemption of units. **Comparable market rates:** In relation to each service, the market rate for any comparable service provided. **Comparable services:** In relation to each separate charge, the AFM's charges and those of its associates for comparable services provided to clients, including for institutional mandates of a comparable size and having similar investment objectives and policies; **Classes of units:** Whether it is appropriate for unitholders to hold units in classes subject to higher charges than those applying to other classes of the same scheme with substantially similar rights.

The Gartenberg Principles

Historical context

In the US, the 'Gartenberg Principles' or 'Factors' were born out of the Gartenberg vs Merrill Lynch Asset Management court case in 1982 to help determine whether investment advisors charged excessive fees to their clients. During the Second Circuit, the court held that "...to be guilty of a violation of Section 36 (b)...the advisor manager must charge a fee that is so disproportionately large that it bears no reasonable relationship to the services rendered and could not have been the product of arm's-length bargaining."

The Court ruled out the notion that the main factor to consider when determining fair value is the price charged by other similar advisors. Instead, the following six factors were considered to determine fair value or whether a breach of fiduciary duty according to Section 36 (b) of the 1940 Investment Company Act had occurred:

1. The nature and quality of services provided
2. The profitability of the mutual fund to the advisor-manager
3. Any "fall-out" benefits to the adviser
4. Economies of scale
5. How the fee structure compares of those of other similar funds
6. The independence and conscientiousness of the funds independent directors

Rather than relying solely on price to determine excessiveness, the court used the six factors to establish whether a proper, informed arm's length negotiation had taken place.

Current US practice

Although indirectly referenced, the Gartenberg factors have been core to the evolution of the value assessment required by the 1940 Companies Act in the US commonly known as section 15(c). As part of the process, the board sends a request for information from the fund manager (also referred to as investment advisor) on a range of different data points. Some relate to the Gartenberg factors and others relate to the overall assessment of the entity itself. Most information can be gathered internally by the fund manager, but some external information is needed for peer group comparisons and the evaluation of third party service providers. The data request is typically highly detailed and comprehensive.

Interestingly, current practice in the US does not require the board of the fund manager to equally weigh up all Gartenberg factors or even request information for all the factors, but it is extremely rare for boards not to consider them all. The final document is generally viewed only between the board and fund manager as this contains highly sensitive information. This lengthy document (of up to 1,000 pages) then gets revised each year. A summary of the assessment process and the conclusion is included in the shareholder report. The format of this can vary across firms, but essentially it covers the governance structure, performance, level of charges, economies of scale and quality of services.

Direction of UK practice and regulation

Within the UK, the current overhaul of the FCA's policy related to value assessment for authorised funds (PS18/8) has been influenced by the US practice and is closely anchored to the Gartenberg factors. Both the US and UK tend to address quality of service, performance, level of charges and economies of scale, however in addition, the UK also explicitly covers comparable market rates (i.e. fee levels and not just structures), retail vs institutional comparable services (i.e. one aspect of economies of scale issues) and unit/share classes.

None of these additional three criteria are part of the original Gartenberg factors and the FCA has drafted these on in addition, though we note that US practice has become to compare comparable market rates (fees, charges etc) also. Unit classes is unique to the UK market as a result of pre- and post-RDR share classes.

VFM frameworks from other sectors

VFM as a concept is utilised in many sectors outside of finance to better understand the optimal use of funding for projects and initiatives. Good VFM can be defined as the optimal use of resources to achieve the intended outcomes.[2]

VFM is a common concern across both government and non-government organisations and is used worldwide in assessing the success of funding projects. In the UK, the National Audit Office (NAO) regularly uses a VFM framework to assess public spending projects. Non-governmental organisations (NGOs) also use value frameworks to determine whether funding has been used efficiently to most effectively achieve their stated outcomes.

