The Association of Investment Companies

Ongoing Charges

Recommended methodology for the calculation of an Ongoing Charge figure

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Contact details

The Association of Investment Companies (AIC) represents closed-ended investment companies whose shares are traded on public markets.

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Contents

Introduction

This paper sets out the AIC's recommended methodology for calculating Ongoing Charges. Ongoing Charges is a figure published annually by an investment company which shows the drag on performance caused by operational expenses. More specifically, it is the annual percentage reduction in shareholder returns as a result of recurring operational expenses assuming markets remain static and the portfolio is not traded. Although the Ongoing Charges figure is based on historical information, it provides shareholders with an indication of the likely level of costs that will be incurred in managing the fund in the future.

It is recommended that all AIC Members adopt the methodology set out in this paper for calculating their principal Ongoing Charges figure. Where appropriate, AIC Members may choose to disclose supplementary expense ratios calculated on alternative bases, in addition to the principal Ongoing Charges figure, if it is believed that this would provide useful information to shareholders. Where AIC Members do provide supplementary expense ratios calculated on alternative bases, it should be made clear that the principal Ongoing Charges figure has been prepared using the AIC's recommended methodology and state the basis on which alternative Ongoing Charges figures have been made.

The Ongoing Charges disclosure replace Total Expense Ratios (TERs) which were historically calculated by investment companies. It is recommended that AIC Members disclose an Ongoing Charges figure, calculated in accordance with the AIC's recommended methodology, in their annual financial reports.

The AIC's recommended methodology will be appropriate for all disclosure purposes, including publication of statistical data by the AIC. Applying an industry standard approach to the calculation of Ongoing Charges will simplify internal procedures for investment companies, create consistent and comparable data across the sector and minimise confusion amongst shareholders and the wider market.

The AIC's recommended methodology is also consistent with rules which require Undertakings for the Collective Investment in Transferable Securities (UCITS) funds to publish an Ongoing Charges figure, thereby creating comparable data between open-ended and closed-ended funds.

Ongoing Charges calculation

The AIC's recommended methodology for calculating an Ongoing Charges figure is based on the following formula:

$$\text{Ongoing charges (\%)} = \frac{\text{Annualised ongoing charges (A)}}{\text{Average undiluted net asset value in the period (B)}}$$

The detailed principles underlying this formula are set out below.

Timing and basis of calculation

It is recommended that AIC Members publish an Ongoing Charges figure each year as part of their annual financial report. The Ongoing Charges figure should be expressed as a percentage to two decimal places.

Relevant figures should be based on information published in the audited annual financial report and on regular reported net asset value (NAV) data (see below). The disclosure should state whether or not the Ongoing Charges figure has been prepared in accordance with the AIC's recommended methodology. Where the AIC's recommended methodology has not been followed, an explanation should be given.

Annualised ongoing charges (A)

The AIC's recommended methodology for calculating an Ongoing Charges figure requires the identification of all relevant expense items. Broadly speaking, ongoing charges are the costs that the investment company would have to pay in the absence of any purchases or sales of investments and if markets remained static through the period. Ongoing charges are different to total expenses as not all expenses are considered to be operational and recurring.

Given the diverse range of expenses which are incurred by investment companies, it is not possible to provide a definitive list of which expense items should be included or excluded from the scope of ongoing charges. Indeed, the determination of ongoing charges can at times require subjective judgement. To aid preparers and to ensure consistency, we have set out below a definition of ongoing charges. This will assist AIC Members faced with unusual expense items in deciding whether they should be included or excluded from the calculation. We have also produced a table showing which of the most common expenses incurred by an investment company should be included or excluded from the calculation of the Ongoing Charges figure.

Some investment companies allocate certain expenses to capital[1] and it may be necessary to 'repatriate' such items in order to determine the total value of the company's ongoing charges for the purposes of calculating the Ongoing Charges figure.

Definition of ongoing charges

Expense items should be included in the calculation of the Ongoing Charges figure where they meet the following definition:

> "*Ongoing charges are those expenses of a type which are likely to recur in the foreseeable future, whether charged to capital or revenue, and which relate to the operation of the investment company as a collective fund, excluding the costs of acquisition/disposal of investments, financing charges and gains/losses arising on investments. Ongoing charges are based on costs incurred in the year as being the best estimate of future costs.*"

Treatment of common investment company expense items

The following table shows the most common expense items incurred by investment companies and whether they should be included or excluded from the calculation of the Ongoing Charges figure, in accordance with the definition set out above.

