
Devin McCune, Vice President Governance, Regulatory & Compliance
Jeff Tjornehoj, Director of Fund Insights



Assessment of Value: how to start the process



Ready for Next

ASSESSMENT OF VALUE

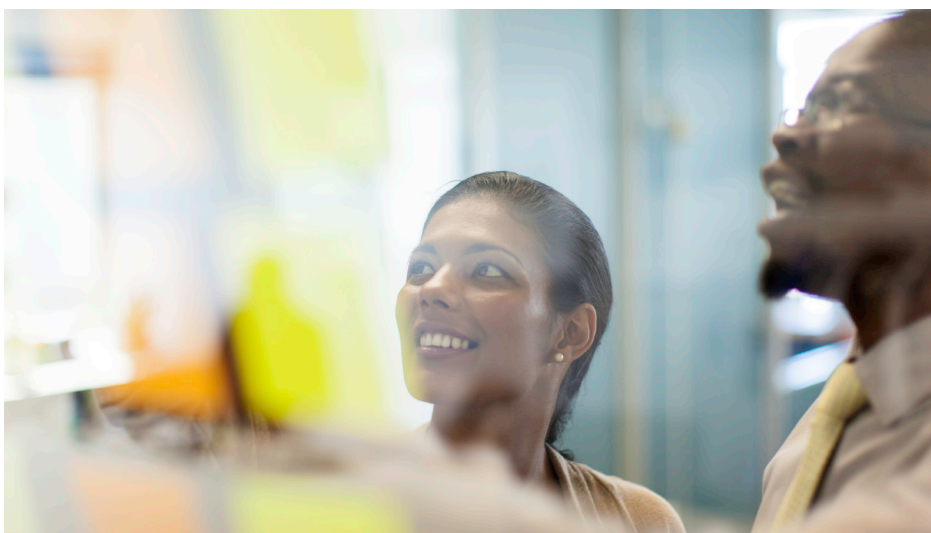
As management companies in the UK are faced with new regulatory oversight as the result of the FCA's Asset Management Market Study (<https://www.fca.org.uk/publications/market-studies/asset-management-market-study>) and ensuing rules, Broadridge is committed to helping navigate the process and provide on-going oversight as efficiently and thoughtfully as possible. This paper represents the first in a series designed to help with the implementation of the Assessment of Value rule (Policy Statement 18/8 <https://www.fca.org.uk/publication/policy/ps18-08.pdf>).

Each paper will focus on factors and data that will help in determining value as well as highlight key components to consider in the process. We will utilise our knowledge of the U.S. 15(c) process that has similarities with the Assessment of Value (AoV) rule, knowledge gained from Broadridge's work in the UK distribution and regulatory sides of the fund business, and from the conversations we've had with many participants in the industry. We welcome your questions, comments, suggestions, and feedback on these papers as our goal is to help inform you as you move forward with implementing your company's Assessment of Value process.

Value - 1 The regard that something is held to deserve; the importance, worth, or usefulness of something. 1.1. The material or monetary worth of something. 1.2 The worth of something compared to the price paid or asked for it. – Oxford Dictionary

With the Financial Conduct Authority's (FCA) new rule requiring management companies and the new independent non-executive directors (i-Neds) to review and analyse funds to ensure a fund provides value, the inevitable question that arises is "what is value"? Over time the industry may come to a similar set of metrics to determine if value exists; however, as we begin our path towards complying with the AoV rule Broadridge feels it is worth investigating factors that may help with the assessment process. We should note that parity in how funds assess value is not necessarily the right answer. Each management company and even each fund within a management company have unique attributes that should be used to determine and measure fund value.

The responsibility for measuring value falls on both executive directors and i-Neds. Intrinsicly, these two groups will enter the discussion from different angles providing for meaningful dialogue and discourse related to each fund. As part of this process both groups will need to have a very detailed and holistic understanding of the funds they oversee. This understanding should include knowledge of what a fund's investment goal is, the strategy the fund will use to reach these goals (both highlighted in other portions of the FCA's Market Study), gain an understanding of how the fund is positioned and marketed to investors, and finally have a general understanding of the market for each fund. While



there are material differences between the requirements for the UK Assessment of Value and the U.S. 15(c) requirement, there are many similarities that can be used as a guidepost to help management companies and i-Neds determine how to evaluate the value of each fund and to create a process that is realistic to adhere to the rule.

HOW DO WE MEASURE VALUE?

While the process for measuring and evaluating the value will vary by management company there are some factors that will be consistent, essentially best practices. Any evaluation of a fund will include quantitative analysis and qualitative analysis. The weighting of these measures will change by management company, likely even by fund within each management company, and over time as each fund company evolves. The consistent quantitative factors used to evaluate value include expense comparisons, total return comparisons, and risk measure analysis. On the qualitative side management companies and i-Neds will utilise data gathered from the quantitative analysis to establish questions and answers that truly help understand each fund.

