Audit insights: investment management

Executive summary

The fundamental economic role of the investment management industry has never been more apparent. Societal and demographic changes and public policy measures have created an urgent need for providers of long-term savings products to serve society. This also presents new business opportunities.

WILL INVESTMENT MANAGERS MEET OUR EVER-INCREASING NEEDS?

Due to increased life expectancies, decreasing state provision and the demise of defined benefit pensions, more people than ever before are facing an uncertain retirement and an acute need to save and invest. Investment managers must be ready to use their expertise and experience to serve customers across the financial spectrum with products and services that are valuable, affordable, appropriate and increasingly personalised.

WILL CUSTOMERS BE ABLE TO UNDERSTAND INVESTMENT RETURNS AND FEES?

Despite its simple business model, investment management is puzzling to many. Customers need more clarity about fees charged, business costs and how to interpret information about the performance of their investments. Otherwise, many will continue to find it too difficult to engage with saving and investing just when they need it most. The industry must commit to providing clarity and boosting customer confidence.

WILL TECHNOLOGY DEMOCRATISE INVESTMENT MANAGEMENT?

Digital platforms, robo-advice and artificial intelligence can help make investment accessible to all. The industry must invest in technology to remain competitive and appeal to digital natives. Providers must also seize the opportunity for growth in this space before core consumer brands exercise their potential to disrupt the market. These changes will help investment managers bring more affordable services and expertise to more people.

To meet their own needs and ensure that customers understand what is happening with their savings and investments, providers must change both their attitude and approach. This will be made possible in part by technology. At present, the cost of individualised services is simply too high for many people. Exploiting technology to make the industry more approachable and accessible will help firms grow and customers save and invest the money they need.

Introduction

Investment management companies are commercial businesses that provide economically essential services for those looking to safeguard their financial future. Investment managers help individuals finance their everyday lives (eg, buying a house) and future needs (eg, building up a retirement income). They also help businesses manage their spare cash to develop and grow, and can help influence the companies in which they invest to do the right thing. In particular, they can support businesses, projects and funds that aim to deliver good social outcomes.

It is in everyone's interest that investment managers can operate profitably and competitively to fulfil their purpose, which is to preserve value for their customers to use in the future. They do this by investing their clients' money collectively across different assets, based on an objective and level of risk agreed with the customer in advance. This objective could be to provide a retirement income, simply grow the amount of money or fund ethical or innovative businesses. Investment management generally falls into two categories: active and passive. Active management involves a human element, where a manager uses analytical research, forecasts and their own judgment and experience to decide what investments to buy, hold or sell. Conversely, under passive management, a fund's portfolio mirrors a market index and returns are based on the index movements.

Social, demographic and policy changes mean that people are relying on their own investments more than ever. These changes have put increasing pressure on the industry to ensure it is able to provide the right products and services to savers and investors. As more and more people come to need the industry, it must be able to meet those needs. Despite a predicted savings gap of £25tn by 2050 (meaning a 'pensions time bomb' for the UK), investment managers are not successfully encouraging people to save. More than half of those aged 21–30 make minimum pension contributions, or have no pension at all.

As demographics change, the number of customers who desperately need investment management services is increasing; however, old business models need to be updated. Against a background of ever-increasing regulation and disruptive technology, old ways of operating are no longer sufficient.

In this report, we highlight three questions that prompt consideration of whether investment managers are fit for the future:

- Will investment managers meet our ever-increasing needs?
- Will customers be able to understand investment returns and fees?
- Will technology democratise investment management?

Although it will be challenging to make the required changes, doing so will create a new group of customers, many of whom have a clear need for long-term savings products. To illustrate these challenges we introduce three fictional people who need more from investment management.

Audit insights: investment management is based on the collective insights of investment management audit specialists from BDO, Deloitte, EY, Grant Thornton, KPMG and PwC.

WHAT IS INVESTMENT MANAGEMENT?

The investment management industry helps people meet financial goals through managing a portfolio of financial assets (eg, shares and bonds) which are bought using the customer's savings or investments. If you have a pension, individual savings account or life insurance product, you are probably working with an investment manager even if you don't realise it. Investment managers buy and sell shares, bonds and other assets for their customers in order to grow the amount of money they hold. This requires a lot of expertise to research companies and assets to invest in, understand their customers' needs, read what markets are doing and understand how values will change in relation to world events.