[1] See Statement of Recommended Practice Financial Statements of Investment Trust Companies and Venture Capital Trusts

Common investment company expense items	Include/exclude from calculation of annualised ongoing charges
Management fee	Include
Performance fee	Exclude – see section below
Directors’ fees and expenses	Include
Audit and tax compliance fees	Include
Custody/depositary	Include
Fund administration	Include
Fund accounting	Include
Company secretarial	Include
Registrar	Include
Legal and professional advisers	See section below
Marketing	Include
Insurance	Include
Registration fees, regulatory fees and similar charges	Include
Interest costs and associated drawdown costs	Exclude – see section below
Irrecoverable VAT	Include – see section below
Tax charge	Exclude – see section below
Realised and unrealised capital gains/losses	Exclude
Currency profit/loss on revenue bank account	Exclude
Costs associated with portfolio transactions (e.g. brokerage or custodian costs, stamp duty, costs of formation of ADRs/GDRs etc)	Exclude
Soft commission and other similar arrangements	Exclude
Trail commission	Exclude – see section below
Restructuring costs	Exclude – see section below
Share buy-backs/issue costs	Exclude
Dividends	Exclude

Performance fees

The AIC's recommended approach is to exclude performance fees from the Ongoing Charges calculation. This mirrors the approach taken by UCITS funds.

However, to address concerns that the exclusion of performance fees could mislead shareholders about the total costs of fund management, it is recommended that, in addition to disclosing the principal Ongoing Charges figure, AIC Members should also disclose:

- details of the performance fee arrangements in place or a cross-reference to where information on the performance fee arrangements can be found (including, where relevant, the outperformance required in percentage terms and the name of the relevant benchmark)
- separate percentage figure for the performance fee. This could be set out as follows:

Ongoing Charges information	
Ongoing Charges (using AIC recommended methodology)	x%
Performance fee	x% [performance fee/average undiluted NAV in the period]
Ongoing Charges plus performance fee	x%

Legal and professional advisers

Depending on the nature of the transactions or activities to which they relate, the costs of legal and professional advice may be included or excluded from the Ongoing Charges calculation. It is recommended that legal and professional costs which meet the definition of ongoing charges set out above, that is to say are likely to recur in the foreseeable future and relate to the operation of the investment company as a collective fund, should be included in the Ongoing Charges calculation. For example, legal and professional costs relating to regular share buy-backs would be included. On the other hand, it is expected that legal and professional costs relating to a one-off corporate transaction such as an issue of a new class of shares or reduction in the share premium account would be excluded.

Interest costs and associated drawdown costs

It is recommended that bank and loan interest, and associated drawdown costs, are excluded from the Ongoing Charges calculation because they are deemed to be an investment related capital expense rather than an operational expense.

Taxation

It is recommended that expenses are included in the Ongoing Charges calculation on an 'all taxes included' basis. This means that the gross value of expenses (i.e. expense plus irrecoverable VAT) should be used. All direct taxes (including corporation tax, deferred tax and stamp duty) should be excluded from the calculation of Ongoing Charges.

Trail commission

Where trail commission agreements are in place, costs may be incurred directly by the investment company. Given the variation and uncertainty of the amounts involved, it is recommended that trail commission is excluded from the Ongoing Charges calculation. It is further recommended that any trail commission incurred by the investment company is separately disclosed in the annual financial report.

Restructuring costs

Restructuring costs, such as expenses associated with restructuring debt, mergers or other types of reconstruction are considered to be one-off items. It is therefore recommended that they are excluded from the Ongoing Charges calculation.

Negative expense items

Occasionally the annual financial statements include negative expense items. These are often the result of a previous over-accrual for items such as audit fees or VAT. It is recommended that, if material, any such negative expense items are treated as a zero expense. This approach reduces the risk of distorting the Ongoing Charges figure and creating confusion in the marketplace.