To demonstrate how these metrics can be used to evaluate a fund, Broadridge typically recommends a tiered approach, looking at results for all funds, funds by asset class, and finally individual funds. This allows an understanding of potential consistent themes, or areas of concern for the board to review.

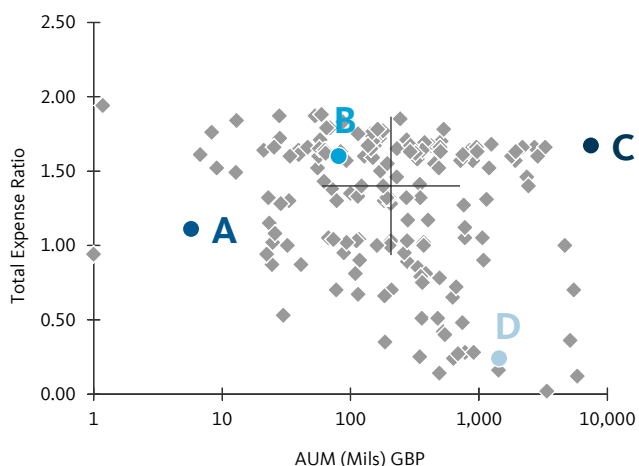
For example, we typically review the relative rankings of all funds run by a management company, then all funds within a specific asset class, and finally each fund individually.

ASSESSMENT OF VALUE CASE STUDIES: LOOKING BEYOND RANKINGS

Many issues will need to be reviewed to determine “value.” If one is to only look at the relative rankings for a fund the conclusion around value may differ than the conclusion drawn when considering additional factors. The four examples presented here, based on actual IA primary share classes in the UK All Companies IA sector, are but a few of the many scenarios directors will encounter in their assessments of value.

Fund A: A relatively small fund (see Figure 1) with just £8 million under management, it nevertheless charged 1.20%—well below the median of 1.40%—and appears to be providing good value for shareholders based on relative expenses alone. As a director, one may wish to inquire further with management about this placement: was it the product of reimbursements by management? Do they expect this charge to persist in the years ahead? Let’s also consider performance: this fund happens to be a “smart beta” fund that intends to track a custom, non-standard index. But tracking this index has been less than optimal for investors, who have had only one year in the past seven since the fund’s inception where it ranked in the top half of its IA category. In addition, the fund

Figure 1
Assets vs. Expenses



has displayed below-average risk, with a beta of 0.92 relative to the FTSE All-Share.

Fund B: While this £100 million fund is still half the size of the median, expenses are slightly higher than the median at 1.60%. Slightly higher expenses may be warranted depending on the complexity of the fund’s strategy. In this case, the fund’s mandate to seek high dividend-paying UK stocks with the potential to include fixed income securities doesn’t appear terribly intricate. Performance has rebounded well in the past three years, producing returns that rank in the 35th percentile, but longer-term performance ranks have been relatively volatile while its absolute volatility (as measured by beta) is rather low—perhaps owing to its somewhat conservative strategy. Investors have lost interest in this fund and fund assets have dropped 70% in the past eight years.

Fund C: Like Fund B, expenses are more than the median but here we have a very large fund that is presumably more capable of passing economies of scale to investors. As with Fund B, this is also a UK equity fund that emphasizes income through dividends. But unlike Fund B, Fund C incorporates various derivative instruments and unlisted securities to enhance returns, which worked well for many years and proved attractive to many investors, but has stumbled badly in two of the past three years. The derivative overlay has mitigated both relative

and absolute volatility (the Fund’s beta is just 0.81), which may be considered an additional service for investors often not provided by similar fund managers. However, it falls on directors to question management whether there is any diseconomy given its substantial assets and to what extent unit holders benefit from the additional portfolio management techniques in light of higher expenses.

Fund D: At first glance this appears to be an easy one—and maybe it is. This fund is one of the larger products in the group and annual expenses are among the lowest, which suggests economies of scale have been passed to unit holders and value has been clearly demonstrated. Still, it’s worth the time to consider if everything is as good as it appears. The Fund is an index tracker, where low expenses are a must, and directors ought to consider where the Fund ranks among similar index trackers, not just among active managers. The Fund attempts to mimic the returns of the FTSE All-Share Index and has improved its execution in recent years, from underperforming the index by 2.0% in 2014 to just 0.2% of underperformance in 2018. As passive investing gains popularity in the UK, is management ready to consider how this fund will be able to compete on price among commoditised peers?