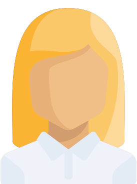
THE POWER OF COMPOUNDING

Compound interest, described by Einstein as 'the most powerful force in the universe', underpins successful investing. The earlier someone starts investing, the better chance they have of meeting their goals, as catching up in later years requires much larger savings.

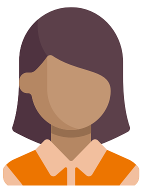
Investing an annual £3,000 at a 2.5% return for the first 20 years of a child's life will yield a £200k+ investment pot by the age of 65. To have a post-retirement guaranteed income of £10,000 a year, savers will need a pension pot of £327,000 by age 65.

The people described below illustrate common problems facing savers. The challenges they face could be alleviated by the actions suggested in this report. Their potential circumstances are considered in further detail at the end of this report.

John is a civil servant who began in his role immediately after leaving school. He is reaching state retirement age, at which point he will be able to draw down his final salary pension, which he has built up over the course of his career. John and his wife own their large family home mortgage-free, and it has exponentially increased in value in the 40 years since they purchased it. John and his wife are attempting to save enough money to raise a deposit for their son to purchase a flat, who is finding it difficult to get onto the housing ladder. John needs a pension investment that will facilitate this transfer of wealth in a tax-efficient manner that he finds understandable and has a low fee.



Janine is a regional sales executive who lives with her teenage daughter in a mortgaged property. She is concentrating on saving to fund her daughter's university education and is intrigued by investment products that could help her do so, yet does not know how to start looking for such a product. Janine has worked for a number of employers and collected numerous small pension pots along the way; she would take the chance to combine them into a single pot if the process were easy and cheap. She understands there are many different savings options but feels overwhelmed by the volume of information and high cost. She also lacks the time to get through it all to make an informed decision. Janine has no other investments and minimal cash savings.



Sandeep graduated from university two years ago and has since been working at a retail store on a zero-hours contract, while attempting to find a full-time job in her desired field. Sandeep lives with her parents while actively looking for a rented house-share to move into. She has a large amount of student debt, which is not currently being paid down, and is not aware of any viable savings or investment products. She believes investment management is just for older, rich people. Sandeep is not eligible for pension payments, sick pay or paid holiday leave through her employer.

Will investment managers meet our ever-increasing needs?

A CHANGING LANDSCAPE FOR LATER LIFE

People are becoming more responsible for their own financial futures. As fewer children take care of their ageing parents, generations are no longer living together. State pension entitlements are also decreasing in value while the age at which they can be claimed is increasing. This means a longer working life and the inability to rely on a state pension as an income in later life. After retirement, longer life expectancies mean that more money is needed to ensure a comfortable old age. Many people will also have to pay for long-term care. All of these factors mean that retirement savings have never been more important.

In addition to these changes, employers have stopped providing defined benefit pensions (where savers were guaranteed a certain income after retirement, with their employers taking on the risk of changes in investment values) and have moved to defined contribution schemes, which are more affordable for companies to run. As investments go up and down, an individual is unlikely to reach a guaranteed or even known level of investment or income when it is time to stop working. Furthermore, many individuals work for different organisations over the course of their career, and are likely to build up numerous different pensions, making it even harder for them to understand their potential financial position upon retirement.

For example, interest rates in the UK remain low, making it challenging to grow money that is invested in real terms (taking into account that goods and services will be more expensive in the future). The government frequently intervenes in long-term savings, introducing policies such as freedom of choice in pensions, which removed the requirement to take an annuity when cashing in a pension pot, and auto-enrolment, requiring all companies to provide and contribute to pension savings for employees. This has led to new savings products (such as lifetime individual savings accounts), and new companies entering the market are trying to capitalise on the new and different ways to save that have arisen as state provision and company pensions have shrunk. As the need to accrue a greater level of savings on retirement escalates, it is now up to individuals to consider how best to use their money.