Subsidiary expenses

Most AIC Members do not have subsidiaries which undertake significant activities and therefore the difference between any group or company data for the purposes of calculating the Ongoing Charges figure is immaterial. However, there are some exceptions.

Under the definition of ongoing charges above, the expenses incurred by subsidiary companies would generally be excluded as these expenses would not relate to the operation of the investment company "*as a collective fund*". Instead, they tend to relate to separate businesses which are run by the investment company.

However, if the subsidiary is being used as a means of routing expenses which would fall within the definition of ongoing charges if they were incurred by the parent company, these expenses should be included in the Ongoing Charges calculation.

It is recommended that, where the principal Ongoing Charges figure excludes subsidiary expenses, the amount excluded should be separately disclosed.

Third party investment management

A few investment companies undertake investment management activities for third parties and receive income for these services. The identification of such costs, and their apportionment between in-house and external activities, can be difficult and subjective. Where uncertainty arises, it is recommended that all such costs are treated as ongoing charges. This is a prudent approach which reduces the likelihood that the Ongoing Charges figure is understated.

Property investment companies

Some investment companies invest directly in property. The principles of the ongoing charge figure remain relevant to this sector and are therefore reiterated here (emphasis added).

> *"Ongoing charges are those expenses of a type* ***which are likely to recur in the foreseeable future****, whether charged to capital or revenue,* ***and which relate to the operation of the investment company as a collective fund****, excluding the costs of acquisition/disposal of investments, financing charges and gains/ losses arising on investments. Ongoing charges are based on costs incurred in the year as being the best estimate of future costs."*

These concepts are discussed in more detail below. Analysis of both concepts is relevant to determining whether the costs are included or not.

Likely to recur in the foreseeable future

When seeking to determine whether a cost should be included, it is important to consider whether costs are "*likely to recur in the foreseeable future*". By way of example, credit loss provisions, such as those triggered by the Covid pandemic may be assessed as unlikely to reoccur so it may not be appropriate to include them within the ongoing charge calculation.

Property investment companies incur direct costs in relation to managing property. They should consider disclosing two ongoing charge figures within their report and accounts similar to the practice used for open end funds:

- Ongoing charge excluding direct property expenses
- Ongoing charge including direct property expenses

The disclosure of both these figures will allow data providers to collect charge figures that are more comparable with open-ended funds while providing full transparency for investors.

Morningstar currently collect the ongoing charge excluding direct property expenses as their primary surveyed charge figure.

Relate to the operation of the investment company as a collective fund

When assessing whether a cost is a direct property cost that should be excluded from the '*ongoing charge excluding direct property expenses*', consideration should be given to whether the cost would have occurred irrespective of the property being held within an investment company.

Those costs which "*relate to the operation of the investment company as a collective fund*" are not direct property expenses and should be included. Those that do not meet this test, should be excluded. As such, many of the day-to-day running expenses of a property may be excluded from the '*ongoing charge excluding direct property expenses*'.

Costs related to managing properties

It is not possible to provide an exhaustive list of direct property costs that should be excluded from the '*ongoing charge excluding direct property expenses*'. Companies should consider the above principles when making this assessment. However, we have reviewed a range of existing disclosures and practices to provide the following list of items that may be excluded from this figure:

- Capital expenditure/building improvements
- Property management fees
- Property acquisition/disposal costs
- Property insurance costs
- Utilities, repair, and maintenance costs
- Property related taxes
- Ground rents
- Empty rates
- Irrecoverable service charges
- Vacancy costs

Ultimately the company should take a view based on their interpretation of the guidance.

Self-managed investment companies

A self-managed investment company may incur costs relating to compensation schemes which are linked directly to investment performance. It can be argued that these types of costs are analogous to performance fees paid by externally managed investment companies. It therefore follows that such costs should be excluded from the calculation of the principal Ongoing Charges figure in line with the recommended treatment of performance fees set out above. It also follows that self-managed investment companies should disclose the same, or equivalent, supplementary financial and narrative information as recommended above for performance fee structures.

Annualised expenses

If the financial reporting period is for a time period other than a full year, the ongoing charges should be annualised for the purposes of calculating an Ongoing Charges figure.

