Trustee toolkit downloadable

Investment in a DC scheme
Tutorial 4 of 5: Charges

Here you will learn more about the charges involved in investments and whether they represent good value for money and, where required, good value for members.

This tutorial is related to the following units in the defined benefit (DB) and defined contribution (DC) scope guidance:

- How DC occupational arrangements work (7a).

This tutorial is linked to **Scenario 2**.

The Pensions Regulator

Who pays the charges?

Trust-based schemes vary as to which costs are paid by the employer and which are paid by the member (also known as member-borne costs). In some cases, the employer bears some or all of the costs related to administration and running the scheme. It is much less common for the employer to bear any investment costs.

In some schemes, the employer only covers costs incurred by employed members so the charges can be higher for deferred members. When referring to a deferred member, these higher charges are called 'deferred member charges'. When referring to an active member, the lower charges are called 'active member discounts'.

In these cases, trustees should consider whether deferred member charges are reasonable and appropriate. When members leave the organisation trustees should make them aware of any change in the charges. From April 2016 charges must be equal for both active and deferred members in some circumstances.

This tutorial focuses on the investment costs and not the costs associated with administration, however these costs must be considered when trustees are setting up and reviewing investment arrangements, particularly where the member bears the costs.

You can learn more by reading the guide to value for members at **www.tpr.gov.uk/value**

Exercise: Types of charge

In the module 'How a DC scheme works (2014)' you learnt about different charges. Can you match the descriptions to the correct charge?

Charges: Annual management charge (AMC), portfolio turnover rate (PTR), total expense ratio (TER)

1. A measure of how frequently an investment manager changes the underlying investments of a fund during a defined period of time.
2. The investment manager is usually remunerated with this charge. It is typically a proportion of the monetary value of the fund over year.
3. Worked out historically. Typically includes AMC and other fees such as legal and audit costs, custodial fees and investment administration fees.

Turn to the back for the answer.

Other costs to members

The AMC, TER and PTR cover some charges, but they are not the only charges members might face.

Platform charges

If a scheme offers a range of investments to its members via a platform then the cost of the platform services is normally passed onto the member. They may be included in the AMC or listed separately. This is typically a percentage fee of the member's investment.

Blended or white labelled funds

In some arrangements there can be an additional cost to members for investing in blended and/or white labelled funds.

You will find more information on this topic in the tutorials **Default investment strategies** and **Alternative investment options**.

Buying and selling units

As members change their investment strategy (either by choice or as part of the automatic switching in a lifestyle strategy) they may incur costs in buying and selling units in fund. This will depend on how a fund is priced. There are, broadly speaking, two types of trading prices of units:

- Dual pricing
- Single pricing (including 'swing' pricing).

Buying and selling units: Dual pricing

This is where the selling price of an investment is lower than its buying price. The cost incurred by members is often named the 'bid-offer spread' and is effectively the difference between the bid price (the price a member would sell a unit at) of a unit and the offer price (the price a member would buy a unit at) of a unit. For example if the bid price was 95p and the offer price £1.00, the bid-offer spread is 5%.

Buying and selling units: Single pricing

As the name indicates, this means that there is only one price. Therefore there is no difference in the price at which a member buys or sells units.

In some single priced funds, investment managers have the discretion to change that price depending on whether there are net inflows or outflows in the fund and this is known as the 'swing price'. This single price can therefore be 'swung' to a bid or offer basis to account for that in/outflow.

For example if there was a large inflow of investments made on a day that a member was disinvesting, the member may sell the units at a higher price (the higher offer/buying price).

Sometimes, when there is single pricing, the investment manager applies a charge which is called 'the dilution levy' for meeting the cost of buying and selling units.

Other charges

You may come across lots of different types of charges in the course of managing your pension scheme. We have provided a 'charges glossary' to help you understand each one, which you can download from the Resources tab on the Trustee toolkit website.

Keeping member-borne costs down

Trustees should consider if the investment fees for the investment options offered to members are competitive, remain appropriate and offer value for money for members.

Actively and passively managed options

Costs and investment management charges are generally lower for passively managed funds than for the equivalent actively managed fund. Trustees should ensure that if a passive fund is used, that the fee is not only lower than that of an active equivalent but also appropriate for a passively managed fund.

You will find more information on this topic in the tutorial **Active and passive management** in the module **An introduction to investment.**

Negotiating fees

Whether a fund is actively or passively managed, research shows that there is scope for trustees to negotiate DC investment fees, both for new and existing scheme arrangements.

Trustees could consider the following factors when approaching investment managers and providers:

- Has the scheme seen significant growth in the size of its assets?
- Has there been a significant influx of new members? Or do you expect an influx of members? This is particularly relevant for schemes chosen to be used as the automatic enrolment vehicle.

Trustees must act in the best interests of members, which includes negotiating the best deal.

Exercise: Charges

Take a look at the three funds in the table below. A member may incur additional costs (such as platform charges) to the AMC but for simplicity we have excluded them in this example. Which fund has the lowest charges?

	Type of fund	Benchmark	AMC	Performance over 3 years per annum
A	Active global equity fund	FTSE All World Total Return Index (GBP)	0.7% pa	8.5% pa
B	Active global equity fund	FTSE All World Total Return Index (GBP)	0.6% pa	8% pa
C	Passive global equity fund	FTSE All World Total Return Index (GBP)	0.1% pa	7% pa

Note that these funds are fictitious and for illustrative purposes only. The exercises are not making any recommendations.