TAKING OPPORTUNITIES AND MEETING CUSTOMER NEEDS

Long-term savings product providers have a social responsibility to enable people to plan and prepare for this stage of life. To take advantage of the opportunities offered by this trend, investment managers must deliver services that meet society’s needs. In particular, the industry needs to combat widespread disengagement and feelings of disenfranchisement that exist among customers. These feelings exist in part because many people find it difficult to engage with finance, despite its lifelong relevance. While financial education and literacy are often touted as the solution to a lack of engagement and understanding, the industry should do more for customers to help combat some of the common reasons why they might feel confused and disengaged.

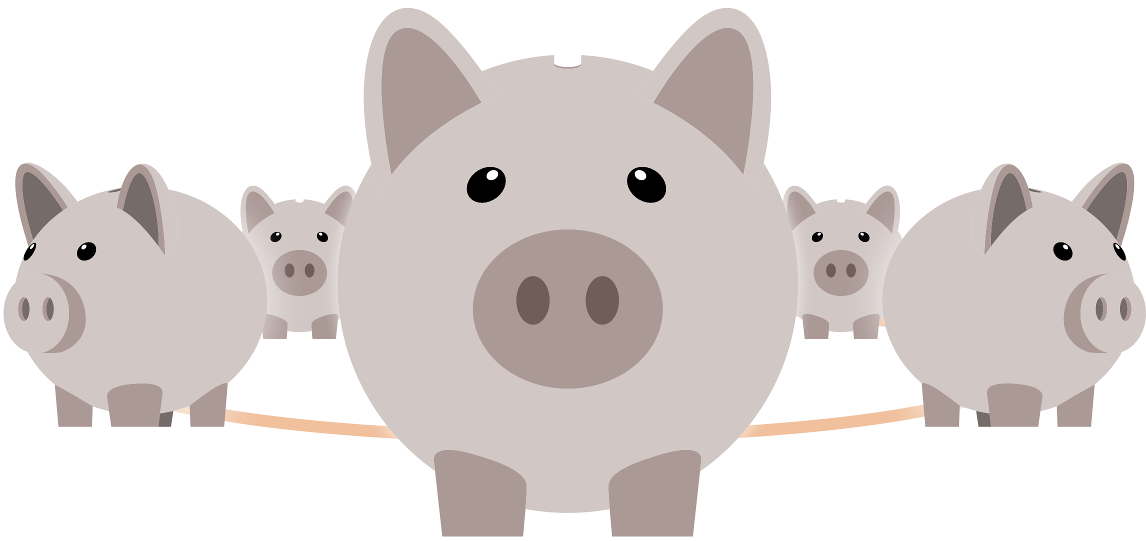
People often find it difficult to make financial decisions due to a limited understanding of risk, conscious or unconscious biases, lengthy delays between decisions and results and, often, the challenge of simply finding the necessary time in busy lives. Investment managers must recognise these constraints and adjust how they operate and interact with customers, while working harder to communicate with people in terms that they understand. A lack of brand recognition with respect to investment managers demonstrates that they must do more to make their presence known to consumers. Otherwise, the sector may be vulnerable to a disruptive new entrant, particularly a well-known consumer business with the ability to invest, such as Google, Apple, Facebook or Amazon.

A GENERATION WORKING FOR LIFE

The issue is particularly acute for young people who have less disposable income and an ever-increasing period over which they need to save. While there is nothing new about younger people having limited spare cash, in the past many more products were aimed at smaller scale savings. For example, many life insurers used to employ a sales force that visited people at their homes to collect regular savings payments. However, various factors, including increasing and costly regulation, mean that the smaller saver is now less attractive and profitable to providers.

This led to a focus on institutional business (eg, investing on behalf of large companies, banks and insurers) and high-net-worth individuals at the expense of the average person. The need to carry out anti-money-laundering and identity checks, and to understand the customer's risk appetite and objectives means that investment management has often been seen as a fairly personal service. Although this is good for those who can afford to pay for it and invest the requisite amounts, business models must change to provide important services to the people who need them.

If investment management does not become more accessible and attractive, the savings gap may widen instead of narrowing, and the industry's purpose — helping people store value to bring into the future — will be frustrated. As a result, either future governments will have to bear the burden of those unable to support themselves in retirement, or those individuals will have to work until death. This is an opportunity for the industry to provide meaningful service and gain a wide range of new customers who will be valuable assets. Technology and the ability to communicate with customers more clearly will be vital to this change.



