YOU CAN DO IT

OVERCOMING THE BARRIERS TO USING INVESTMENT COMPANIES ON PLATFORMS

A MARKET INSIGHT REPORT FROM

the lang cat

BEFORE WE GET GOING

This paper was commissioned by The Association of Investment Companies (the AIC) as part of a wider project looking at some of the barriers – both real and perceived – to using investment companies on platforms. And importantly, how advisers are getting around these barriers. It builds on the paper we produced in 2018, revisiting some of the themes we examined and looking at how (and whether) things have moved on over the last year.

We said it last time round and we'll say it again because it's still true. This is a sponsored analysis, as we are known to carry out when we think the topic is pertinent, interesting and we have something to add. These papers are a bit of a departure, however, being sponsored by an industry body rather than a commercial entity with a corporate mission and sales managers to feed.

That all said, our ground rules still apply. First, we let the AIC check we got the facts right when referring to some of the characteristics of investment companies. But it didn't get to check or challenge any other data or facts, especially those concerning our view of the shape of the market or our proprietary research.

Second, this isn't a view from the lang cat on the relative merits of investment companies over other investment options. That's a conversation for another day, where individual circumstances and investor suitability trump all.

Lastly, we believe that organisations hire us for work such as this because of our independence and for the honest, direct and sometimes plain awkward opinions that come with it. These are our views and they are 100% free of any influence or editorial control by the AIC. The paper is based on a combination of our experience in the market, our own research and views from the advisers we regularly speak to. The day we let ourselves be compromised is the day it all falls apart for us.

Trust that, or don't – but it is the truth.

CONTENTS

A NOTE ON RESEARCH

Throughout this report, we will lean on and reference 'our research' and various statistics. These are taken from the following lang cat publications:

- *Fixed That For You: State of the Platform Nation*, our annual guide to the advised platform market.
- *State of the Adviser Nation*, our inaugural study of adviser sentiment.
- *Platform Market Scorecard*, our quarterly analysis of the advised platform market.

INTRODUCTION

Well hello again. Fancy seeing you here.

If you're currently feeling a tangible sense of déjà vu it might well be due to this paper being just the latest in the not-inconsiderable body of work the lang cat has produced in collaboration with the good people at the Association of Investment Companies (AIC from hereon in). You can find out more about all that on page 18.

Our most recent work was *We Have Trust Issues*[1], a white paper that flagged a number of reasons to be cheerful about the future of investment trusts, but which also took an honest look at why their adoption still lags that of open-ended funds. We called it Trust Issues because, you know, investment trusts and all that. But we're going to try and remember to call them 'investment companies' here so that we don't make some very nice people rather grumpy. We're thoughtful that way.

We reckon the brave new world, where investment companies[2] compete on a level playing field with open-ended funds, remains elusive. Sure, there have been some nice results at a time when markets weren't feeling particularly cheery. The sector scored a major hit with the launch of the £822.5m Smithson Investment Trust, the biggest ever, but it remains a minnow compared to the open-ended sector.

NUMBERS!

The last day of July 2019 was a happy one for fans of big round numbers as investment company assets passed the £200 billion milestone for the first time (they actually hit £200.3 billion). Assets have doubled in the last six and a half years and purchases of investment companies on advised platforms reached £1 billion in both 2017 and 2018. The impact of the Retail Distribution Review (RDR) in wiping out open-ended fund commission has played no small part in this positive growth.

However, before we get too excited, we must note that the open-ended sector remains around six times the size[3]. That's in spite of the notable advantages of investment companies: performance, dividends, holding illiquid assets. More recently, there has been an uncomfortable incident with a certain fund manager who, in the style of Lord Voldemort, shall not be named. His series of unfortunate events[4] showed the limitations of the open-ended structure in some style. It is perhaps a little too soon for this to be reflected in flows, but at the very least it should prompt a reappraisal of investors' long-held prejudices.

In our previous paper we mentioned a number of regulatory developments that we think might tilt the balance back in favour of closed-ended vehicles. Those developments are ongoing, so their impact is difficult to quantify. For example, the Product Intervention and Product Governance Sourcebook (PROD) increased the focus on a segmented approach to the needs of the end client, but we're yet to see tangible evidence that this is translating into a measurable shift in investment process and selection.

1. https://www.langcatfinancial.co.uk/product/we-have-trust-issues-barriers-to-using-investment-companies-on-platforms
2. That's a quick win in the remembering column. High five!
3. https://www.theia.org/industry-data/fund-statistics/funds-under-management/1
4. We're mixing our literary references here but you get the point.

OK, WE'LL NAME HIM

We can expect the Woodford incident, the repercussions of which continue to play out in the open-ended world, to draw further regulatory and parliamentary scrutiny – something which may play to the strengths of investment companies. It's early days yet, but the super-catchily titled *Investment Association UK Funds Regime Working Group's Final Report to HM Treasury Asset Management Taskforce*[5] acknowledged that 'daily dealing is not realistic for funds investing in highly illiquid assets'. The Woodford debacle showed that quite a lot of things could become 'highly illiquid assets' with alarming ease.

