Broadridge®

Getting to grips with the Assessment of Value

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Assessments of value [AOV] obligations play an integral role in helping the UK Financial Conduct Authority [FCA] determine whether or not AFMs [authorised fund managers] are providing an adequate service to their underlying retail investors. While seen by some AFMs as being unduly onerous, AOVs – if undertaken intelligently and thoughtfully – can be hugely beneficial for managers.

THE GENESIS OF THE AOV

In 2017, a landmark report — 'The Asset Management Market Study' [AMMS] — was published by the FCA. It did not make enjoyable reading for the funds industry. The FCA criticised the active asset management industry for having weak price competition, excessive profitability and fees; a lack of outperformance relative to its benchmarks and poor governance. Most worryingly, the FCA calculated that there was approximately $109 billion of 'active funds' who were effectively mirroring an index yet still charging high, active fees.[1]

The FCA did outline a number of remedies to these deficiencies. In its original report, the FCA talked about introducing a 'Value for Money' assessment for investment firms in what would have required asset managers to self-analyse whether clients had received value for money on an ongoing basis, the findings of which would need to be documented annually.[2] However, the industry lobbied against these proposals, highlighting to the FCA that Value for Money assessments risked focusing too much on fund charges as opposed to actual value.[3]

This resulted in the premise of 'Value for Money' being replaced with 'Assessment of Value.' According to international law firm Simmons & Simmons: "the removal of the term "value for money", is a positive development for the industry, reflecting a more holistic approach to the assessment of the service and value provided to investors." [4]On governance, the FCA proposed that AFMs should appoint a minimum of two independent directors on their boards — and for these independent non-executives to comprise of at least 25% of the board' membership.[5]

UNDERSTANDING THE AOV

AOVs comprise of seven main criteria, namely;

1. Comparable market rates
2. AFM costs
3. Comparable services
4. Performance
5. Quality of service
6. Economies of scale
7. Share class units

But what do these mean in practice? Take AFM costs, for example. **The FCA has focused extensively on profitability, but a balance does need to be maintained. Funds must be sustainable, which is not always straightforward given some of the margin constraints and AUM contractions the industry is facing.** Nonetheless, investment firms do need to evidence that the management fees for their funds are sufficient to sustain current operations but are not excessive. On economies of scale, managers need to demonstrate how scale is being used to the advantage of all investors [i.e. fee discounts, etc]. Firms must also assess performance against the fund's objectives, again something which is not always straightforward owing to uncertainties around benchmarks and the time horizons being used. In regards to comparable services, regulators want to see proof that retail investors are not paying managers substantially higher fees than institutions for similar services. The FCA believes these provisions will be crucial in safeguarding the interests of investors and ensuring they get proper value.

IMPROVEMENTS NEED TO BE MADE

More than two years after the AOV was first introduced, the FCA issued a damning rebuke of the industry's approach to the assessments. In a review of 18 fund managers conducted between July 2020 and May 2021, the FCA noted that while some AFMs were conducting AOV assessments well, others made assumptions which simply could not be justified, thereby undermining the credibility of the report. On performance, the FCA said many firms did not consider what the fund should deliver given its investment policy, strategy and fees. "Firms spent a disproportionate amount of time looking for savings in administration charges that cost investors relatively little compared with the time spent reviewing the costs of asset management and distribution that typically cost investors much more," it read. The FCA continued that some managers used poorly designed processes and methodologies resulting in incomplete assessments of value [e.g., failing to assess elements like performance, AFM costs or failing to perform assessments at share class level]. And finally, the FCA claimed independent directors did not "provide the robust challenge we expect and appeared to lack sufficient understanding of relevant fund rules." In short, it is clear that more effort needs to be put into AOVs.