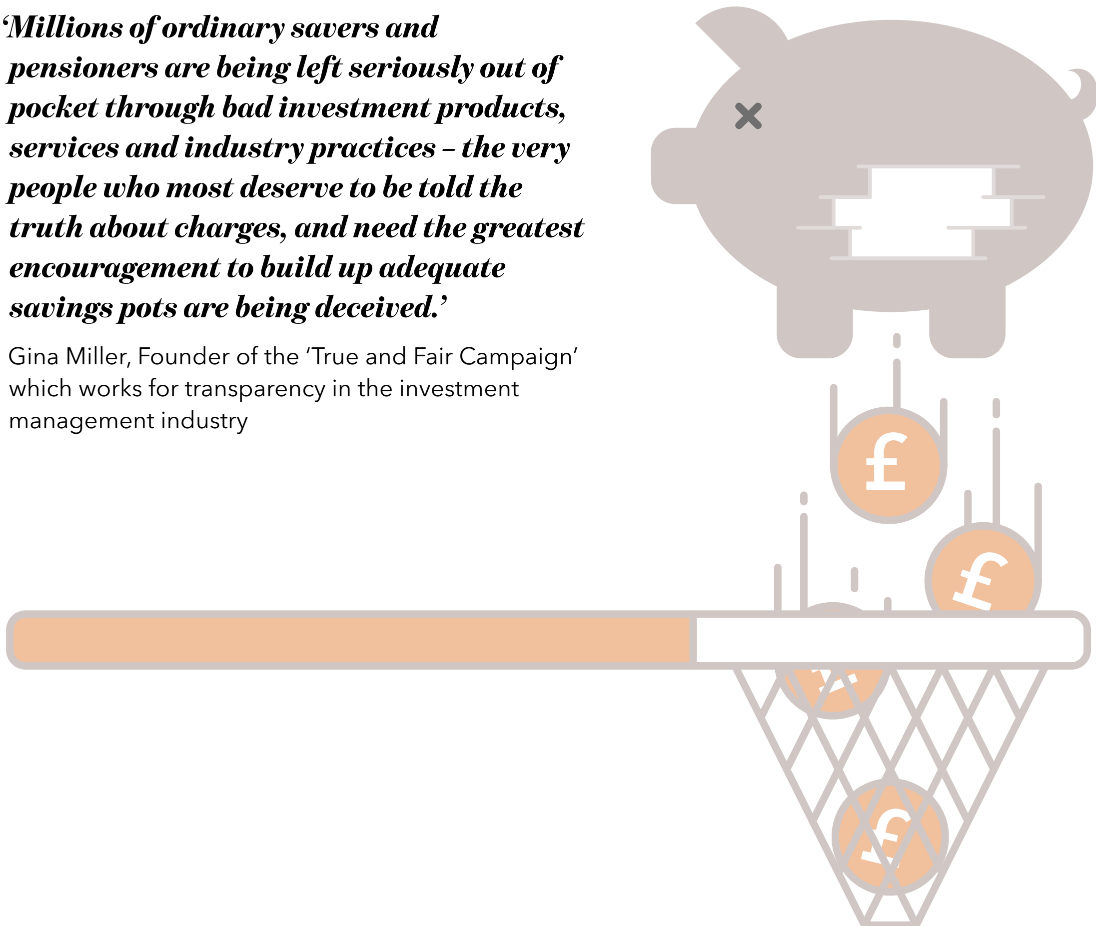
Will customers be able to understand investment returns and fees?

Although investment managers have a relatively simple business model, the way in which they operate can be difficult to understand. Information regarding fees charged, the costs of investment management and the resulting investment performance can be complex and unclear. Managers must be able to communicate clearly what fees are charged and why, the investment selection process, the performance of products compared to one another and between different managers, and how much a customer's investment has gained or lost over a period of time. If people cannot understand the service they are receiving or the value they are gaining, they will be unlikely to want to keep paying for it.

