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Public Response to FCA DP21/3

Submitted on 10th December 2021 **by email** to **VFMdiscussionpaper@fca.org.uk**

Dear Sirs,

Morningstar welcomes the opportunity to comment on the joint discussion paper about driving value for money in DC pension schemes. Morningstar's primary mission is to empower investor success and has an extensive line of products for individual investors, professional financial advisers, and institutional clients.

Morningstar researchers have commented positively about the FCA Assessment of Value rules that have applied to authorised funds since 2019. We have viewed them as a very positive addition to fund governance and to investor documentation and seen them already yield benefits to investors and expect continued enhancements as the process continues.

Bringing a similar discipline to the DC market, which, for many people, houses their most significant pool of investment assets, is a welcome development. Indeed, since many investment options in DC schemes are into underlying authorised funds, a part of the reporting requirements could usefully be to include the result of the most recent value assessment for each such fund, or at least those that have been identified as not offering value, or been put on watch.

Our most detailed comments centre on the performance questions. In regard to customer service and scheme oversight, we agree that quality of communication is a valid factor to include in the assessment of value. Other factors, such as administration and governance, are, in our view, table stakes for any pension provider. Measuring the extent that these services exceed regulatory minimums can be largely subjective and, in the context of the long-term nature of pension savings, of less importance than cost and performance, assuming that investors have access to a good range of fairly priced investment choices that are provided with efficient means for them to switch holdings and contributions.

Regarding costs, we suggest that one of the most beneficial outcomes would be to enable Independent Governance Committees, or IGCs, and Governance Advisory Arrangements, or GAAs, and ultimately investors, to easily ascertain the additional costs over and above those of the underlying funds into which they are ultimately investing. Other rules, notably MiFID II and PRIIPs, already shine light on the costs of authorised funds which many DC plans offer as investable options to their DC policyholders. Being able to identify the comparative costs of investing via a DC plan versus an underlying fund directly (for example in an ISA) would help investors determine the most cost-effective channel through which to maximise their savings.

On behalf of Morningstar, we again thank you for the opportunity to contribute and will be happy to engage further, answer other questions or provide additional information that may be helpful.

Yours faithfully,

Andy Pettit, Director, Policy Research (EMEA) : Lia Mitchell, Senior Analyst, Policy Research

Chapter 3: Investment Performance

Q1. Do you agree that consistent disclosure of performance is necessary to enable better decision making?

Pension savings will often be, or become, an individuals' largest pool of savings. As such, consistent disclosure of performance is vitally important. As well as providing an individual with information on their returns, it will facilitate comparison with alternative schemes and relevant benchmarks. While switching schemes as a result of poor performance would not be a common step, any relative underperformance could be a contributory factor in individuals taking more interest in, and control of, the investment choices into which their contributions are invested.

Providing context for investment performance in the disclosure is also vitally important to enabling investors to make better decisions. As the CFA notes, "Performance evaluation cannot be conducted in a vacuum. By its nature, performance evaluation is a relative concept."[1] To ensure the disclosure empowers investors to understand their pension performance, the performance of a reasonable benchmark should be included. This is further supported by behavioural research, which has shown that anchoring bias results in "placing too much weight on an initial piece of information."[2] In this case, the bias could work in the favour of investors, as a disclosure with the performance of both their investment and a benchmark provides a better basis upon which they can anchor a decision than their investment performance in isolation.

Disclosures Net of Costs

Q2. Do you agree that comparisons should be of net rather than gross investment performance?

Costs are an integral component of the performance an investor receives, as they directly reduce the gross return achieved by their investment manager. We therefore agree that comparisons should be based on net of cost returns. Particularly in the unit-linked DC market, the same underlying investment fund may be available in multiple pensions plans offered by different providers. Comparing net returns of such products will help illuminate which schemes are levying higher plan charges and/ or have negotiated more or less attractive fees with the underlying fund provider.

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[1] Bai-Marrow, A., & Radia, S. 2017. Benchmarks and Indices. https://www.cfauk.org/professionalism/research-and-position-papers/benchmarks-and-indices#gsc.tab=0

[2] Villanueva, M.C. "How Does Anchoring Impact Our Decisions?" *The Decision Lab*. https://thedecisionlab.com/insights/consumer-insights/anchoring-influence-daily-decisions/

Morningstar research[3] has repeatedly identified lower costs as the biggest indicator of outperformance[4] and funds that perform slightly worse than peers but with lower costs can be a better option to maximise investor value over the long-term.