Turn to the back for the answer.

Exercise: Value for money

Based on the last three years' performance, which fund offered the best value for money?

Turn to the back for the answer.

Why would trustees offer high cost options?

As investment experience delivered to a member is an important determinant of good member outcomes, trustees should consider whether the charges for a fund are reasonable in relation to the expected investment returns. Trustees should consider if the funds are offering good value for money.

Example

Looking for a restaurant to eat, you may see two fast food restaurants next to each other. If one was offering a meal for 25% less than the other, then you would probably agree that the lowest charge was the best value. But looking a little further, there is also a smarter restaurant – with your favourite food – that offers a menu at a higher price. You know that you can save money by going to the fast food restaurants, but is that really what you are looking for?

What is good value?

When considering what constitutes good value trustees should also consider that value doesn't necessarily mean a member has a bigger pot at retirement. It may mean, for example, that a member experiences much lower volatility in the route to accessing their benefits. Members can benefit from being able to plan for retirement with greater certainty.

It is reasonable to pay more for a fund if you believe it will benefit the member with higher investment returns after the impact of fees or a less volatile journey to accessing their benefits.

You will find more information on this topic in the tutorial **Value for money and charges** in the module **How a DC scheme works (2014).**

How can trustees keep costs in mind?

Below are some different ways trustees can focus on costs.

Chair's statement

Trustees of many schemes offering money purchase benefits must produce an annual chair's statement.

Amongst other items the chair's statement must set out the costs and charges incurred in each of the scheme's investment options (including any default arrangements) and report on the trustees' assessment of the extent to which charges and transaction costs represent good value for members.

Trustees should seek advice as to the extent to which these requirements apply to arrangements within their scheme.

Scheme booklet

Trustees can also ensure members are aware of the costs involved in investing in their scheme by setting out the TER in the scheme booklet.

Trustees can also remind members of these costs by including them in regular communications sent out to them. For example, trustees could send members a summary of the chair's statement alongside the annual benefit statement.

Net or gross?

Trustees should consider the impact of fees on a fund's investment return as this is the return the member will receive. This is known as 'net of fees performance' which we looked at in the exercise earlier in this tutorial. Performance considered before the impact of fees is known as 'gross of fees performance'. It is important to consider a fund's performance alongside its performance objective.

Trustees should be careful to ensure that they compare 'like with like'. By using the 'net' figures, they will be taking into account the charges that have been applied.

Investment fund performance objectives are stated either gross or net of fees. In this context, the 'fees' is likely only to include the AMC. The additional costs that make up the rest of the TER can vary and are often taken out of the performance of the fund even before the gross of fees figure.

Charge cap

The government has set a 0.75% charge cap for member-borne charges in all default arrangements within DC schemes used by employers to comply with their duties under automatic enrolment legislation. This cap includes platform or administration costs borne by a member but does not include transaction costs.

Trustees will need to ensure that the charges borne by members for the default arrangement of schemes used by employers to comply with their duties under automatic enrolment legislation do not exceed this cap.

The government has stated that the cap on charges will be reviewed by the Department of Work and Pensions (DWP) in 2017.

You can learn more by reading the guide to value for members at **www.tpr.gov.uk/value**

Answers

Types of charges

1. Portfolio turnover rate 2. Annual management charge 3. Total expense ratio

The investment manager is remunerated by the AMC, expressed as a proportion of the fund value annually, eg 0.8%. It can sometimes be a fixed fee but this is rare. If members are aware of costs, it is likely to be this one.

The TER is worked out historically and includes costs such as AMC, legal and audit costs, custodial fees and investment administration fees. It does not include transaction costs incurred when buying and selling investments, the taxes associated with those transactions and the costs associated with entering or exiting from a fund or a scheme. The TER is a more complete measure of what the member is paying for the services they are getting, but it does not capture all the costs and charges that apply.

The PTR is a measure of how frequently an investment manager changes or 'turns over' the underlying investments of a fund during a defined period of time, usually a year. It is calculated by taking either the total amount of shares bought or the total amount of shares sold (whichever is less) and dividing by the total asset value of the fund.

Transaction costs are affected by the level of activity in the fund, therefore PTR can give an indication of what the transaction costs are likely to be, based on the rate at which investments are 'turned over'. In conjunction with the TER, it can provide trustees with a more complete picture of the likely costs.

Charges

Fund A has an AMC of 0.7%, Fund B has an AMC of 0.6% and Fund C has an AMC of 0.1%. So in this case Fund C has the lowest charges.

Value for money

In this simple example, we need to work out the 'net of fees performance':
performance – charges = net of fees performance

For Fund A, the net performance is 7.8% pa, Fund B 7.4% pa and Fund C 6.9% pa. This means that Fund A provided the better value for money over this three year period. Of course, working out value for money will be more complex than this due to other charges to take into consideration, changes in performance over longer time periods, volatility and performance in relation to objectives and benchmarks. We will look at this in more detail in the tutorial **Managing performance** later in this module.

You have now reached the end of this tutorial. The next one in the series is **Managing performance**.