FAIRER FEES

'Millions of ordinary savers and pensioners are being left seriously out of pocket through bad investment products, services and industry practices – the very people who most deserve to be told the truth about charges, and need the greatest encouragement to build up adequate savings pots are being deceived.'

Gina Miller, Founder of the 'True and Fair Campaign' which works for transparency in the investment management industry



Even institutional investors can find it difficult to understand the level of fees fully, and individual savers and investors face a much more acute challenge. The Investment Association has developed a new disclosure code for investment managers that is intended to deliver a 'comprehensive and consistent charge and cost accountability framework'. However, although a number of initiatives to improve transparency have been introduced over the years, criticisms regarding the opacity of fees remain. Customers are no more likely to understand fee structures now than before these initiatives.

Fees, which vary between firms, fund the ecosystem that supports the investment process.

TYPICAL CHARGES FOR INVESTMENT MANAGEMENT	
Investment management charge	An ongoing charge for investment and portfolio management, usually calculated as a percentage of assets under management.
Administration charge	A charge for administration and other services, such as maintaining a record of your investment and calculating the value of the fund each day.
Platform fee	The fee for using an online service to review your portfolio and use interactive tools to manage investment.
Entry and exit fee	Paid when joining or leaving the investment manager.
Fund trading costs	Charges for buying and selling the investments that make up the fund.
Performance fee	Usually calculated by reference to the increase in the fund's gross or net asset value (usually referred to as the 'NAV'), which represents the value of the fund's investments.
Advice fee	If you invest with the help of a financial adviser, you pay a separate charge for this advice.

Confusion over fees has led the Financial Conduct Authority to call for a single all-encompassing fee, and for further clarity to be provided to customers if performance fees are charged. Going forward, investment managers will have to prove their quality in order to charge performance fees. This represents a shift from the current model of charging by quantity of investment. Technology may help simplify the investment process, removing cost and therefore reducing the fees that can be levied.

CLEARER COSTS

In addition to fees paid, there is little transparency surrounding the factors that determine investment managers' overall remuneration. Due to a limited understanding of the choice of factors used to make up bonuses and incentives, customers are unaware of the motivations that drive investment managers and ultimately the direction of their savings. Although the remuneration of bankers is currently under more scrutiny than that of investment managers, this trend may shift as the importance and awareness of savings increases.

REAL RETURNS

More must be done to provide customers with meaningful and understandable information on where and how their money is invested. Most currently receive a high volume of information in statements and disclosures. This approach allows investment managers to argue that they are totally transparent and allow individuals control over their portfolios. However, investors need to be able to digest the information provided and be fully educated about the aspects that are most important to them, not overwhelmed with irrelevant data.

This will allow them to change the aspects of their investment portfolio or savings that are most important to them.

Fund performance is presented in a variety of ways, including straight performance, performance against standard benchmarks, such as the FTSE All-Share index, and performance against more bespoke benchmarks, selected by the fund manager. Improving clarity in this area and making it more consistent and comparable between funds could help customers compare managers. Simple conclusions, such as gain or loss in the year, should be easy to decipher, not presented under the cloak of 'value of units', where returns are depleted by fees. Currently, this information is not presented transparently.

THE ADVANCE OF PASSIVE INVESTMENT

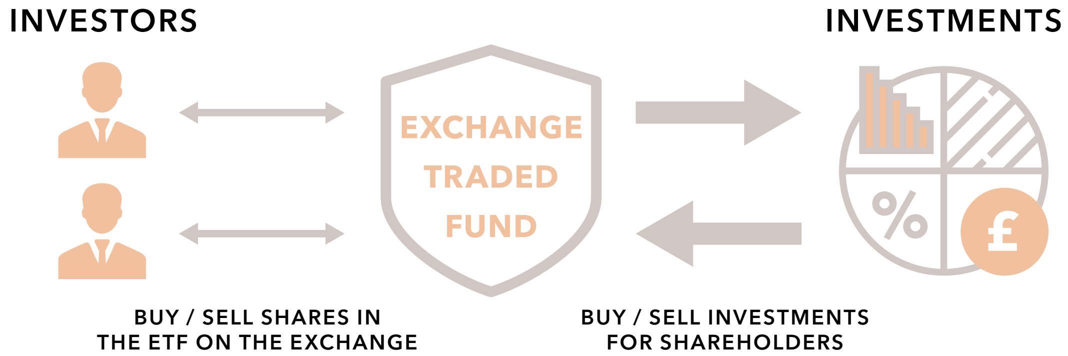
The accelerating trend towards tracker funds and continued squeeze on active managers' margins may enforce a fee overhaul. The exchange-traded fund (ETF) market is worth over £3.6tn and is growing further as consumers favour passively managed funds due to their simplicity, low price and easily understandable nature.

