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Retail Distribution Policy
Financial Conduct Authority
12 Endeavour Square
Canary Wharf
London E20 1JN

Submitted by email to PRIIPsCfI@fca.org.uk

Dear Sir or Madam,

Morningstar welcomes the opportunity to respond to the PRIIPs Call for Input. Morningstar's primary mission is to help investors reach their financial goals. Because we offer an extensive line of products for individual investors, professional financial advisers, and institutional clients, we have a broad view on the proposals to improve the quality, comparability, and robustness of information available to investors.

Much of our response stems from our screening and analysis of data that we have collated on around 50,000 classes of PRIIPs, predominantly category 2. We shall be happy to share more of this data or conduct further analysis on it if it can assist your ongoing work.

We hope the response is helpful, and we would be happy to discuss it with you further.

Yours sincerely,

Andy Pettit
Director, Policy Research

PRIIPs Call for Input Questions and Answers

Q1: Are you experiencing problems with clarifying the scope of the PRIIPs Regulation? Please provide examples of product types where you believe there is uncertainty as to whether they are in scope.

This question is not directly related to Morningstar, though, in our capacity as a data aggregator, we have seen isolated examples of PRIIPs KIDs being published by UCITS. These KIDs are published in addition to a UCITS KIID, so, whilst these funds are fulfilling their UCITS obligation, it raises a technical question as to whether products that are not required to (including UCITS, prior to 2020) can choose to publish a KID. We don't think this is the case and believe that it could cause confusion to investors that may warrant a re-statement of the rules.

Q2: Have you tried to resolve this uncertainty and faced difficulties in doing so? If so, please provide details and examples of the difficulties you have faced.

Not applicable.

Q3: Have any of your calculations of transaction costs under the slippage methodology led to negative, zero or unexpectedly large transaction costs? If so, please provide examples, together with the full calculation of how the output has been obtained and explaining any assumptions that have been made.

Whilst Morningstar does not calculate transaction costs, we have collated PRIIPs data on around 50,000 classes of PRIIPs (and more than 105,000 investment funds publishing MiFID data).

Negative transaction costs have been reported by 2,151 (523 UK-domiciled) classes of PRIIPs. Seventy-five classes of PRIIPs have reported transaction costs in excess of 7%, 66 between 5% and 7%, and 79 between 3% and 5%.

Further, we have seen examples of some UCITS that have calculated transaction costs on both the full PRIIPs methodology and the methodology for new PRIIPs, and in some cases used the latter figure for MiFID reporting purposes. We are concerned this can cause confusion to investors, who may see the same underlying investment available via different PRIIPs showing different transaction costs.

Q4: If you are an investor (or represent investors), what has been your experience with disclosures of transaction costs? Have you found these disclosures helpful in making your investment decision? Conversely, have you come across disclosures of costs which you found difficult to understand, or which you felt unable to rely on? Please provide supporting examples and evidence.

The disclosure of transaction costs is a helpful addition to cost disclosure. From an analytic perspective, they will become another component that Morningstar Manager Research will review as part of its assessment of price when analysing investment funds.

Transaction costs = (explicit costs + implicit costs – dilution levy), and we think that combining the three components into one number, without disclosing the breakdown, limits the value of the combined total. For example, a large PRIIP might have very competitive explicit trading costs but suffer heavy implicit costs. Its total transaction costs may be the same as a smaller PRIIP that has relatively high trading costs and below-average implicit costs. Also, without knowing the dilution levy component, relatively high explicit costs may be hidden because they are being borne by incoming or outgoing investors, and subtracted from the disclosed transaction costs.

Further, providing the information for each of the three years that comprise the published average transaction cost would give insight to the variability and, if one exists, the trend of the costs. This would also help investors by using the same figure that would be shown in MiFID ex-post disclosures, where transaction costs should relate to a one-year period.

Knowing the composition would exert more price pressure on the controllable trading costs and, over time, provide more illumination of the variability of implicit costs and their typical levels for different types and sizes of PRIIPs.