ENGAGING WITH THE RIGHT PROVIDER

With the FCA having admonished the industry over the quality of its AOVs, it is vital managers work with providers who have the correct skillsets to support them with their AOV assessments. This could help managers avoid further regulatory censure. There are other reasons to work with credible third parties. For many fund managers, the AOV requirements are yet another cost of doing business. In addition to the unprecedented volatility and performance challenges, fund managers are facing rising operating spends and added regulatory requirements. In the years superseding the financial crisis of 2008, UK [and EU] asset managers have been hit with regulations such as UCITS V; AIFMD [Alternative Investment Fund Managers Directive]; MIFID II [Markets in Financial Instruments Directive II] and SRD II [Shareholder Rights Directive II], all of which have created massive overheads. Although the AOV does appear complicated, the process can be externalised to third party providers — such as Broadridge — who have the scalability; depth of resources; technology infrastructure and industry leading expertise to support managers with their requirements. This enables investment firms to both benefit from economies of scale and allocate more internal resources to revenue generating activities.

The appointment of an external provider is also advantageous from an impartiality perspective. If conducted internally, AOVs could face regulatory and investor scrutiny if the assessments are judged to be excessively subjective. An outside vendor, however, is more likely to be independent, meaning the AOVs will carry greater weight and integrity. The complexity related to the quality of reporting centers around distilling complex and detailed information that the board utilises to evaluate value into a report that is understood by retail investors.

In addition, value statements are used by fund selectors and advisors as part of the decision. Having a provider that can offer quantitative, independent support to managers, especially when they are developing the criteria for their own evaluations is vital. Similarly, providers must also develop reports – based on quantitative analysis — which can facilitate better comparability. Outside providers can also play an invaluable role in strengthening fund governance — another critical element of the FCA's demands. Broadridge has worked across multiple clients in an effort to support boards and to ensure they are able to fulfill their duties.

It does this by providing training to boards to ensure they understand the processes for creating various comparison groups, aggregating data and creating visualisations of the data for any quantitative analysis. Such consultative engagement is vital to ensuring robust governance.

Full documentation of Broadridge's process and methodology are provided with all the reports it creates. Beyond Broadridge's work ensuring that the board is comfortable with its materials , the company also provide a qualitative analysis to boards and attends board meetings to support the review and discussions which occur during the AOV process. Broadridge's qualitative analysis focuses on many of the factors — which may be driving costs and performance both independently as well as against peers or indexes.

AOV AS AN OPPORTUNITY

AOVs should be seen as an enabler for the asset management industry. In today's highly competitive environment, the ability of a manager to demonstrate that they are offering genuine value will be a compelling proposition for many return-hungry investors. Working with multiple clients, Broadridge has helped establish how to show and explain a fund's value versus the criteria required by the FCA. Broadridge has worked extensively to ensure that investors are made aware of the overall processes, methodologies and general rigour with which the board is involved in the AOV process.

The granularity of the AOVs give managers the opportunity to conduct deep dives on their own funds, potentially enabling them to etch out cost savings. This is vital given some of the pressures facing the sector. The AOV could also confer benefits for fund board directors. For example, AOVs can help them better analyse a fund's health. By going through the AOVs in depth, directors can make an assessment on what improvements need to be made to the fund, or if it would make more sense to simply liquidate it. Ultimately, the AOV provides excellent insights into the working of funds, giving directors and managers alike invaluable information, which can then be leveraged to improve the business. Rather than viewing the AOV as another piece of reporting, managers should embrace it as it could help strengthen their businesses.

With other regulators — including the Central Bank of Ireland [CBI] and CSSF [Commission de Surveillance du Secteur Financier] in Luxembourg — potentially introducing their own value assessments modelled on the AOV, asset managers need to ensure they have the systems and processes in place to fulfill these reporting requirements.

LEARN MORE

To find out more about our Assessment of Value offering, please contact:

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[1] FCA [2017] – Asset Management Market Study
[2] Simmons & Simmons [April 5, 2018) Asset Management Market study: A change of approach from the FCA to the assessment of 'value for money'
[3] Simmons & Simmons [April 5, 2018) Asset Management Market study: A change of approach from the FCA to the assessment of 'value for money'
[4] Simmons & Simmons [April 5, 2018) Asset Management Market study: A change of approach from the FCA to the assessment of 'value for money'
[5] FCA [2017] – Asset Management Market Study

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