Q3. Do you have any suggestions on how to make disclosure of net investment returns effective given that there may be varying charges for the same funds within multi-employer schemes? For example displaying a range, or requiring disclosure of each different level of net investment performance.

Any disclosure provided to individuals should be focused on the investments they hold and the costs they experience. This might be usefully supplemented with equivalent data for the full range of investment options open to them within their scheme. This would provide the ability to compare what returns would have been available via different investment objectives, assets and geographies, and might in turn contribute to some individuals moving some of their assets away from the default option.

Disclosure of investment returns from multi-employer schemes to governance committees, trustees and boards should ideally provide returns for all instances of fee levels that are offered. Alternatively, to avoid situations where the highest or lowest fee levels are in reality only available to a small number of schemes or employers, bands could be displayed, indicating the proportion of firms that receive the returns in each band.

Q4. Would it be helpful to mirror the DWP's approach in terms of the reporting periods?

We agree that consistency across schemes, and a range of time periods are both helpful, although there are a few other factors that should be considered.

First, most pension savings are in the form of monthly savings, so providing returns on that basis, as well as time-weighted returns based on a lump sum initial purchase, would generate a return more similar to what the investor has experienced.

Second, in the unit-linked pension market, any given investment options tend to have multiple series, where each series was open to investors who commenced their pension policy at a point in time but will subsequently be closed to new scheme members at such time as fees are amended. Newer members would be invested into a later series of the same fund, but which applies the new charges, higher or lower, that were in effect at that time. This significantly multiplies the actual number of investment options available within a scheme and that might need to be reported on and investors will need to know in which series their pension savings reside.

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[3] Boyadzhiev, D., & Garcia-Zarate, J. 2020. Morningstar European Fee Study, Dec 2020. https://www.morningstar.com/en-uk/lp/european-fee-study

[4] Russel, K. 2016. "How Fund Fees are the Best Predictor of Returns." October 4, 2016. https://www.morningstar.co.uk/uk/news/149421/how-fund-fees-are-the-best-predictor-of-returns.aspx

Third, newer funds may have a perceived advantage in the event they are only old enough to present one time period, and/ or they have lower charges than older series. Track record extensions, or chain-linked performance, is common, but not comprehensive in these instances and it's important that supporting information explains what that data is portraying.

Lastly, some years ago, the Association of British Insurers devised an 'I-net' methodology in an effort to put funds from different providers on a level-playing field in terms of a consistent net-of-charges return stream, regardless of which charges are deducted from the fund and which from the scheme. Many such series continue to be published.

The case for Disclosing more than One Metric per Scheme

Q5. Would publishing a set of metrics based on age cohorts bring investment performance reporting closer to the saver's investment performance experience of a pension scheme/product? If not, is there a better alternative we have not considered?

We agree that metrics on scheme performance could be made more relevant by providing them based on age cohorts, however a consistent methodology for these calculations will be needed to allow IGCs, GAAs, and investors to compare schemes. As mentioned in the discussion paper, savers at different ages are likely to have different investment profiles in terms of risk and asset allocation based on their time to retirement. Performance metrics that cut across the entire scheme are therefore limited in reflecting the investment experience of most savers in the scheme if there is a wide range of ages in the workforce. Additionally, schemes could have different approaches to blending the performance of the different stages of the glidepath, making comparison between schemes ineffective.

Q6. When considering which age cohorts to consider, is the example we have provided appropriate? Alternatively, would it be more effective to mirror the DWP's approach?

Approaching the set of metrics from either the perspective of age to retirement or age of individual could be effective, but more defined cohorts or ages are likely needed to allow each stage of the glidepath to be presented distinctly.

Q7. What disclosures, if any, should be made for self-select options?

Disclosure of investment performance for self-select options is important to ensure IGCs, GAAs, and investors can evaluate the performance of all investments that may be in their portfolio, however, there are likely no scheme-level metrics that would be relevant for these options.

Risk-adjusting Return Figures

Q8. Do you think reporting based on age cohorts would be enhanced through the use of risk-adjusted returns as an element of a scheme's VFM assessment or would risk-adjustment then be unnecessary?

We agree that risk-adjusted returns could be a useful element of a scheme's VFM assessment, particularly for IGCs and GAAs. When reporting on the scheme and investment options to investors, we are wary that reporting multiple return types over the same periods may create unnecessary confusion. Instead, we suggest aligning the risk reporting for investors with the risk measures reported by PRIIPs or UCITS, facilitating easier comparison with investments held through other channels and providing a consistent metric for savers.

