FI Supervision

Survey of Funds of Funds

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FI supervision

FI supervision Finansinspektionen frequently publishes supervision reports in a numbered series. These supervision reports are part of FI's communication. The reports describe the investigations and other supervision carried out by FI. Through these reports, FI presents its observations and assessments as well as its expectations in various matters. This information can support firms in their operations.

Summary

Funds of funds are a common consumer product. FI has therefore conducted a survey of 25 funds of funds managed by 25 fund management companies and AIF managers.

FI has surveyed 25 funds of funds managed by 25 fund management companies and AIF managers. FI has scrutinised how the consumer is informed about fees and how the managers have reported their funds of funds' objectives and performance. The managers have been asked whether they invest their funds of funds' capital in their own funds and about the reasons for doing so. FI has not studied how the funds of funds are actually managed.

The survey indicates that the fees charged for funds of funds are generally high, especially when compared with index funds and Swedish equity funds. The information provided about the total fees applicable to funds of funds is sometimes unclear. Close to half of the funds of funds surveyed do not utilise a benchmark index, which makes it more difficult for the consumer to evaluate these products' rate of return targets. The majority of managers invest their funds of funds' capital in their own funds. The reason for doing so is said to be discounts obtained in underlying funds. Despite these discounts, the total fees are high. Investing in the manager's own funds presumes the manager dealing with their conflicts of interest.

In light of these observations, FI concludes that there is room for improvement if managers are to ensure that they always act in the best interest of unit holders.

What has FI surveyed?

FI has surveyed 25 funds of funds managed by 25 fund management companies and AIF managers. The information materials concerning these funds of funds has been scrutinised and the companies have provided FI with information about what it is that determines whether or not they invest in their own funds.

A fund of funds is a fund that invests a substantial portion of its capital in other funds. There is an extensive market for funds of funds as these are offered to consumers by a large number of market participants.

A consumer who invests in a fund of funds is indirectly investing in a number of funds that are the fund of funds' underlying funds. Consequently, an alternative to a fund of funds is for the consumer to invest directly in the underlying funds or in other funds with a similar investment policy. A fund of funds may be more difficult to understand as its fee structure is more complex due to the additional layer of fees. Accordingly, it is more difficult to assess whether the investment provides value for money. If a fund of funds is investing in the manager's own funds, there is a conflict of interest that may have a detrimental impact on the consumer. This makes it especially important for the consumer to be given clear information about the fund of funds.

FI has therefore conducted a survey of 25 funds of funds managed by 25 fund management companies and AIF managers (referred to subsequently as "managers"). FI has reviewed the key investor information documents and other information materials for these 25 funds of funds. The level of the fees and how the customer has been informed of this has been examined. FI has also reviewed how managers are reporting their funds of funds' performance to consumers. The managers also had to submit data concerning the underlying funds that are included in their funds of funds' holdings in order to allow FI to chart how common it is for managers to invest in their own funds. In this survey, FI has not studied in any detail how the funds of funds are actually being managed.

What has FI found in the survey?

FI's survey has resulted in a number of observations. The survey shows that the fees for funds of funds are generally high. The way fees are disclosed differs. Close to half of the funds of funds do not use a benchmark index in order to evaluate performance. The majority of fund management companies invest their funds of funds' capital in their own funds.

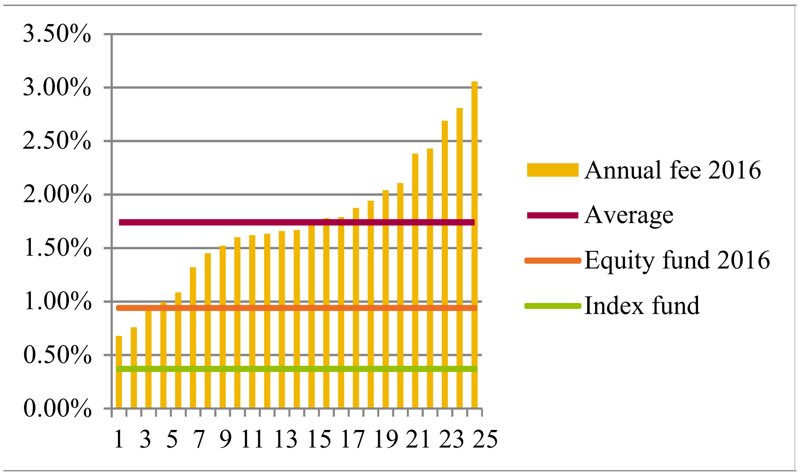
FEES

It is difficult for a consumer to gain an overview of the long-term impact fees have on their savings.[1] One prerequisite is for the consumer to be given information concerning the total fees charged by the fund of funds. This information has to be transparent and thus make it possible to compare different products.

