Deutscher Fondsverband

BVI Research

ESMA'S VALUE FOR MONEY PROPOSAL PUT TO THE TEST

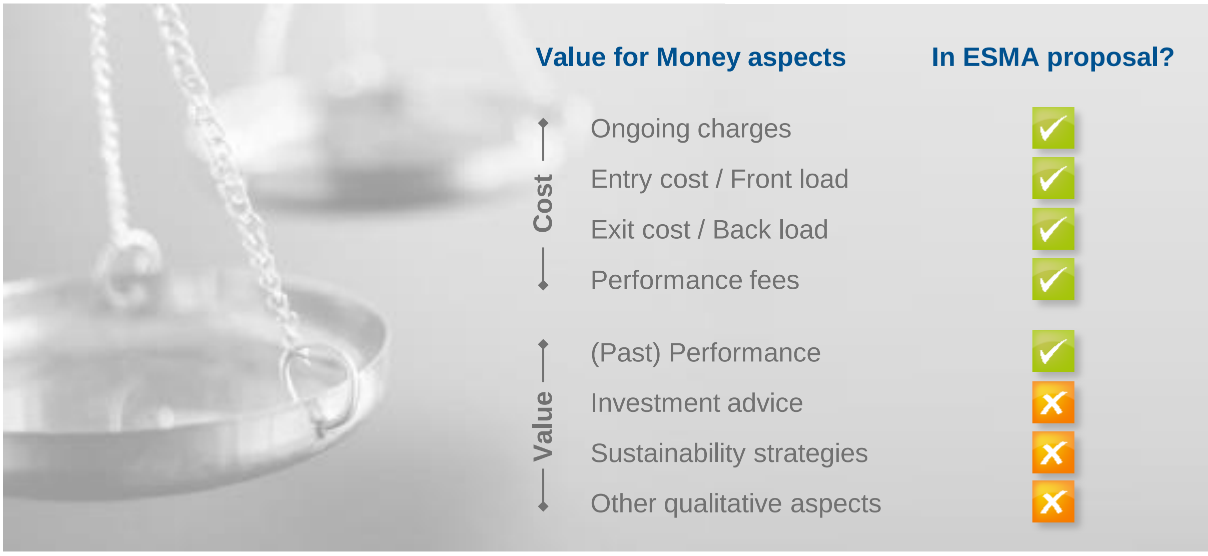
Assessing Value for Money of investment funds solely based on cost and past performance is likely to mislead retail investors

The Value for Money (VfM) test proposed by the European Commission aims to assess whether costs and charges of investment products are justified regarding their performance as well as other benefits. First ideas on the test design for investment funds by the European Securities and Markets Authority (ESMA)[1], however, indicate that it will include products' cost and charges vs. their past returns only.

In this paper, we show that a VfM test based on ESMA's proposal is likely to mislead retail investors. First, it neglects several important dimensions of value. Second, the test is unlikely to detect poorly performing funds. This is because past returns are only loosely related with future performance. According to our analysis, 77 percent of equity, bond and balanced UCITS with low returns in 2014-18 achieved average or above average performance in the next five years. Third, too detailed peer groups often create inconsistencies; whether a fund passes the test depends more on the assigned group than its return.

Proposals for carrying out Value for Money tests neglect important aspects of value

Details of the VfM test are still being discussed. Moreover, it is unclear which regulatory measures will be



[1] See ESMA. "Value for Money benchmark. ESMA's staff initial views". Council Working Party 6-7 November 2023

taken against funds failing the test. In any case, it is essential to make sure that the test is designed very accurately to correctly identify funds not yielding value for money.

Due to perceived structural differences between funds and other investment products, such as life insurance contracts, funds will only be compared to other funds. In our view, this is a missed opportunity to increase competition between product types for the benefit of the investor. But even if this narrow scope is adopted, there are many issues that prevent funds to be classified adequately.

Costs are a straightforward indicator – but they are only meaningful if considered in the context of all benefits of a certain strategy. Unfortunately, a quantitative VfM test is likely to neglect benefits of a product other than past investment returns due to their complexity and difficulties to obtain relevant data. Possible factors determining value for end investors that are likely to be not part of the test design include, but are not limited to:

- Whether the cost of advice is included; in the EU, advice may be remunerated via commissions (i.e., as a part of the product cost) or fees paid by the investor.
- Individual sustainability strategies – beyond the mere classification as a fund according to Art. 8 / Art. 9 SFDR – that require additional research, such as a focus on green bonds.
- Whether advanced risk management techniques are used, e.g. to reduce tail risks.