One common framework is the 4Es:

I. Economy
Minimising the cost or resources used, while taking into account the quality

II. Efficiency
Relationship between the outputs produced and the resources used to produce them

III. Effectiveness
Extent to which the objectives are achieved and difference between actual impact versus intended objectives

IV. Equity
Determines whether the benefits were distributed fairly as intended

The first three criteria are more frequently applied, whilst the fourth is a more recent addition, added by the Independent Commission for Aid Impact (ICAI) in 2011.

Evaluation of VFM has gained wide spread acceptance, but there is still debate over which methods for analysing benefit and effectiveness are best. Across different sectors there are at least six methods for evaluating VFM. All have roughly the same outline but have been adapted for different objectives. The most commonly used is the cost-effectiveness model, which is also the primary tool for the NAO.

Cost-effective analysis is based on the relative costs and outcomes of achieving the goal. It is often used to compare two or more programs to evaluate (i) the efficiency of resources used under each program to generate the outputs and (ii) how effective these outputs were to achieve the stated goals of the program.

Within the finance industry, VFM is often equated with low cost. This binary approach ignores other factors including the quality of the output and its effectiveness in helping investors achieve their goals. The assessment of VFM in other sectors is further advanced and more nuanced, and regulators of the financial services industry could use some of these concepts in developing the VFM framework.

[2] *Source: National Audit Office (NAO) 'What is a value for money study?'*

Key aspects of assessing VFM

We think that there are three key areas in the assessment of VFM: Costs and charges; Output, defined as Risk and Return; and Service and Quality. In the following sections we outline considerations in each area.

1. COSTS AND CHARGES

The costs and charges incurred by clients in financial products form a fundamental part of a VFM assessment but need to be considered in context and reviewed alongside other factors.

We note that asset management is often consumed as part of a bundled offering, for example with administration or platform services. Costs will vary depending on the scale and complexity of the product or service, along with other factors including levels of investor protection and governance.

The following three-step process could be used to facilitate consistent evaluation of costs as part of the VFM assessment:

Step 1: understanding roles, responsibilities and client base
In an increasingly complex world where the boundaries between service providers are being blurred, and investment firms have multiple client types and distribution channels, it is essential to understand the ecosystem of product types, associated regulations and responsibilities through which a value assessment should be done.

Step 2: identify the universe of costs and charges relevant to a particular product and distribution channel
The universe of cost and charges associated with the delivery of investment management services can be complex. This complexity is driven in part by regulatory, tax and distribution requirements, including the extent of bundling. For example, a segregated, developed equity mandate managed directly for an institutional pension scheme will have a different range of charges compared to a wealth management client investing their private savings via a platform into a fund-of-funds. Obviously, not all of charges are levied by the asset manager, but they will have an impact of the client's overall perception of value.

The table (Figure 2) below sets out the main charges and metrics that firms and clients doing a VFM assessment could consider:

FIGURE 2

	Asset manager	Platform/wrappers	Intermediary
Direct costs	Annual management charge	Platform charge	Advisor charges
	Custody / depositary	Product wrapper charge	Service / activity charges
	Fund administration	Dealing	
	Fund accounting		
	Legal / audit		
	Entry/exit		
	Tax		
	Performance fee		
Indirect costs	Security lending	Cash account balances	
	Execution		
	Slippage		
	Anti-dilution		
	Portfolio turnover		
	Dealing spreads		
	Foreign Exchange		

Step 3: undertake cost assessment
A monitoring and evaluation framework can assist in assessing the reasonableness of the costs and charges data. This framework could include one or more of the following:

1. **A single benchmark figure or range** against which all aggregate (and possibly underlying) costs are monitored.

2. **Asset class or sector specific benchmark ranges**, for example compare the costs of XYZ UK Equity fund against all other funds in the UK All Companies sector.

3. **Individual fund analysis** – time-series monitoring by fund to check for anomalies in the data (eg: fund A incurred indirect costs of 0.20-0.25% for the last three quarters, but this quarter the number is 0.75%).