If the trend towards passive investment continues, investment managers will have to react; this can already be seen with various funds changing to a single pricing model for buying and selling units in its funds. However price transparency is still lacking, even in the relatively simple world of tracker funds. In 2017, some investment managers offered tracker funds costing up to 10 times more than comparative products offered by rival managers. This wide disparity over pricing inevitably leads to confusion over what one can get for one's money.

Until investment managers are clear about fees, costs and performance, the perception of unfairness will exist and people will continue to feel disengaged with the industry. A customer should be able to understand and distinguish between good-value investment products, just as the average customer can distinguish between healthy and unhealthy food. By empowering customers to take more responsibility, the industry can help combat a lack of financial understanding.

WHAT IS AN ETF?

ETF products track an index, which could be linked to any financial product, such as a commodity or bond. This gives the investor the advantage of investing in an entire index by investing in a single product, making it cheap and easy to manage the investment. The investor can then share in the gains or losses of the entire index. For example, an investor purchasing an FTSE 100 All-Share ETF will be invested in the entire FTSE 100, without needing to purchase 100 individual shares. If the FTSE 100 increases by 1%, the investors' return will also be 1%.



Will technology democratise investment management?

THE ENHANCER AND ENABLER

As fintech companies and investment providers introduce digital technologies to their service offering, traditional investment managers will have to keep pace with these changes to hold onto market share. The industry has so far been slow to undertake technological change. Although technology will create huge potential opportunities in a number of areas and allow the industry to transform and simplify itself, its adoption is not without risk.

Investment managers can use technology to engage with individual customers, whose need for the industry is steadily increasing. Technology can provide easier and cheaper access to products and services and facilitate interaction between managers and customers in an accessible and affordable way. As customers are experienced in using technology in other facets of life, such as booking holidays, banking and shopping for food and clothes, they will have high expectations. In particular, customers will demand a customer experience that gives them total control over their portfolio and ensures that all their queries are easily resolved.

New technology and increased data will allow for proper personalisation instead of trying to deal with customers as a pre-defined type. However, this will require time and investment to get right. A product that suits personal circumstances, preferences and risk appetite will automatically be more appealing to an individual, which will foster greater engagement with the industry. This technology will help alleviate the feelings of alienation and confusion associated with dealing with pensions and long-term savings providers. A technology-enabled service can reduce the problem of complicated and extensive fees, and mitigate perceptions of the industry as exclusive and expensive.

The technology to do this exists, or is rapidly developing. The current proposition of many investment managers does not suffice and will not fulfil the requirements and demands of the wider population who need their services. Necessary upgrades to existing technology and systems will service these demands and allow investment managers to build relationships with a much larger customer base at a lower overall cost. The industry must invest and take this opportunity to simplify and enhance its business practices, to diminish the sense of exclusivity and become easy to understand.

THE GROWTH OF ROBO-ADVICE AND ARTIFICIAL INTELLIGENCE

The industry is currently dominated by active management. Digital technologies and artificial intelligence will allow investment managers to greatly increase the range of products on offer via passive investment. Providers will be able to create tailored and customised products to fit an individuals' risk profile, resulting in a strategy that suits each customer whatever their needs.

As technology enables greater product customisation, the growth of 'robo-advisers' can help make services cheaper and more accessible, with lower minimum investments and simpler fees. Software can automatically make investment and portfolio decisions for customers, based on their pre-assigned risk levels. This method, although still very small in assets under management terms compared to the entire industry, is growing rapidly and provides a cost-effective and simple solution.