To adequately determine whether a fund yields sufficient value to an investor to justify its cost level, a products' positioning regarding these aspects would require a price tag. Given that there are tens of thousands of different strategies among EU funds, this is impossible to do. It therefore does not come as a surprise that ESMA excludes these aspects in its initial proposal but focuses on past gross performance as the only measure for value of a product.

While the neglect of other benefits alone reduces the informative value of the VfM test significantly, the use of past performance creates additional problems: After all, it is for good reasons that documents advertising investment funds point out that "past performance is not indicative of future results". First, superior returns due to active management decisions may or may not be sustained in the future. But, more importantly, a significant part of performance is determined by the overall strategy, i.e., market returns, rather than managers' skills.

Past performance is not a useful indicator for future returns

To showcase adverse effects created by the restriction to past performance, we have tested whether poor performance is consistent over time and can therefore be used to inform potential investors that a product is likely to lack value for money. We consider retail share classes of equity, bond, and balanced UCITS in terms of their gross performance from 2014 to 2023. All data on assets managed refer to end-2023 figures to ensure consistency. We use Morningstar Direct, which contains sufficient information on more than 18,000 UCITS share classes from across the EU and their past performance, representing around 70 per cent of the relevant market in 2023.

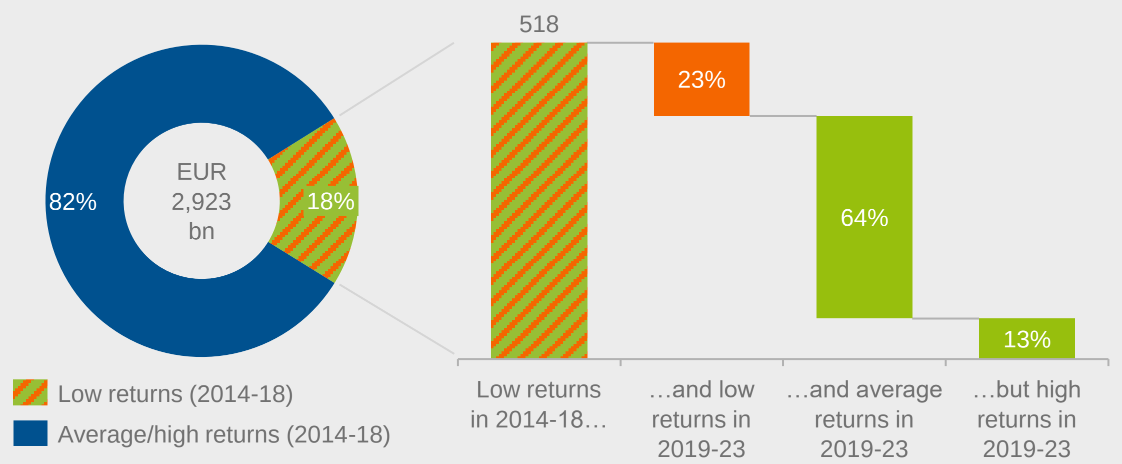
We follow ESMA's systematic of clustering funds. As a base case, we create a total of 42 peer groups for each theoretically possible combination of broad asset class (equity, bond, balanced), the Summary Risk Indicator (SRI 1-7), and management style (active, passive). We then split the entire dataset into two independent intervals of five years, i.e. 2014-18 and 2019-23. This corresponds to the most common Recommended Holding Period (RHP) in our sample. Once again mirroring the ESMA proposal, we rank products according to their returns. The 25 percent of share

How are funds ranked? (Example)

We consider all funds of a certain peer group – for instance all active equity UCITS with a risk indicator (SRI) equalling 4. This includes more than 5,000 share classes of almost 3,000 funds with a broad range of individual investment strategies.

All products are ranked according to their gross performance in the 2014-18 period. The worst performing 25 percent of products in this peer group achieved 4.7 percent or less per year. In 2019-23, the cutoff point moved to 7.3 percent due to favourable market conditions. A fund with a performance of 5 percent p.a. would therefore be considered as average in the first and underperforming in the second 5-year-interval.

Persistence of low investment returns of UCITS funds between 2014-18 and 2019-23



Source: Own calculations based on Morningstar Direct

classes with the lowest performance in gross terms are classified as underperforming. In addition, we distinguish between overperformance (top 25 percent) and average performance (middle 50 percent).

Our analysis shows that in the 2014-18 period, 4,639 share classes of equity, bond and balanced funds which managed 18 percent of total assets in 2023 had underperformed their peers. This equates to more than EUR 500 billion. Another 43 percent of the market achieved average performance, funds managing 39 percent of all assets outperformed their peers.