Q9. If risk-adjustment is used, what risk-adjustment metric(s) would you suggest? For example, the Sharpe ratio as i) a standalone factor, or ii) in combination with other risk metrics?

One of the challenges with risk-adjusted returns is explaining them in understandable terms to investors.

The Sharpe ratio as a standalone metric can be counterintuitive for investors as two funds with equal average excess returns will flipflop between receiving the higher and lower score depending on whether the average excess returns are positive, equal, or negative. When positive, the fund with lower volatility receives the higher Sharpe ratio score, but the opposite is true when average excess returns are equal or negative, the fund with greater volatility receives a higher score.

Standard deviation is another measure of risk that may be considered; however, it can be a poor measure of fund volatility on its own and, again, may increase investor confusion. Risk-adjusted return measures based on standard deviation assume risk is fully captured by standard deviation, which is only the case if excess return is normally or lognormally distributed. However, this is not always the case. Further, standard deviation does not differentiate between variation above and below the mean, but investors generally dislike downside variation more than upside variation.

Various alternatives exist, including, by way of example, the Morningstar risk-adjusted return based on expected utility theory to model how investors trade off return and risk.[5] We believe this is a more intuitive risk-adjusted metric for investors than many standard ones.

Another alternate, as mentioned in our response to Q8, the PRIIPs or UCITS risk indicator could be utilised for consistency.

Q10. Is there any reason why it would be impractical to report on risk-adjusted performance metrics in addition to providing a metric based on actual performance returns?

While IGCs and GAAs would likely find both important in assessing a scheme's VFM, reporting both risk-adjusted and actual performance metrics could increase investor confusion if not explained and presented properly.

[5] Morningstar Methodology. 2021. The Morningstar Rating™ for Funds. https://www.morningstar.com/content/dam/marketing/shared/research/methodology/771945_Morningstar_Rating_for_Funds_Methodology.pdf

Q11. What are your views on presenting returns as an annual geometric average to provide consistency with the DWP's requirement?

Aligning with existing disclosure requirement simplifies the reporting process and can aide investors by providing consistent metrics for them to consider. Additionally, returns are commonly presented as an annual geometric average on disclosure investors receive when investing through other channels. For these reasons, including annual geometric average returns for the periods would be a helpful component of a scheme's VFM assessment

Comparisons and Benchmarking

Q12. We would welcome views on how you see this developing. Would it be helpful/possible to establish a benchmark, or would you prefer to compare cohorts against a market average or against a few selected similar schemes? If so, how would that selection be made?

We believe it is important that such benchmarks should reflect investable alternatives to the product being benchmarked. Category or peer averages do not achieve this, and it would be helpful for a range of benchmarks to be developed that align with the age cohort statistics referred to in Q5.

Q13. Do you think a commercial benchmark is likely to emerge if these data are made publicly available?

As data becomes more readily accessible on the costs and performance of investments in schemes, we think these are likely to emerge, however the quality of these will depend significantly on the data that is made available. For example, without information on how assets are distributed amongst the investment options of a scheme, benchmark costs can't account for how investors are using the scheme. By way of example, benchmarks for pension costs exist in the U.S. in part because assets in the investments are reported on an annual basis for plans with over 100 participants, allowing third parties to calculate a more accurate asset-weighted average.

Similarly, third parties developing commercial benchmarks would need data that captures the usage of the investments in schemes to ensure the benchmark aligns with the asset allocation, risk, and goals of the scheme. While IGCs and GAAs may have this data currently, they do not always have the expertise to develop their own benchmarks. Ensuring the necessary data is made publicly available will enable third parties to aide IGCs, GAAs, and investors by developing high quality, data-driven benchmarks.

Chapter 4: Customer Service and Scheme Oversight

Q14. Do you agree the quality of communication is a relevant factor to consider in VFM assessments?

Quality of communication can be a relevant factor in VFM assessments given the impact it can have on investor behaviour. As one example, research has shown that the timing of financial education is significant in determining its effectiveness.[6] Schemes that provide just-in-time notification and education to investors may deliver better outcomes at the same or reduced cost, creating greater VFM. While we acknowledge quality of communication can affect a scheme's VFM, measuring and assessing it consistently is a challenge. There are many elements to assessing the quality of communication, such as content, accessibility, and timing to name a few, and measuring these individually and collectively may require an overly complex framework.

Q15. Do you agree administration is a relevant factor that contributes to long-term VFM?

While administration is important, we would argue that most investors have only occasional engagement with their providers and the quality and experience of that engagement does not merit equal billing with the much more consequential issues of performance and cost.