Providing the implicit costs separately could also eliminate criticism of the transaction cost figure and help it gain more acceptance and prominence. Unlike the spread element, the market movement aspect of implicit costs is an opportunity cost, equal to pricing differences over a matter of minutes or hours. While not inconsequential, when considered in the context of PRIIPs that largely have recommended holding periods of at least three, and usually five, years, they should not distort or hide the more controllable explicit costs.

To take an extreme example, in a rapidly rising or falling market, the implicit transaction costs would be minimised by waiting for a price to stabilise before placing a trade. Doing so for a buy in a rising market or a sell in a falling market would not be a good outcome for investors.

Lastly, to give even more context to the transaction costs, we would like to see a reintroduction of the requirement to publish the portfolio turnover ratio. This additional piece of information would give insight into whether the transaction costs were accumulated on a small or large amount of trading relative to other PRIIPs, and even to compute a cost per trade proxy figure. This could contribute further to downward pricing pressure as well as factor into the upcoming value assessments arising from the FCA Asset Management Market Study.

Note, to be useful, turnover ratio should be calculated using the international norm of taking either the lesser of the total amount of new securities purchased, or the amount of securities sold over a period, divided by the total net asset value of the PRIIPs (rather than the old UCITS formula).

Whether our suggested breakdowns and extensions of the data ultimately appear on a KID, we believe publicly available disclosures with a standard taxonomy work best because they empower third parties such as “fintech” and “reg-tech” firms to analyze and contextualize critical information and amplify a call to action for ordinary investors.

Q5: Please provide your views, supported by evidence, on the SRI and on the extent to which the required and optional sections of the risk narratives enable the risks of a product to be adequately explained to consumers.

The SRI is defined as an indicator of the likelihood of losing money, but we see examples of counterintuitive results. For example, over 800 classes (predominantly invested in bonds) with an SRI of 2 show moderate performance scenarios that are negative (and around 180 classes show negative favourable scenarios).

Further, comparison across PRIIPs is not straightforward because

- it is based in part upon the recommended holding period of each PRIIP
- it combines market risk with credit risk
- it is calculated differently across the four categories of PRIIPs and, even within each category, dependent upon data availability

To the first of these points, two PRIIPs with the same return pattern and VaR will have a different VEV (and, conceivably, SRI) just by virtue of the recommended holding period they cite.

On the basis that more clarity, in simpler terms, is better for an investor, we think that the market risk could be expressed in more-explicit terms. For example (based upon a CVaR calculation applied to the fund's prior five years of returns data),

- 'This product has x% chance of losing more than y% over a period of z years', or
- 'Given a £10k investment, there is an x% chance of losing £y'

Presenting the information in this way would have an additional benefit of mitigating confusion caused by expressing the KID measure of risk on the same scale and appearance as the volatility-based UCITS KIID SRRI. This confusion will peak if and when UCITS switch to producing KIDs after 2019, when many will appear as lower-risk investments on the basis of the SRI. A fuller summary can be seen in our response to Q6.

The statement could be supplemented with an indicator of credit risk, enabling investors to easily see which PRIIPs are exposed to credit risk and which are not. The prescribed matrix that determines the SRI from the intersection of market and credit risk, shown below, highlights that a PRIIP with an SRI of 5 might comprise substantially high credit risk and minimal market risk, or all market risk and minimal credit risk, or anywhere in-between.

	MR1	**MR2**	**MR3**	**MR4**	**MR5**	**MR6**	**MR7**
CR1	1	2	3	4	5	6	7
CR2	1	2	3	4	5	6	7
CR3	3	3	3	4	5	6	7
CR4	5	5	5	5	5	6	7
CR5	5	5	5	5	5	6	7
CR6	6	6	6	6	6	6	7

Only 2,234 PRIIPs classes report a credit risk of greater than 1 amongst the approximately 50,000 PRIIPs for which we have collated data. Separating the reporting of the two risks would enable both easy comparison across PRIIPs of the market risk and easy identification and comparison of those PRIIPs exposed to credit risk.

