1/6 of 1,013 European equity funds behaving like closet trackers (Better Finance)

Closet trackers: the problem that won't go away?

The challenge of paying fees for actively managed funds but ending up with little more than index hugging strategies is not a new challenge to the industry, but rising levels of transparency may lead to an ending of this practice. Jonathan Boyd, Adrien Paredes-Vanheule, Alicia Villegas and Ridhima Sharma report

Paying for butter but ending up with margarine is an ongoing challenge to consumers. Ditto, paying for wine that looks more purple than red. And so it has proven in the asset management industry, where the phrase 'buyer beware' is no longer seen as sufficient by competition and other regulatory authorities to allow practices to continue that leave buyers paying for one thing but getting another.

In a recap of recent years' developments, law firm Simmons & Simmons stated on its elexica free-to-access database of notes on ongoing legal issues, that it is one that has been under a brighter spotlight for the past few years.

"In 2014 a class action was filed against Sweden's second-largest fund house, Swedbank Robur, in relation to allegations that it had mis-sold investors closet index trackers. The action was initiated by the Swedish Shareholders' Association (SSA) and more than 2,500 investors signed-up to the lawsuit. Ultimately, the action was dismissed by Sweden's National Board for Consumer Disputes, who held that they, as a Board, did not have the appropriate authority to hear the case," Simmons & Simmons wrote.

"In January this year [2016] the Norwegian Consumer Counsel announced that it will be seeking compensation for 137,000 investors in a fund managed by DNB Asset Management, which has been accused of being a closet index tracker. The body is planning to pursue a class action against the asset manager or launch a legal claim as a pilot case on behalf of one representative consumer on the grounds that investors paid for a service they didn't get.

"In February 2016, Esma [the European Securities and Markets Authority] published a statement providing details of its supervisory work on closet index tracking funds. Esma began its investigation of the asset management industry as a result of concerns that the practice may harm investors who may not receive the service or risk/return profile to which they agreed based on the fund's disclosure documents. From Esma's initial sample analysis of 2,600 funds for the period 2012-2014, it concluded that between 5% and 15% of equity funds could potentially be closet

£109bn UK FCA estimates of assets in 'partly active' funds

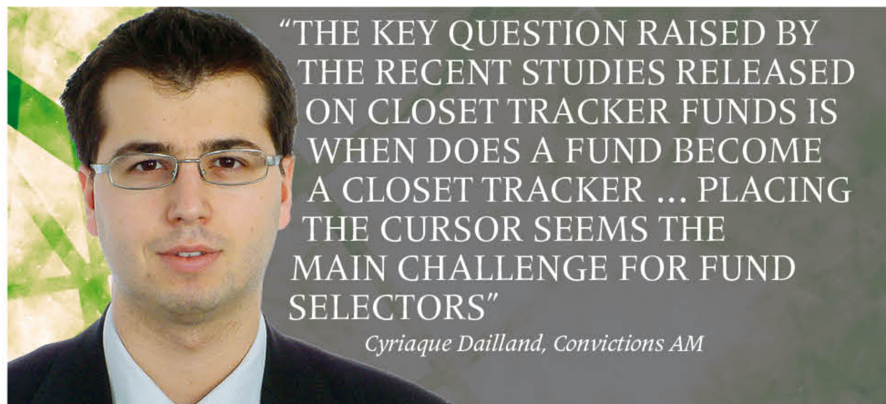
trackers. The statement concluded that 'the potential practice of closet indexing in Europe raises questions that merit closer analysis'."

But Esma's output on this issue has suffered much abuse.

For example, AMF, the French market regulator, responded that in its view the France-domiciled funds suggested as closet trackers were not, because the quantitative metrics used for the research were insufficient to support the claims. Europe's biggest asset manager by AUM, Amundi, referred to the AMF position in the matter.

And *Better Finance* "decided to replicate the research by Esma and disclose the findings and the full list of funds."

That research resulted in a list of 165 funds that were termed "potential closet indexers" – as reported online by *InvestmentEurope* in February this year (www.investmenteurope.net/regions/better-finance-releases-closet-tracker-fund-research).



INVESTIGATIONS

Meanwhile other authorities continue their investigations into the issue, spurred on by a blend of desire to improve consumer protection as well as the context of continuously rising net investment flows to passive investment vehicles – including both tracker funds and ETFs.

The UK Financial Conduct Authority, which is responsible for Europe's biggest single market by AUM, published its *MS15/2.2 Asset Management Market Study Interim Report* in November 2016, following an investigation into levels of competition in the industry.

It said that the UK asset management industry manages some £2.7trn (€3.1trn) on behalf of overseas investors, out of a total AUM of £7trn (€8trn). The report also found that the average active management fee for equity funds was 0.9%, versus 0.15% for the average passive fee.

Whether gauged on the overall £7trn of AUM or the £2.7trn of AUM that the industry manages for overseas investors, that difference in cost represents substantial pounds and pence – or euros, Swiss francs, NOK, SEK, DKK and others besides – and investors would be right to express concerns about being charged active fees for closet trackers.

SELECTOR VIEWS

Miguel Ángel Olmeda, private portfolio manager at Bank Degroof Petercam Spain, is among those who have expressed concerns about the ongoing challenge closet trackers pose to fund buyers.

"It is a problem not to have correctly classified this type of funds. Active management entails a high management fee and, for this, the results must justify such commission," he says.

"If, on the contrary, the result is very similar to the index, without any additional value, the same investment result can be achieved by vehicles with low commissions, such as indexed funds or ETFs."

"The goal of investing in an active management fund is the generation of consistent alpha, so I ask for, at least, a tracking error above 4.50," he adds, in reference to a widely used measure of deducing to what extent a manager may be avoiding hugging a benchmark.