Q16. Do you agree the effectiveness of governance is a relevant factor that contributes to long-term VFM?

Governance is clearly important, and subject to specific regulatory requirements. Discerning the difference in governance practices above these minimum requirements is difficult to measure and ultimately significantly reflected in scheme performance and cost.

Q17. In your opinion, are there any obvious service standards missing from the above list? Please explain how your suggestion contributes to scheme value.

These may be incorporated within the 'administration' umbrella but in our view, key elements for investors are the ability to view and redirect their contributions; switch investments between fund choices; view online valuations; receive relevant communications on a timely basis; and be well signposted on how they can get further information or advice.

Q18. Do you agree this is not a role for the regulators at this stage?

Morningstar's view is that if service metrics are to become a formal element of assessing value for money, regulators should be involved in scoping and defining the parameters and in reviewing proposed solutions. Without this, we contend that service should not form a formal part of the assessing because each provider may justify the quality of their service in different ways. While this can contribute to evolving best practice ideas, it will not in the short term

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[6] Fernandes, D., Lynch, J. G., Jr., & Netemeyer, R. G. 2014. "Financial Literacy, Financial Education, and Downstream Financial Behaviors." *Management Science*, Vol. 60, No. 8, P. 1861-1883. https://pubsonline.informs.org/doi/abs/10.1287/mnsc.2013.1849

provide a useful comparison for IGCs, GAAs, and investors. A similar scenario has been seen in the authorised fund market, as identified in the FCA July 2021 review.[7]

Q19. Would it be helpful to appoint a neutral convenor to develop a service metrics standard? If not, who do you think should create metrics on service in pensions?

We could see some limited value in continuing to explore methods to develop standardised service metrics, between industry participants and other third parties.

Q20. Do you think that over time independent certification against a standard is worth exploring for benchmarking service metrics? If not, what alternative arrangement would you suggest?

In our view this should not be considered in detail until such time as there are some more concrete and viable metrics proposals.

Chapter 5: Costs and Charges

Q21. Should we use the existing administration charges and transaction costs definitions in developing VFM costs and charges metrics?

While we agree that consistency with existing cost definitions will simplify disclosure for investors, we support separating the administration charges into fund management and pensions administration. The additional transparency will enable IGCs, GAAs, and investors to assess the VFM of each of these and to more easily compare costs with investing through other channels (for example in an ISA).

Q22. Would splitting out the administration charges be a more useful metric? If not, are there other definitions you think would be more appropriate?

We agree that splitting out the administration charges would be a more useful metric. As the basis of administration charges could differ, distinct reporting would allow for each to be represented clearly. While fund management is generally charged as a percentage of assets, pension administration could be a set annual amount. As savers' pensions grow, the value of a set pension administration charge grows, and this may not be apparent to savers if the charges are only reported on a percentage of assets basis.

Additionally, this would facilitate easier comparison with investing outside the DC scheme where there could be variation in costs at both the fund management and account administration levels.

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[7] FCA. 2021. Authorised fund managers' assessments of their funds' value. https://www.fca.org.uk/publications/multi-firm-reviews/authorised-fund-managers-assessments-their-funds-value

Benchmarking

Q23. Do you agree we should introduce benchmarks for costs and charges?

With public reporting of the costs and charges assessed by both schemes and the investments within schemes, the industry will likely develop benchmarks for costs and charges as well as those for performance discussed before. This has been the case in other markets, such as the U.S. where workplace pensions file an annual report with the Department of Labor. These reports have been filed exclusively electronically since 2010 and are available for anyone to download online. As a result, several companies, Morningstar included, process these filings to extract information on the pension system, including the costs of the plans and the investments utilized within the plans. While not all pensions are required to disclose their investments, a sufficient number do that reasonable benchmarks for costs and charges can be determined. We agree that benchmarks for costs and charges are helpful in evaluating a scheme's VFM and expect they would be created should the necessary information be made more accessible.

Q24. What are your views on our suggested options for benchmarking costs and charges? If not these options, what benchmarks should be used?

We agree that tailoring benchmarks to address a reasonably similar cohort of schemes is necessary to ensure they provide a relevant comparison. Segmenting benchmarks by workplace and non-workplace pension products is reasonable given the different environments and scales these products operate under. As discussed in our response to Q23, benchmarking of workplace pensions in the U.S. is done by multiple firms, and the common approach is to segment the market by the assets of the plans. As the proposal mentions, economies of scale can provide schemes certain advantages in pricing, so comparing the costs of all schemes, regardless of size, could set an unachievable benchmark for smaller schemes.