Regarding the risk narratives, the current free-form text afforded to product manufacturers can result in different explanations of the same risks by different manufacturers. Some may contain more jargon than others. Some will catalog every conceivable risk, however remote it is.

We think that these other risks could be better and more consistently explained to investors. This might be via a standard list on each KID, with those relevant to that product being ticked or, alternatively, a set of standard short descriptions of each type of risk from which each product copy and pastes those relevant to it.

Either approach makes it much easier for investors and advisers to screen products that are exposed to particular risks rather than having to read and interpret the documents of many different products.

Q6: Do you have any examples of products where the prescribed methodology for assessing and presenting risk leads to a counter-intuitive or potentially misleading SRI? If so, please provide examples.

We have compared the SRI and SRRI of 38,242 share classes of UCITS and other open- and closed-end investment funds, and over 88% of them will appear as lower-risk products on a KID than on a KIID. The breakdown is -

Number of classes	**SRI minus SRRI**
459	-3 and less
10,156	-2
23,197	-1
3,509	unchanged
224	+1
404	+2
293	+3 and more

The distribution of SRIs across all the PRIIPs for which we have sourced data is -

SRI	**# PRIIPs**	**Observations**
1	1,153	Predominantly money market products but also includes 315 classes across allocation, alternative, fixed income, and property funds.
2	11,895	Predominantly fixed-income products but includes 62 emerging-markets and small-cap equity funds (which have SRRIs of 5 and 6).
3	12,183	Approximately 3,000 allocation, 3,000 equity, 3,000 fixed-income, and a mix of other product types, including six money market PRIIPs.

4	14,236	Approximately 84% are equity PRIIPs. Also includes 233 fixed-income products – emerging-markets debt and, counterintuitively, sterling inflation-linked.
5	1,812	
6	355	
7	179	

Q7: Have you experienced any practical issues with the calculation and presentation of performance scenarios in the KID? If so, please provide details so that we can identify any further practical difficulties not fully contemplated in our statement of January 2018.

The performance scenarios are defined as an estimate of potential returns based on the past performance of each PRIIP. Many studies have deduced that past performance is not an indicator of the future, and we understand that this was the prime reason for excluding past performance from the KID. It therefore seems odd to present scenarios based upon it, using, in virtually all cases, data accrued only during a bull market. Further, the resultant scenarios are not comparable across PRIIPs that have different recommended holding periods.

Analysing one randomly selected fund, a sterling bond fund, we have looked at every annual return to each month-end between 2004 and 2018 and found the actual minimum one-year return was negative 5.07% and its maximum 15.9%.

This compares with the following published scenarios for the same fund.

	1 year	½ RHP	RHP
Stress	-19.54	-6.52	-5.13
Unfavourable	-2.97	-0.23	0.63
Moderate	3.65	3.65	3.64
Favourable	10.71	7.67	6.75

Looking over the entire set of monthly returns for the same fund shows an actual maximum loss of negative 6.7% (negative 24.3% annualised), achieved over a three-month period to November 2016. Its maximum gain was 48.5% (9.2% annualised), achieved over a 4.5-year period to April 2013.

The maximum loss experienced over periods longer than one year (to avoid annualising returns achieved over less than one year) was negative 6.1% (negative 3.4% annualised), achieved over 22 months to the end of October 2008.

Meanwhile, the nature of the scenario calculation formula results in most of the approximately 36,000 PRIIPs that have provided performance scenarios showing:

- In the moderate scenario, the same annualised return for each of the three time periods in the moderate scenario (3,119 exceptions)
- In the favourable scenario, an annualised return greater over the half recommended holding period than for the full recommended holding period (3,368 exceptions)

- In the unfavourable and stress scenarios, annualised returns greater over the recommended holding period than those over half of that period (683 and 2,338 exceptions, respectively).