Adopting new technology will also help active managers become more efficient, and therefore reduce costs. Large amounts of data can be analysed quickly and accurately to aid stock picking and develop the portfolio more quickly and efficiently to take advantage of market swings. Although passive strategies are increasing in popularity, there are still active decisions that need to be made in a passive fund, such as portfolio weighting. Proper data usage can aid this. Managers who can blend the benefits of robo-advice with hands-on human experience will see efficiencies and a more attractive product, as long as they are able to clearly explain and present the benefits that they now bring.

A quarter of UK adults have little or no confidence in managing their money. This is partly due to the opaque nature of the industry. These strategies will make investment management far simpler to follow and understand, and will hopefully produce enhanced returns. Moreover, new technology will allow customers to self-invest and drive their own investments, increasing confidence along the way.

THE BLOCKCHAIN REACTION

Blockchain technology has the potential to revolutionise how many industries operate, and could do the same for investment management. A blockchain is secure by design and operates via a decentralised distributed computing system, making it perfect for records management. This will increase the efficiency of back-office functions in a secure manner, as data is held across the network instead of centrally. It also eliminates the risk that an attack will wipe out the core of a firm.

Blockchain has the potential to greatly enhance the customer experience while managing risk. In particular it can significantly streamline the on-boarding process, speed up compliance procedures, such as 'know your customer' and anti-money-laundering checks, make the management of portfolios and clearing and settlement of trades more efficient, and decrease waiting times for customers. Furthermore, on the blockchain an audit trail is created automatically, making it easy to track these processes.

Some investment managers are responding to this by assessing blockchain capability as they look to cut costs and provide more timely and accurate data. Transaction processing and settlements can be transformed as there is no need for intermediaries. This will reduce costs while increasing safety and transparency. There will also be added benefits to the valuation process as blockchain produces live fund-valuation figures.

However, incorporating blockchain into the daily operations of an investment manager will be challenging. For example, the regulatory and legal implications of holding customer data on the blockchain are unknown and will need to be determined, and the cost of replacing existing technological infrastructure with blockchain capability will be significant.

BLOCKCHAIN

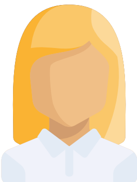
EMPOWER AND ENHANCE

Technology clearly has a role to play in empowering those currently not saving and investing as they need to be, and enhancing the experience of those who are. This will require firms to invest in IT, be willing to test new ideas (which may fail) and balance innovation with getting the basics right (ie, data protection, cyber security and IT resilience). Making long-term savings products and investment services available (and attractive) to more people will benefit the industry as well as these new customers.

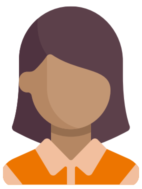
TAKING CONTROL OF YOUR FINANCIAL FUTURE:

If the changes considered in this report were implemented, this is how life could look.

John reaches state retirement age. He is in frequent contact with the investment manager holding his final salary pension pot. Together they are working to configure a tax-efficient strategy that will allow John to fund a deposit on a flat for his son. John regularly logs into his online pension account, where he can clearly view the value of his pension, assess his expected annual income and change his investment preferences, as well as view his singular and traceable investment fee. John feels in control of the process and can view a timeline showing the expected date of the purchase of a flat.



Janine now has a single pension pot combining her various pension payment contributions across different employers' schemes. Janine was able to complete this process through one 30-minute phone call, after selecting an investment manager based on a TV advert she viewed. Now each time Janine moves employers, she merely has to inform her investment manager, who then works alongside Janine's new employer to add her new pension payments to her existing pot. In addition to her pension fund, Janine has opened a savings fund at the same investment manager, as she trusts them more than her bank. The low minimum investment allows her to deposit small amounts frequently and at little cost as there are no hidden fees. Janine feels comfortable contacting the investment manager regularly to assess the progress of her pension and savings funds, as well as discussing new ideas.



Sandeep has been engaging with investment managers via social media to determine if she can make small regular payments into an ethical investment fund that will begin to pay off her student loan. Sandeep regularly uses various managers' apps to build hypothetical scenarios to determine how much she could save on a monthly basis to pay off her loan within a certain timeframe. As ethical investment is important to her, she finds it helpful to build mock portfolios and investment products via an app to determine if a certain investment manager can fulfil her preferences and provide a reliable income. Sandeep is confident in approaching investment managers for standard financial advice, for which no fee is charged.

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