The AIC works tirelessly to try and address some of the issues and potential misconceptions highlighted in our previous paper, but the Woodford problem may have done investment companies' work for them. Does explaining the discount/premium seem complicated compared to explaining what's gone on within the Woodford Equity Income Fund? We don't think so.

WE ALL HAVE OUR ISSUES

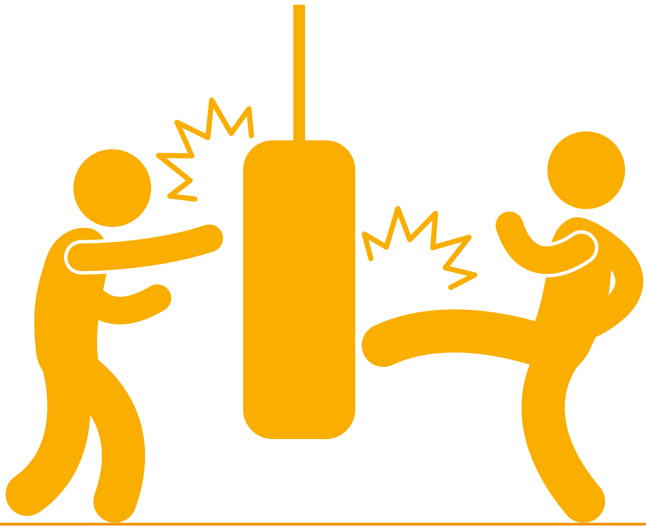
However, some issues do look ingrained to us. First, vertical integration (VI) and its impact on the shape of investment propositions is a problem and will certainly lock investment companies out of certain big firms. More than half the main providers, platforms, consolidators and advice groups are integrated to some extent. Where they are, at least three of the four elements of the value chain – advice, platform/product, investment solution and underlying funds – tend to be integrated. Secondly, consolidation across the advice industry continues apace, concentrating investment selection in the hands of fewer people. That's difficult news for investment companies.

Finally, the lion's share of business on platforms continues to be placed via model portfolios and our research[6] highlights how few of these have investment companies as an underlying holding. Our case studies – which look at real-world examples of advisers using investment companies – suggest that incorporating them into model portfolios isn't as big an ask as it's made out to be, but advisers may take some convincing and for the time being, the problem is proving tricky.

RELATED CONTENT KLAXON

What's that you say? Case studies? Oh yes, that's (largely) why we're here. Over the course of the summer, the lang cat spoke with a number of advisers who use investment companies within their propositions. We'll introduce them properly at the end of this paper but, as we revisit some of the main barriers to investment company usage that we surfaced last year, we'll draw on our conversations to see how those advisers view the barriers in question and how they're overcoming them.

See you on the other side.



5. https://www.theia.org/sites/default/files/2019-07/20190731-UKFRWGreport.pdf
6. Over 94% of total holdings on adviser platforms are in funds and cash.

REVISITING THE BARRIERS

1 THERE IS AN INHERENT MARKET BIAS AGAINST INVESTMENT COMPANIES

Old habits die hard. Even though there is no longer a compelling financial disincentive for advisers to recommend investment companies, adviser business models count against them. Investment companies suffer from being a non-commoditised product in an increasingly commoditised world.

SUITS YOU SIR

In the adviser world, suitability rules have generated an increasing reliance on model portfolios because advisers don't want to get caught recommending different portfolios to same-risk clients. Consistent outcomes rule supreme. The theory is that model portfolios are incompatible with investment companies. One argument is that the discount/premium element throws out the calculations, making it impossible for one client to have the exact same portfolio as another client who shares their risk profile. Our case studies suggest that not all advisers find this difficult:

LOSING YOUR BALANCE

There is also a problem with liquidity, argue the creators of model portfolios. It can be difficult to manage large movements into and out of investment companies, which makes switching and rebalancing difficult. Using investment companies in model portfolios alongside funds can be complicated by reporting and rebalancing needs. Advisers report that unless used for the majority and rebalanced all on the same day, investment companies can become expensive or impossible to rebalance.

Fund flows are the reason investment companies are largely excluded from best buy lists. Hargreaves Lansdown, for example, has long argued that a mention on its Wealth 50 list could funnel tens of millions of pounds into investment companies and few could support that. However, with best buy lists under scrutiny, it may not be the problem it once was.

Andy Parkes of Finance Shop says: "It's about understanding what we're buying and doing the research at a grassroots level. We need to establish how we expect it to behave, the best- and worst-case scenarios and the blend with the other constituents in the portfolio. It's about trying to diversify the portfolio by understanding what we own, and it doesn't necessarily matter whether it's investment companies or an open-ended fund."

NETWORKING SKILLS

We also find a general disinclination by networks and large integrated firms to use investment companies. Part of this is that many find their risk profiling tools categorise the majority of investment companies as 'high risk' or 'adventurous'. Others mandate (or facilitate) flows to their in-house investment proposition, which is more than likely to be made up of open-ended funds.