Although intuitively attractive, having a single benchmark against which all investment management funds/approaches can be compared would be misleading (for example, comparing money market and property funds in the same analysis). A more meaningful approach would be to use a combination of 2 and 3 above. So, a per fund analysis as an initial flag, and then evaluating funds in groups by relevant sector. There may also need to be a distinction made between active and passive funds.

A further consideration is around what data should be included in any monitoring and evaluation framework. For example, should it be just the aggregate costs, or each identifiable data item provided (or both). Best practice should be to monitor each underlying data item as well as the aggregate number. This is likely to be an approach that is worked towards over time, due to the quality/availability of data in the short term.

The table below (Figure 3) shows an example of how a framework could be structured to assess the value of indirect costs. Questions around frequency of monitoring, what action is taken if a fund moves from green to amber etc, would need to be addressed.

2. OUTPUT: RISK AND RETURN

Output is a key component of the assessment of VFM, and risk and return are the fundamental outputs of the investment management industry. Risk and return can be calculated in different ways and can look different when focusing on short versus long horizons. We think it is important that the assessment of risk and return should be focussed on long-term outcomes.

In attempting to create a uniform approach to assessment of output, one needs to consider the wide range of strategies that would need to be covered by this framework and be able to identify which measures are most suitable to a broad fund universe. Some of the difficulties when evaluating return-based metrics are how to deal with different fee structures (fixed vs performance), how to go about netting out fees and dealing with different live performance horizons. Many fund structures have varying fee levels for different share classes and new launch funds have limited live history.

For risk, the most commonly used measures are volatility and market beta, but these lack insight into tail risk. For asymmetric strategies that use options or other volatility instruments, most of the risk cannot be explained with the commonly used measures.

The remainder of this section outlines some issues in the assessment of risk and return in relation to VFM assessment.

Return
a. **Reverse order reporting of performance:** In terms of the return aspect, we believe there are some simple approaches that can foster long termism which will benefit both client, industry and the economy. We would advocate reporting and evaluating performance returns in backward order, starting with 'Since Inception' then 10 year, 5 year and so on. This simple requirement immediately puts attention on long term returns over short term.

b. **Weight to longer term:** To bolster this effort, there could be merit in providing a weighted average number, with bias to the long term e.g. 50%*5Y, 30%*3Y, 15%*2Y, 5%*1Y. This return number would align clients and asset managers alike to focus heavily on long term returns.

FIGURE 3

Sector	Example funds	Total indirect costs		
		Acceptable	Closer monitoring	Take action
European Equity (ex UK)	XYZ European Equity	0.20%-0.25%	± 0.10%	± >0.10%
Global Bonds	ABC European High Yield	0.10% - 0.20%	± 0.05%	± >0.05%

c. **Triangulation:** Using a single compounded metric for return would be difficult to assess VFM overall and instead we would advocate a dashboard showing returns for the overall strategy – as specified above versus 1) the benchmark if relevant, 2) the strategy's peer group and 3) a low cost passive alternative. We recommend asset managers are mandated to provide all three comparisons or give a specific reason given as to why not.

Risk
Measuring the risk taken to achieve returns is vital to the VFM assessment.

In the late 80's and early 90's value at risk (VaR) became a well-known risk measure used by many traders. VaR estimates the potential loss on a portfolio looking at the tail of the distribution. The usefulness of the measure is its ability to compare across different strategies and asset classes. In early 1994 JP Morgan extensively worked on the methodology and publicly published the risk estimates used in the calculation of VaR. Led by the CEO at the time, Dennis Weatherstone, he wanted to understand the risk across the various trading desks and as each used VaR in their own risk analysis, this became the natural choice for looking at the risk of the overall firm book.

Given the compatibility and ease of comparison of VaR, it is used in a number of regulations such as Basel III and Solvency II, among others. Both of these regulations have been established to ensure the liquidity of the banking and insurance industry.