The fund selection process overall is important in order to avoid buying such a fund, he continues.

"The ratio of information is the most important data for the selection of a fund. Later, we carry out a qualitative analysis on the strategy of the fund by directly contacting the asset manager and, when we can, the fund manager, to have an explanation of their investment methodology.

"In my opinion, the best way [to identify closet tracker funds] is through quantitative analysis, by studying its evolution against the benchmark over a minimum period of five years. To perform the analysis, you can take different ratios: bull / bear beta; information ratio to different periods, 3, 6, 12 or 18 months; tracking error; excess return, alpha, among others."

That said, he also says that regulators have a role to play, given the difference between levels of active management fees versus vehicles such as ETFs. He is in no doubt about the effect these differences are having on demand: "As we can see, the ETF industry has seen an exponential growth in recent years, but the growth potential is even greater by analysing the relative figures [between the US and Europe]."

METRICS

Cyriaque Dailland, fund analyst-manager at Convictions AM identifies another key facet in the debate, which is the lack of industry standards for defining a 'closet tracker' versus any other type of fund.

"The key question raised by the recent studies released on closet tracker funds is when does a fund become a closet tracker," he says.

"Hence placing the cursor seems the main challenge for fund selectors. A number of components can be checked to assess whether a fund can be classified thus. A fund's tracking error remains a pertinent but insufficient criteria. It enables investors to know

16bps Decrease in asset-weighted fees charged by equity fund managers 2013-2016 (Morningstar)

how much a fund differentiates from its benchmark, but a tracking error does not provide information on the fund's performance. Between a fund with a tracking error of 8%, generating 2% alpha, and another fund with a tracking error of 2% but achieving robust alpha as a result of a good stock picking, we would rather invest in the latter strategy. Tracking error can help to assess the room for manoeuvre of a fund but as investors, we tend to focus more on alpha generation.

"The methodology used in Esma and *Better Finance*'s studies should be reviewed. The initial assumption of both studies is to compare the fund to either the benchmark filled in the fund prospectus or to a Morningstar category. Theoretically several European equity funds compare themselves to the Stoxx Europe 600 index but at the same time have a market cap, sector, style or country bias. The benchmark filled in the fund prospectus therefore no longer matches the structural biases of these funds. Funds are compared with inadequate benchmarks. A European equity fund can carry a tracking error of 6% or 7% compared to the Stoxx Europe 600 but its alpha generation could come from the bias it carries.

"AMF's observations seem pertinent. Esma and *Better Finance* used a basic methodology. Funds could have a tracking error of 3% and generate alpha. More searches are needed on the evolution of the funds. Esma has really raised the topic."

"Closet tracker funds are very close to enhanced (tilted) management. This is not what we want for our truly active fund selection. We are not going to pay 1.5% to 2% fees for a fund replicating an index. We invest in ETFs and futures for this purpose."

A SYMPTOM OF POOR SERVICE

Jean-Paul Nicolaï , CEO of Wiseam and Witam Multi Family Office, takes what he himself term a "somewhat radical" view on the issue.

"If closet tracker strategies are not put aside after fund analysis, it means that either some independent financial advisers are not doing their job properly or that individual investors get impressed by large asset management names or that advisers operating in distribution networks are selling some poor in-house products on the demand of their bosses. It would then be a symptom of poor servicing globallly. I believe these bad funds have no place in the fund selection of institutional clients even though a number of small institutional players are still victims of bad practices.

"To sum up, bad funds are not only closet trackers. The fund price is not the issue and the identification of low quality funds is easy nowadays. Also, independent financial advisers shall continue to professionalise themselves in order to form a real alternative to banking networks.

"At Wiseam, we look for managers generating alpha not managers reproducing risk factors. The way fund managers build their risk factor exposure does not matter much as long as we can identify that exposure and if they generate alpha. Benchmarks therefore become secondary factors and tracking error even more so. We use innovative econometric methods to determine risk factor exposure and alpha. We only select managers that are able to justify what we empirically identify."

Roland Meerdter, co-founder at Door Funds, also raises questions about reliance on single metrics such as tracking error, which in turn are predicated on past performance.

"Ex post performance results alone, eg, tracking error, tell fund investors too little about whether a fund is a closet tracker. Yes, a closet indexer will have a low tracking error but is it sufficient to delineate that, say, ABC Fund is and XYZ Fund is not a closet indexer through the use of a hard and fast 'over/under' of tracking error TE< 4? Over what time period and under what market conditions? At best, a tracking error threshold is a necessary, but by no means a sufficient, condition to label a product as a closet indexer.

"This thinking is rooted in an archaic approach that assumes no transparency or access to information beyond performance figures. Who is leading this hunt?"

SELECTORS' CHOICE

Frank Huttel, head of Portfolio Management responsible for global macro research, fund selection and fund management at FiNet Asset Management, notes that ultimately it is up to fund selectors as to whether they use closet trackers or not.

"We do not look at the tracking error, we rather prefer active share as a measure," he says.

"But yes, we invest in active funds with a low TE from time to time if we want exposure to a certain market. But it is mostly a tactical play and not for the long term. While conducting due diligence with managers, it's easy to find out very fast who is active or not. Just look at the charts!

"Typically, we do not look at funds, which track a benchmark. We rather prefer themes or sectors. Those funds are active, especially if you invest in themes. The active share approach could be one good measure to separate active funds from closet funds.

"Local market regulators do not implement stronger monitoring on closet tracker funds. It is not bad having a closet tracker fund as long as you know it. However, the costs should be reduced. Not everybody wants or can use ETFs.

"Our company hopes asset managers get either more active or close some of the funds. We need more active management. Passive is a dumb way to buy stocks. We hope this does not lead to higher demand for ETFs. We are an advocate of active fund management," he concludes. ■