FI's survey shows that the annual fees charged by funds of funds are generally high, These fees range from 0.68 to 3.06 per cent of the capital invested in the fund. The capital-weighted average is 1.71 per cent. As an indication, this can be compared to Swedish equity funds where the capital-weighted[2] average fees were 0.94 per cent in 2016. Compared to index funds, the difference is even higher; the capital-weighted average fees for an index fund was 0.37 per cent in 2016[3].

Figure 1: Annual fees 2016

(The average of the 25 funds of funds' annual fees in red, the average of Swedish equity funds' capital-weighted average fees in 2016 in orange and the average of index funds in green)



1. Interview investigation targeting Swedish households, published in *Rapport om hushållens ekonomi* [Report on household finances], dated 12/02/2018

2 Capital-weighted means that the average fee reflects how savers have actually invested their money.

3 According to a press release from the Swedish Investment Fund Association of 18 August 2016 that is based on figures from Morningstar, values from 1 May 2016.

The fees charged by a fund of funds consist partly of the costs associated with the underlying funds and partly of the costs associated with the fund of funds and its management. Many funds of funds have stated that discounts are of great importance when selecting investments. However, FI concludes that, in spite of the discounts, the total fees are high compared to other investment options.

Key investor information documents, information materials and fund rules have to specify clearly what fees are charged by the fund. Some of the funds of funds surveyed charge several fees: an annual fee, subscription and/or redemption fees and/or performance-based fees. Performance-based fees from both the fund of funds and its underlying funds have to be reported in the fund's key investor information document. However, this is being done in different ways. Five of the managers surveyed do not report these fees at all. For these funds of funds, the actual fees charged may have been higher than the level it is possible to discern from the funds' information materials. This would mean that consumers have not been informed correctly about the total fees charged by these funds of funds.

EVALUATION OF THE FUND'S PERFORMANCE AND TARGET

The key investor information document has to provide clear information about the fund's management strategy. The reasons for this include allowing the consumer to gain an understanding of the fund's expected risk and return. More than half of the managers have specified their funds of funds' rate of return objectives in relation to a benchmark index, which is presented in the fund of funds' key investor information document. Comparing a fund of funds' rate of return with a relevant index makes its objective clear and it is thus relatively easy for a consumer to gain an understanding of whether or not the fund has performed well.

The remaining funds of funds included in the survey specify neither a benchmark index nor a clear objective for the fund's management. Instead, it is common to use expressions such as "achieve maximum possible value growth" or "achieve satisfactory growth of invested capital over time". Two managers in the survey state that their fund's objective is absolute return.[4] The lack of clear objectives makes it difficult to evaluate a fund of funds.

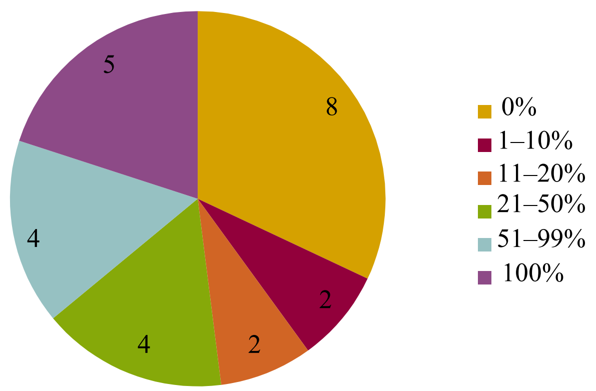
4 Absolute return means that the fund shall deliver a positive return regardless of the development of the market.