Investments in other funds

Where a 'substantial' proportion of the portfolio is invested in other funds and where the relevant information is readily available, the investment company should consider incorporating a relevant proportion of the ongoing charges of the underlying funds into its own Ongoing Charges figure. For these purposes, 'substantial' is considered to be 5%.

(For these purposes, it is the total of all investments in funds which is relevant, not whether any individual investment in a single fund is 5% or more. So, if an investment company has a number of investments in funds, each of which is below 5%, but the total of all these investments is above 5%, the above recommendation applies.)

As specified in European guidance (Methodology, paragraph 8, page 5) other funds includes CIUs (Collective Investment Undertakings). Other funds therefore includes UCITS, Alternative Investment Funds (AIFs, as defined under the AIFMD) and Packaged retail and insurance-based investment products (PRIIPs).

Where the relevant information is not readily available and the investment company's Ongoing Charges figure does not reflect any costs of the underlying funds, it is recommended that this fact is disclosed in the annual financial report along with a statement of the percentage of the portfolio which is held in other funds.

Material changes

Where it is believed that an expense figure based on the last audited annual financial report is not representative of future costs to a material extent, for example because the company has negotiated a change to the management fee arrangements, then consideration should be given to how the impact of this change should be communicated to shareholders. Options include disclosing details of why and how the Ongoing Charges figure may not be an accurate reflection of future costs, adjusting the Ongoing Charges figure to take into account the actual future cost (along with an explanation of why the adjustment has been made) or providing an additional expense ratio which reflects the actual future costs (along with an explanation of why this additional figure has been given). Consideration should be given to which approach provides the most useful information to shareholders.

Preference shares

Although preference shares sometimes carry voting rights and can sometimes be treated in the accounts as being shareholders' funds, to all intents and purposes they are a form of long-term financing. It is therefore recommended that they are treated as such in the Ongoing Charges calculation and are deducted at book value from total assets to arrive at the net assets figure attributable to ordinary shareholders.

Average undiluted net asset value in the period (B)

The AIC's recommended methodology for calculating an Ongoing Charges figure uses, as the denominator, the average of the net asset values (NAV) in the period. It is recommended that net asset values should be calculated on the basis of debt at fair value and including current year income.

The AIC is aware that alternative bases are available for measuring the denominator of an expense ratio. One option is to use gross asset value which measures assets before the deduction of long-term debt. An expense ratio using gross asset value as the denominator gives an indication of the costs relating to the actual size of the investment portfolio that the manager is managing. Another option is to base the denominator on market capitalisation, thereby generating an expense ratio which shows the drag of costs on the current value of the shareholder's investment.

Whilst these alternative bases can provide meaningful information, the AIC's recommended practice is to calculate the Ongoing Charges figure using net asset value. This approach will ensure consistency across the investment company sector and aid comparability with open-ended funds.

As explained on above, AIC Members can choose to disclose supplementary expense ratios calculated on alternative bases, in addition to the principal Ongoing Charges figure, if it is believed that this would provide useful information to shareholders.

Calculating an 'average' net asset value

The AIC's recommended methodology for calculating average net asset value for the purposes of the Ongoing Charges figure is to use the average of net asset values at each NAV calculation date. The number of NAV figures used to calculate the average will therefore depend upon the frequency with which the investment company calculates its net asset value as part of its normal business activities. It is recommended that NAV figures are only used where a full NAV calculation has been carried out using actual data and that, where estimated NAVs are produced, these are ignored for the purposes of this calculation.

As an example, if the investment company performs NAV calculations on a daily basis, its average net asset value figure for the purposes of the Ongoing Charges calculation will be the average of the daily NAV figures during the relevant period. Similarly, if the investment company only calculates its net asset value on a quarterly basis, the average net asset value figure for the purposes of the Ongoing Charges calculation will be the average of the quarterly NAVs during the relevant period.

This approach means that those AIC Members which publish NAVs on a more frequent basis than quarterly will be able to produce a more 'accurate' average figure which eliminates the impact of significant fluctuations in asset values. At the same time, this approach does not impose additional valuation burdens on AIC Members that are invested in assets such as private equity and property where valuations take longer to perform and NAV figures are published with less frequency.

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