However, no one risk estimate can give a clear reflection of the risk born by an investor so we recommend a dashboard of risk measures. For a rounded view, risk statistics that could be used include Sharpe and/or information ratio - since inception, ex-post drawdown, Value-at-Risk and a few generic stress test results. Some of these won't be applicable to every strategy and it would be expected that asset managers report under a 'comply or explain' model. Differentiation in risk calculations outside of agreed market standard to be disclosed by the asset manager with rationale.

Worked example
Consider two example European equity strategies with £100m in assets. In the assessment of VFM we need to assess each strategy's output – risk and return – which could be done in a format along the lines shown below.

FIGURE 4

	Portfolio A	Portfolio B
Returns metrics		
Since Inception	3%	5%
10 year	NA	5%
5 year	NA	3%
3 year	5%	1%
1 year	1%	-3%
Return Composite	2.5%	3.5%
Benchmark	4%	4%
Low cost alternative	4%	4%
Peer Group	3.5%	2%

Risk metrics		
Information/Sharp ratio	0.4	0.6
Monthly VAR 99%	2.5%	4%
Drawdown	-8%	-12%
Stress – GFC	-15%	-18%
Stress – Tech bubble burst	-12%	-21%
Stress – Ruble crisis	-6%	-9%

For the investor, Portfolio B looks really appealing having delivered weighted comparative returns of 3.5% pa compared to Portfolio A's 2.5% pa. However, Portfolio B is riskier than Portfolio A having a higher VAR of 4% vs 2.5%, historically has experienced larger drawdowns and the simulated stress tests are significantly bigger.

For an investor who does not have the appetite for that level of risk Portfolio A would potentially be more suitable, even though B has provided higher risk adjusted returns.

[3] *For those strategies which have incentive fees, we would advocate using Black-Scholes method to dermine the value of the incentive component allowing a more like-for-like comparision.*

3. SERVICE AND QUALITY

These are various services and features that may differentiate investment management offerings that are otherwise comparable in terms of risk and return, and hence be part of the consideration of value. The client may feel these features are worth paying a premium for, though assessment of the features is mostly judgement based and qualitative means, and the reasonable premium to be paid is also a matter of judgement. In short, different clients will place different value on the same services and features because of their own individual priorities and circumstances.

i. Clarity and consistency of investment process
Clients are likely to be more confident in the future returns from an investment process that is clearly specified and consistently followed. It should be clear how the process is applied and any changes to the process should be explained.

ii. Quality of governance and internal controls
Clients are likely to value good governance of the investment services they are purchasing, whether a fund or a mandate. For example, the existence of an experienced and independent fund board can give clients confidence that the manager will be challenged and held to act in the best interests of the clients. As with most of the quality and service features discussed here, evaluations of experience and independence will be subjective.

Governance should apply to operational delivery as well as to the investment process. The service provider should comply with applicable laws and regulations. Procedures should be documented, communicated and subject to regular review. Audit and independent review can be part of the process of giving clients confidence in the quality of governance and internal controls.

iii. Efficiency of administration
Clients will value accurate and efficient administration, for example, subscriptions and redemption transactions. It is important to define key performance indicators and evaluate performance against the KPIs on a regular basis. Failure to meet the KPIs could be a negative indicator in the assessment of VFM. Benchmarking can also take place, comparing the service standards with comparable organisations. A comply or explain approach could be relevant, for example explaining any short term deviations from KPIs or comparators.

iv. Quality and timeliness of reporting
Investors will be likely to value provision of clear, accurate and useful reporting that provides insight to stated investment process and the returns delivered. Some clients may place great value on (say) real-time web-based reporting, whilst others might be content with more traditional written updates and performance reports. The client may have bespoke reporting requirements that require incremental work and hence warrant a higher than standard fee.

v. Access to advice, insight, and thought leadership
The client may value receiving wider investment insights from the manager as part of the service over and above the insight delivered directly as part of the portfolio management. These could form inputs into and challenge to the client's own wider investment decision making, e.g. strategy and asset allocation.