In other words, almost one fifth of the assets under management would have been under scrutiny for the 2014-18 period: The corresponding funds would, as a consequence, face (regulatory) measures or sanctions in case the costs would be considered as comparatively high. However, this raises the question whether such an approach will lead to meaningful protection for investors. The answer is clearly no, as the funds' performance in the following 5-year period shows: Funds managing 77 percent of the affected assets achieved an average or above-average performance between 2019 and 2023. Underperformance was only persistent for funds managing 23 percent of total assets in our sample.

This is because the main reason for low returns is funds' exposure to market risks that materialise at certain points in time. It is very unlikely, though, that the same detrimental effects unfold in several consecutive 5-year-periods. This underscores that a metric solely based on historical return data is likely to cause severe errors and will confuse investors when trying to detect investment funds not offering value for money.

More detailed peer groups do not increase stability over time

The issues mentioned above indicate that the peer groups need to be designed carefully to effectively control for structural differences. In the initial ESMA proposal, as well as in our analysis so far, peer groups capture some important aspects, such as the broad asset class, Summary Risk Indicators, and the management style. The sustainability status (SFDR) and the investment horizon are also discussed as additional defining features for peer groups. Finally, single-market funds, i.e. products only sold in one EU market, may form their own set of peer groups.

In addition to extending the set of dimensions included in the VfM test, it is worth discussing how detailed the peer groups should capture individual dimensions. Notably, asset classes may be divided further into more groups based on the geographical investment area, a funds' sectoral focus or factor exposure, and other characteristics.

By considering more detailed peer groups, the differences between fund strategies in any group get much smaller. Investment funds in these more comprehensive groups should then be exposed to (more or less) similar market risks. To assess whether this standard-

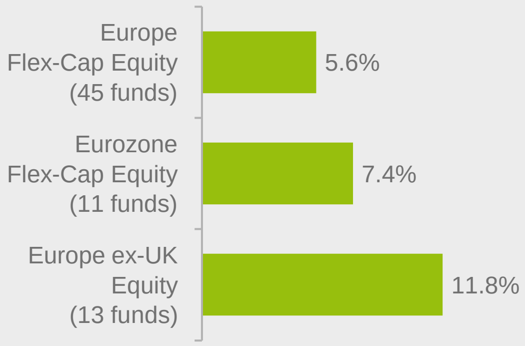
Scenario	Description of peer group factors	Number of peer groups	Groups with ≥10 ISINs	Share of groups with ≥10 ISINs	Share of persistently low returns
1	Base case with 3 asset classes, SRI, and management style	42	28	67%	23%
2	Like (1), but split into 26 broad asset classes	1.092	173	16%	31%
3	Like (2), but including SFDR status and single market funds	4.368	450	10%	28%
4	Like (1), but split into 234 Morningstar asset classes	9.744	815	8%	31%
5	Like (4), but including SFDR status and single market funds	38.976	1.695	4%	31%

Source: Own calculations based on Morningstar Direct

isation changes our results, we have calculated the share of underperforming funds in 2014-18 with persistently low returns in the next 5-year period for different scenarios. We find that in alternative scenarios, the share of persistently underperforming funds increases from 23 to 28-31 percent of total assets considered. While the ratio increases by some percentage points, products managing more than half of the assets still show no persistency in low performance.

With up to 39,000 peer groups, above specifications include a level of granularity of little benefit for retail investors. Narrowly defined peer groups are needed for tasks like competitive analysis at a fund management company. For a typical retail investor, subtle differences in the investment strategy are of little interest. Moreover, as ESMA correctly points out, there is the risk of having an excessively small sample of products in a peer group – which may even make the VfM test technically impossible. Even in Scenario (2), where we consider 26 asset classes, but do not look at SFDR status and single market funds, only 16 percent of theoretically possible peer groups include at least 10 share classes.

Annual return threshold for underperforming funds by peer group in 2019-23



Source: Own calculations based on Morningstar Direct

As the current proposals on VfM only focus on the relative position of a fund vis-à-vis its peers, i.e. there are no absolute thresholds, the analysis of small peer groups often yields unintended results. The return of a single share class may drastically change the threshold for the lowest 25 percent of funds. This can be seen by comparing the cutoff points for similar peer groups investing in European equity. We consider Morningstar categories, i.e. Scenario (4), and look at actively managed UCITS with a Summary Risk Indicator of 4.

To give one example: the 25th percentile for funds investing in "Europe Flex-Cap Equity" was 5.6 percent p.a. in the 2019-23 period. In contrast, for the arguably similar peer group "Europe ex-UK Equity" it amounted to 11.8 percent. While technically correct, the detailed asset class split would cause undesired consequences: A fund generating double-digit growth would face (regulatory) measures or sanctions while a very similar product with returns of 6 percent p.a. would not be under scrutiny. A useful, consumer-orientated VfM test should try to avoid such inconsistencies.

Contact
markus.michel@bvi.de
+49 69 15 40 90 242