We think these findings are worthy of further analysis to establish why the exceptions do not exhibit the same scenario patterns. For example, is it due to the nature of their returns; their recommended holding periods; the nature of their charges; a change of investment strategy; how newer PRIIPs have completed the necessary data set; or different interpretation or execution of the calculations.

Regardless, looking at most KIDs and seeing that most PRIIPs indicate a higher annual return over ½ RHP than over RHP is not reflective of reality. We took the Morningstar UK Equity Income sector and looked at the three- and five-year annualised returns to the end of August 2018. There were 162 classes with a five-year annualised return greater than their three-year annualised return, while 214 classes showed the reverse situation.

The following example, whilst extreme, illustrates the meaninglessness of some of the scenario data, showing as it does an annualised return of 5,532,045,700.69%.

Performance scenarios

Investment 10000 USD		0.0027397 years (recommended holding period)
Stress scenario	What might you get back after costs	7 094.94 USD
	Average return each year	- 100 %
Unfavourable scenario	What might you get back after costs	9 140.28 USD
	Average return each year	- 100%
Moderate scenario	What might you get back after costs	9 986.46 USD
	Average return each year	- 28.92%
Favourable scenario	What might you get back after costs	10 733.11 USD
	Average return each year	5532045 700.69%

In our opinion, past performance over standardised periods offer the most comparison to investors. The KIID graphical presentation is effective in this regard, providing an impactful visual showing that returns can be variable and negative. Alternatively, if the intent is to provide an indication of possible gains or losses that a product might provide, then this could be achieved by showing maximum loss and maximum gain over one or more periods.

In our view, the challenges of explaining to investors what the figures mean, the broad range of possible returns and limited comparability, coupled with the complexity and cost of calculation, do not justify the inclusion of performance scenarios for category 2 and 3 PRIIPs such as collective investment funds.

We do think that in the case of category 3 structured product PRIIPs, the performance scenarios do offer an improvement to investors by adding context to the product terms and illustrating more clearly the possible outcomes in different market conditions.

Q8: Have consumers who are using KIDs to make investment decisions encountered any issues with the performance scenarios presented to them?

Not applicable.

Q9: Are there any other experiences with the implementation of (and compliance with) the PRIIPs legislation that you wish to raise with us? Please include evidence to support the points you make.

We are very supportive of increased disclosure of costs in a standardised way. The underlying information that PRIIPs manufacturers must compile is valuable, but the mandated presentation does not maximise its value to investors.

In our view, the disclosure of costs could be enhanced. Consistency with MiFID reporting can provide much more familiarity to investors than getting different documents and underlying data about their investments. For example, the below industry-developed template is, in our view, a much crisper and easier to understand summary of costs than the reduction-in-yield presentation and puts every product on a level playing field by using a standard growth rate. Adding a negative growth-rate scenario would reinforce that PRIIPs might lose value and that there will still be a cost.

Value of £10,000 invested	1yr at 3% pa	5yrs at 3% pa
If there were no charges		
After charges		

Finally, a couple of specific observations on the KID costs are:

- It is highly unlikely that PRIIPs which levy a one-off back-end load or redemption fee will do so over the recommended holding period. Most of these fee structures are on a sliding scale and, logically, will be designed to be zero at and beyond the recommended holding period. Therefore, PRIIPs levying these fees, but with different holding periods, will be at optimal lowest cost at different times, but this may not be immediately evident to a reader of the 'Costs over Time' section of the KID.
- The reduction-in-yield concept is not widely understood. Incorporating initial charges into it and portraying them as an annual cost is not reflective of how an investor incurs them. While they are part of the overall cost, it is not common practice for them to be expressed in this way in other areas of personal finance. For example, a mortgage arrangement fee is not incorporated into the quoted interest rate of the mortgage.

Q10: As a user of the KID what is your overall experience of the information provided? Please provide examples of where the information received is useful in informing investment decisions?

Not applicable.