vi. Quality and effectiveness of asset stewardship
Diligent stewardship of the assets in the portfolio (i.e. share voting and engagement) should serve to improve risk and return over the longer term and hence can be a valuable feature of the services delivered by the asset manager.

vii. Integration of ESG and sustainability in the investment process
Similar to the stewardship arguments, including assessment of ESG issues in the investment decision making for process for the portfolio could be expected to improve the risk and return characteristics over the longer term. Some clients may value inclusion of this perspective over and above the direct impact on return and realised risk.

This section in the VFM assessment allows consideration of reasons beyond risk and return of why the costs of one product or service may be higher than another. However, as mentioned earlier, VFM is in the eye of the beholder and the material benefit of each of these would be subjective for each client to determine whether the additional cost is warranted.

Bringing it all together

As we have highlighted earlier, the difficulty with any consideration of VFM is that it is inherently and heavily related to context. Individuals and institutions each have different perceptions of what creates value for them.

This can be seen even in the differences within the requirement outlined by the various regulatory bodies shown in the examples table on page 4 (figure 1).

Complex and multi-faceted

An assessment of VFM is a useful means by which the investment management industry may gauge client satisfaction and by which clients may evaluate the services they receive. However, though it may be intuitively appealing to adopt a single, simple measure, we consider this to be an unhelpful objective. The fact that there are multiple elements to assess, combined with the significant differences which exist within each of these elements and the difficulty of benchmarking products and services with different levels of investment complexity, makes it unrealistic to try to shoe-horn everything into one yardstick.

Three main elements

As outlined above, when making their assessment of VFM, a client is likely to focus on three elements, namely; the generation of an attractive, risk-appropriate return over a timescale compatible with the investment horizon of the investor, net of costs but inclusive of the perceived service benefits received.

Risk-adjusted return

Intuitively, the perception of VFM is more likely to be positive when the investment returns generated meet the investor's objective. Thus, an assessment of risk-adjusted performance is clearly an important factor. However, while this may be widely accepted, the calculation of a single metric applicable across a wide range of investment products / services is fraught with difficulty.

Long-term investment horizon

As we argue above, we would encourage taking a long-term assessment of return, though we recognize that it is very difficult to get many clients to do this, particularly if faced by a period of underperformance early in the relationship. It is also the case that, even when a long-term approach is taken, the difference in time horizons over which the investment objective is expected to be achieved may be materially different from product to product and client to client.

A Risk 'Dashboard'

Associated with this, the choice of an appropriate risk metric is also not without its difficulties. Investors have different attitudes to risk – some will expect their manager to take more risk, other to reduce it. While VAR has become widely used and accepted, it is not necessarily the best metric in all cases which leads us to conclude that a mix of measures may be better, assembled in a bespoke dashboard agreed with the client to meet their requirements.

Cost must be viewed in context

The level of costs incurred by an investment management product or service varies, in part dependent on both the scale and complexity of that product or service (e.g. bundled or unbundled) along with the level of investor protection and corporate governance provided. The level of cost incurred by a large index Exchange Traded Fund (ETF), we would expect, will be heavily influenced by the level of variable costs - such as the AMC - rather than the fixed costs which at large scale should be a minor factor in the determination of the overall cost to investors. In the case of a small (e.g. sub £100m) active fund, the impact of fixed cost on the overall level of costs is still likely to be significant as, of course, will the variable costs.

The value of independence, governance and high quality administration

In deciding which asset manager offers better VFM, not only would a client be likely to consider what returns they are achieving but also, in return for incurring those costs, what level of quality and reassurance is provided. For example, if the smaller active fund had engaged top tier administrators, custodians and auditors along with assembling a genuinely independent board, while proportionately more expensive, this might be deemed by the client as an expense worth paying, particularly if the fund was following a complex strategy. One would also hope that in circumstances such as this the independent board would itself be concerned to ensure that over time, the value delivered to the investor was acceptable and measurable.