HOLDINGS OF FUNDS MANAGED BY THE SAME COMPANY AND CONFLICTS OF INTEREST

Funds of funds are allowed to invest in underlying funds managed by the same company. However, this creates conflicts of interest that must be dealt with by the manager.

The majority of funds of funds have holdings of funds that are managed by the same company. The managers state that they choose to invest in their own funds because they receive a discount on the fees charged by these. Five of the funds of funds in the survey invested exclusively in funds managed by the same company. Four funds of funds invested 51–99 per cent in their manager's own funds. The majority of the managers that invest all or large parts of their holdings in their own funds do not inform the customer that investing in their own funds is permitted. Figure 2 below shows the percentage of the funds of funds' capital that was invested in the same fund management company's funds as of 30 June 2017.

Figure 2: Holdings of the manager's own funds
(The proportion of the funds of funds' capital invested in the same company's funds as of 30 June 2017)



Source: FI's compilation of the companies' reported holdings as of 30 June 2017.

Conclusions

Managers shall always act in the best interest of unit holders. FI has identified three areas where there is potential for improvement with the aim of ensuring that consumers are better protected when investing in funds of funds.

FI expects fund managers, as well as other financial firms that provide investment products to consumers, to manage funds of funds that are of a high quality and good value for money. Consumers shall be given comprehensible and relevant information about a fund of funds so that they are able to decide whether they will save in the fund of funds or if investing in other funds will yield a better return. However, FI's investigation shows that funds of funds are relatively expensive. In addition, consumers are not being provided with sufficient information to enable them to properly evaluate funds of funds. Many managers are investing in their own funds, citing large discounts as the reason for doing so. Based on these observations and conclusions, FI has identified three major areas where there is potential for improvement. These will be followed up as part of FI's ongoing supervision.

1. HIGHER FEES – JUSTIFICATION AND INFORMATION

All fees charged by a fund of funds shall be reported clearly to the consumer. This is especially important for these specific products as their fee structure is more complex.

The level of fees in funds of funds is generally high, despite of the majority of managers receiving discounts on underlying funds. Fees have a major impact on long-term savings, which is why higher fees require higher rates of return.

2. THE IMPORTANCE OF THE ABILITY TO EVALUATE

FI is of the opinion that the funds of funds' objectives shall not be expressed in empty catchphrases. The consumer is not able to evaluate whether a fund of funds has performed well or poorly if there is no clear objective for comparison. Giving the consumer an opportunity to evaluate a fund of funds' performance is fundamental to their ability to determine whether or not it is good value for money.

FI is of the opinion that using a benchmark index for comparison is often a good and simple way to evaluate the performance of a fund of funds. In the case of those funds of funds where a comparison with a relevant index is not possible, FI expects the manager to inform customers about the fund of funds' performance in some other way.

3. MANAGING CONFLICTS OF INTEREST USING OBJECTIVE EVALUATION

The majority of managers invests the funds of funds' capital in their own funds. This creates conflicts of interest that may be detrimental to the consumer. FI is of the opinion that discounts on fees in the underlying funds shall not be the determining factor when managers are deciding whether to invest in their own funds. In spite of these discounts, total fees are generally high compared to other options. All investments in the managers' own funds shall instead be undertaken on the basis of an objective analysis that aims to ensure the investment protects the interest of customers in the best possible manner.

Furthermore, FI is of the opinion that consumers should be informed that the manager invests in their own funds. The reason for this is to ensure that all information about the fund of funds is transparent, clear and relevant.

FUTURE SUPERVISION

FI works continually to inform companies and the general public about the applicable rules. FI's report *Priorities in FI's supervision to strengthen consumer protection 2018* states that in 2018, FI will continue prioritising the supervision of advice given to consumers and complex fee structures.

In so doing, FI is continuing its scrutiny of funds and fund management fees. Analyses of fund products have been published in FI's Consumer Protection Reports in the years 2015–2018. FI has also published memorandums and online broadcasts about this subject on its website.

Finansinspektionen
Box 7821,103 97 Stockholm
Street address Brunnsgatan 3
Telephone +46 8 408 980 00
Fax +48 8 24 13 35
finansinspektionen@fi.se

www.fi.se