Figure 2
Total Expense Ratio vs. 3 Year Total Return

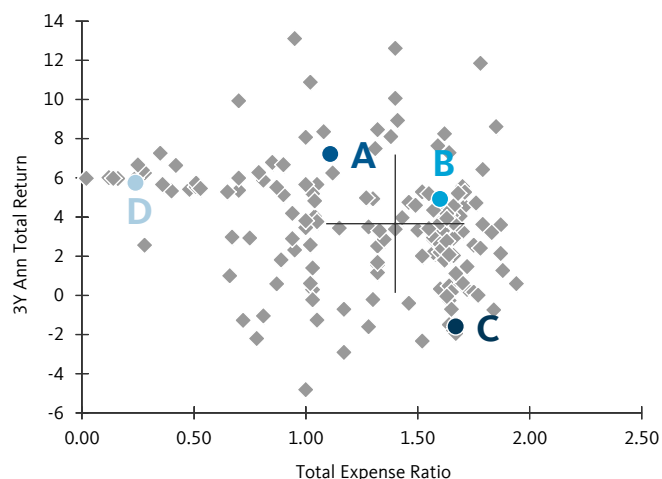
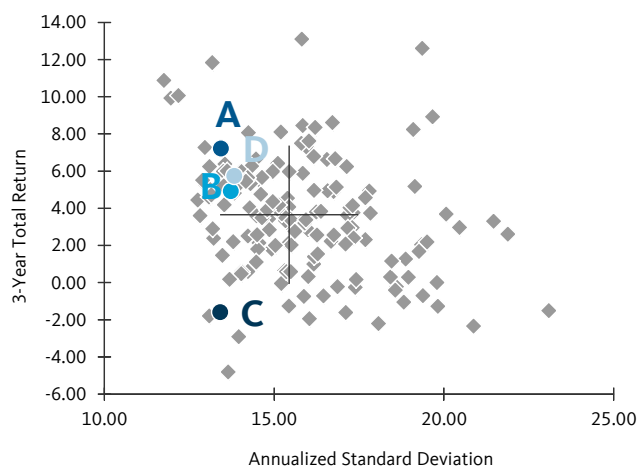


Figure 3
3 Year Standard Deviation vs. 3 Year Total Return



PUTTING IT ALL TOGETHER

While using a fund's relative ranking is a reasonable starting point for the process of assessing value, as the case studies on previous pages demonstrate, it is by no means the only factor to consider. When looking at a broad investment classification comparisons and rankings can be deceptive. The refinement of comparison groups, looking at those funds with the most similar investment strategy, can help with ensuring the quantitative data is meaningful. In addition, it is incumbent on directors to know that a fund is "smart beta" and therefore should have lower relative expenses than the larger classification. In our future papers we will dive deeper into the options for peer grouping, how to review a fund's expenses, the performance and risk analysis of funds, how to evaluate all share classes, and finally putting everything together as part of the evaluation process.

PREPARING FOR THE UNKNOWN

One part of the Assessment of Value work that management companies and i-Neds will need to undertake is the actual review of data and comparison groups to help determine if there is value for investors. A second major component to AoV, especially this first cycle, is related to the process. Management companies and i-Neds have never been through

this evaluation before and effort spent now on the process to make sure everything is ready starting October 1, 2019 (or whenever your funds fiscal period ends) will make the work easier, more informed, and actionable. As part of this series Broadridge will be providing ideas on focus areas to make the process better.

SIX TO NINE MONTHS FROM FISCAL YEAR END

1. Engage with both the new i-Neds and executive directors on content and thoughts related to what they want or expect to see in AoV reporting.
2. If your funds have multiple fiscal periods determine how AoV reporting will be handled. Will you do reporting within four months of each fiscal period or will you consolidate to one or two AoV reviews per year?
3. If you are consolidating reporting for multiple reporting periods, do you want to use annual report data or should you include pro forma data to represent current expense rates?
4. Create sample AoV report design and content, allowing engagement from all interested parties.
5. Outline overall project timeline for process from the end of the fiscal period based on time to update fiscal data, select and review peers, create final internal reports, and draft final report to shareholders.

“Any evaluation of a fund will include quantitative analysis and qualitative analysis. The weighting of these measures will change by management company, likely even by fund within each management company, and over time as each fund company evolves.”

Comments and questions from readers of this white paper are welcome. Additionally, if you would like to have more detailed data presented related to your funds we can incorporate that into a study. Please direct any feedback to:

Devin McCune

Vice President Governance, Risk & Compliance
Devin.McCune@broadridge.com

Jeff Tjornehoj

Director of Fund Insights
Jeff.Tjornehoj@broadridge.com

Broadridge, a global fintech leader with over \$4 billion in annual revenue listed on the S&P 500 index, provides communications, technology, data and analytics. We help drive business transformation for our clients with solutions for enriching client engagement, navigating risk, optimizing efficiency and generating revenue growth.

broadridge.com

Ready for Next

Communications
Technology
Data and Analytics