Investor reporting

The perceived value of investment management may be enhanced by the fact that the level of service the client receives both in the provision of the product itself and ancillary services is high. Timely, articulate and transparent reporting is likely to aid a client's perception and understanding of the risks taken and performance generated thereby adding value. The provision of broader market commentary and / or thought pieces in other areas may also be a valuable element of the service offered, albeit very difficult to measure.

Benchmarking

A key element of each component above is the extent to which they can be benchmarked individually. In the case of risk-adjusted return, the industry is reasonably used to doing this, though as we highlight above, there is a strong case for emphasizing longer term returns when benchmarking performance both versus absolute and peer comparators.

Benchmarking of costs is, in one sense straight-forward via the use of a TER / OCR metric. However, when considering VFM, one might want to consider the extent to which certain costs are more obviously to the benefit / protection of the client than the profits of the manager. The use of a large-scale passive ETF comparison may be both simple and effective, though we would note that there remain significant differences in the cost structures of many such ETFs. Benchmarking the service component is very difficult and may best be done by the use of client survey results, either by the manager themselves or third-party providers.

Thus, an individual investor who simply wants to achieve an equity-type return over a ten-year time horizon from an active manager should be able to use a relatively simple approach in assessing the VFM provided by comparing the return, cost and service components to those which would have been achieved had they chosen a large passive ETF. On the other hand, a pension fund seeking to compare the VFM delivered by two managers following complex but different strategies are likely to use a more detailed set of measures in forming their opinion. The box below provides on perspective for weighing value and cost for active funds.

Given the importance of the context in which the client is making both their initial choice and ongoing assessment, rather than seeking to create a single metric to measure VFM, we would favour a more modular approach in which it is the investor's circumstances and objectives combined with the complexity and volatility of the investment product which determines the specifics of the assessment. What would, however, be very helpful, is that a common framework is established within which the investment management industry and the various regulatory bodies can work to produce consistent and meaningful assessments appropriate to the product and / or service being delivered.

Applying VFM to active fund management

One approach that could form part of the VFM assessment for active fund managers would be to define the VALUE (V) they generate as the difference between the performance of their fund (before management fees) and the performance of a passive index fund investing in similar assets, net of the passive management fee. VFM could then be assessed by comparing the fees or MONEY (M) paid by the client for the active management of the assets with the overall value added V.

Defined like this, the relationship between M and V can then be expressed in a number of different ways. For example, VFM could be defined most simply as: V/M , or the units of value generated by the manager per unit of fees charged. Any VFM score over 1 would indicate that the manager has outperformed by a sufficient amount to cover their fees charged.

A more useful way to present the information would be to consider the problem from the client's perspective. What proportion of value generated, over and above a passive equivalent, is left for the client after the manager has been paid?

We can calculate the Client's Share of Outperformance ('CSO') as follows:

$$CSO = \frac{(V - M)}{V}$$

To see how this might be used in practice, consider the following three hypothetical manager return histories. The VFM and CSO calculations have been added for each.

As the data shows, Manager B has generated the higher VFM even though Manager A charged lower fees and Manager C had better gross performance. Using CSO provides a more balanced perspective when choosing managers rather than simply looking for the lowest cost or highest performance.

There are limitations to this approach. In the example above, Manager C's higher fees may be justified by other qualitative factors that are not captured in the calculation. Similarly, it ignores the level of risk taken to generate returns, and no calculation can help with real challenge of assessing the manager's ability to generate value in future. Obviously, the approach can't help assess VFM for a passive fund. The suggested approach does nevertheless, provide a useful starting point for further discussion of the value created by an active fund, providing a means of looking through different fee structures and performance.

FIGURE 5

%		Scenario		
		A	B	C
Gross Returns	G	5.25	6.50	7.25
Passive Equivalent	P	5.00	5.00	5.00
Gross Out / (Under) Performance	(G-P)=V	0.25	1.50	2.25
Manager fee	M	0.30	0.75	1.75
Net Returns	G-M	4.95	5.75	5.50
Net Out / (Under) Performance	V-M	(0.05)	0.75	0.50
Value for Money	V/M	0.83	2.00	1.29
Client share of Outperformance	(V-M)/V	N/A	50%	22%

Standardised reporting

The introduction of various regulations at both UK and EU level, coupled with other industry initiatives, have led to the development of a number of data exchange templates to support the consistent delivery of cost, charges and performance information. These templates form an important part of the wider assessment of VFM because they are often the first step in ensuring the data used to perform any value analysis is robust and comparable. This in turn should lead to a higher level of trust in the outcome.

The table below lists the main templates currently (or soon to be) in use by the asset management industry:

FIGURE 6

Name of template	Development body	Coverage	Link
IDWG Templates	Institutional Disclosure Working Group (FCA)	Institutional mandates (including private equity, physical assets, custody)	https://www.fca.org.uk/publication/documents/summary-idwg-recommendations.pdf
European MiFID Template (EMT)	European Working Group	Investment products subject to MiFIDII	https://www.theinvestmentassociation.org/investment-industry-information/data-exchange-frameworks/
European PRIIPs Template (EPT)	European Working Group	Insurance products required to produce PRIIP KIDs	https://www.theinvestmentassociation.org/investment-industry-information/data-exchange-frameworks/
Defined Contribution Pensions Template (DCPT) Fair Value Pricing Template (FVPT)	Association of British Insurers / Investment Association	UK DC workplace pensions	https://www.theinvestmentassociation.org/investment-industry-information/data-exchange-frameworks/
Local Government Pension Scheme Template	LGPS Advisory Board / Investment Association	UK Local Government pension schemes	http://lgpsboard.org/index.php/the-template
Institutional Limited Partners Association Reporting Template	Institutional Limited Partners Association	Private equity	https://ilpa.org/reporting-template/get-template/

Conclusion

VFM is a clear area of regulatory focus and regulation is driving asset managers and clients to think about how to assess value. But VFM can serve a wider purpose in terms of helping build trust and confidence in the asset management industry and its ability to beneficially serve its clients.

We argue in this paper that while there is no single metric likely to capture VFM, there is merit in having a consistent framework for assessment. Broadly, clients are likely to focus on generation of an attractive risk appropriate return over a timescale consistent with their investment objective, net of all costs, but taking account of quality of service. The analysis should be long-term in nature.

As stressed at several points, VFM is not all about cost. It is about what has been received – investment return and wider service benefits – in relation to the charges paid. Different clients may weigh these aspects different in their assessment.

Finally, we note some remaining challenges. VFM assessment is fairly new and it will take time to establish a common understanding between asset managers and clients. We recommend early and regular engagement between the parties (or their advisers) to define the required parameters.

The regulatory environment can help to build this framework. It should not be so prescriptive as to be one size fits all, but at the same time if we can harmonise requirements across sectors – for example, we now have somewhat different requirements across trust-based, and contract-based DC pensions, and UK regulated funds - it will help to build understanding and foster constructive dialogue on the issues at the heart of VFM.

Further reading

Relevant previous CFA UK publications
CFA UK Position Paper on the Value of the Investment Profession (April 2016)
https://www.cfauk.org/-/media/files/pdf/professionalism/value-of-the-investment-profession-report.pdf

CFA UK Position Paper on Fees & Compensation (April 2013)
https://www.cfauk.org/-/media/files/pdf/pdf/5-professionalism/3-research-and-position-papers/fees-and-compensation.pdf

Relevant previous CFA Institute publications
GIPS (Global Investment Performance Standards) (effective from 1st Jan. 2011)
https://www.gipsstandards.org/Pages/index.aspx

Principles For Investment Reporting (Second Edition 2014)
https://www.gipsstandards.org/utility/pages/search_results.aspx?k=principles%20of%20investor%20reporting&s=GIPS

A Murder on the Orient Express: The Mystery of Fund Underperformance (2012) by Charlie Ellis, CFA
https://www.cfapubs.org/doi/pdf/10.2469/faj.v68.n4.2

Regulatory publications
The Pension Regulator: A Guide to Value for Members (July 2016)
http://www.thepensionsregulator.gov.uk/docs/dc-vfm-guide.pdf

Pensions and Lifetime Saving Association: Assessing Good Value for Members (December 2015)
https://www.plsa.co.uk/portals/0/Documents/0558-Assessing-Good-Value-for-Members-A-Good-Practice-Guide.pdf

Pension Policy Institute: Value for Money in DC Workplace Pensions (May 2016)
http://www.pensionspolicyinstitute.org.uk/uploaded/documents/2016/201605%20PPI%20Value%20for%20money%20in%20DC%20workplace%20pensions%20-%20executive%20summary.pdf

FCA: Consultation on further remedies – Asset Management Market Study
https://www.fca.org.uk/publication/consultation/cp18-09.pdf

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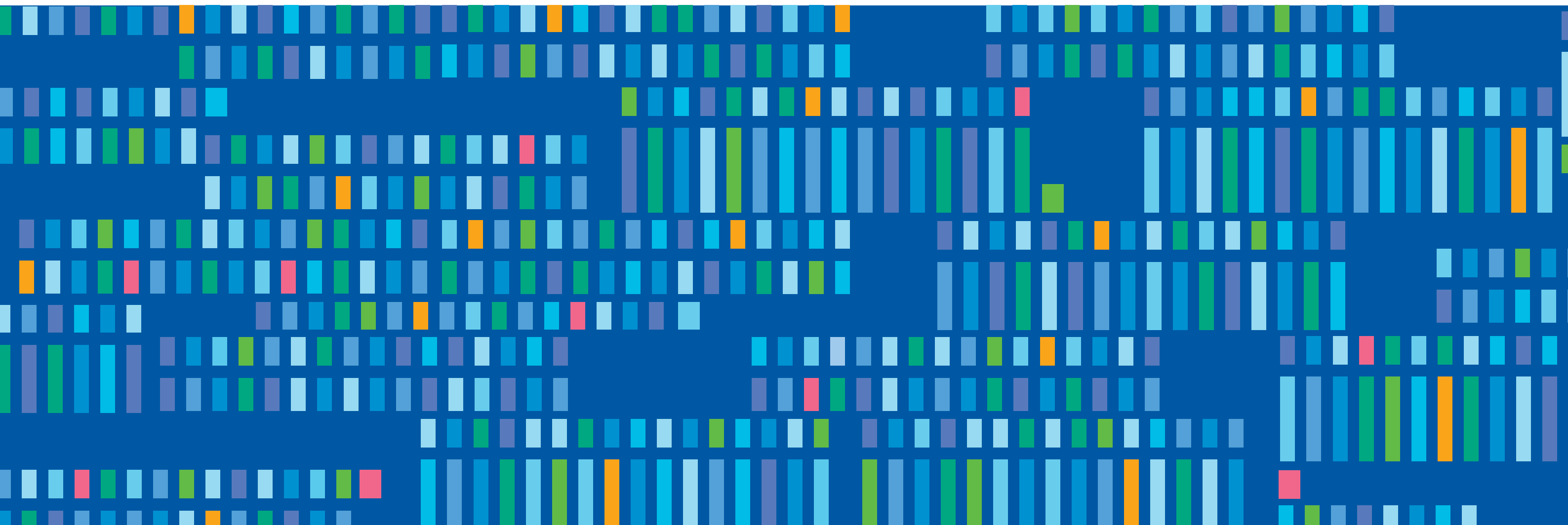

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