We don't, for the time being at least, see strong evidence that this trend will be overturned. If anything, the general shift towards consolidation may see the problem worsen. Nucleus, for example, recently reported its lowest net inflows for many a quarter, specifically due to a number of its users being bought out. Overall, it means greater concentration in fewer investment solutions, which in turn means more flows controlled by fewer providers.

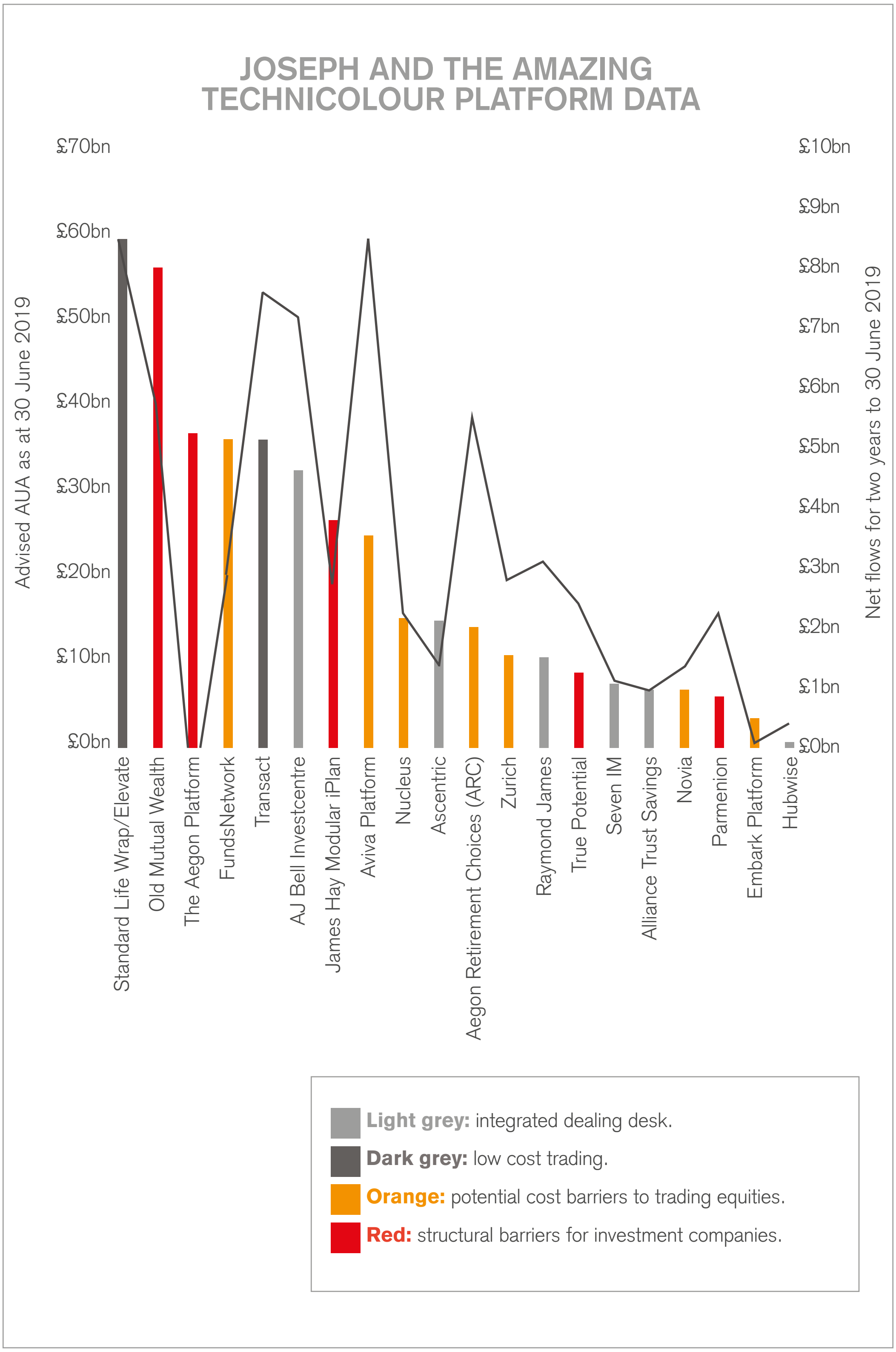
PROD *could* be the great counterbalance to this. Advisers must evidence suitability of products and investment services by client segment. We have yet to see how the FCA will enforce the regulation, but it may prompt some reflection from advisers. Can they really claim to be meeting the needs of all clients without a consideration of investment companies?

Our case study advisers argue that true independence is not possible without a review of investment companies:

Simon Munday of Prosperity IFA, for example: **"As independent financial advisers, we feel it's our duty to have analysed all types of investment when putting together portfolios for our clients, considering unit trusts, investment trusts, exchange traded funds (ETFs) and whatever else is out there as part of building a suitable client recommendation. Investment trusts have to be part of the review process."**

GO WITH THE FLOW

Let's take a moment to turn our attention to advised platforms and the chart below (Yes, it is rather eye-catching, isn't it?).



The bars in this chart represent an ordered view of the assets under administration (AUA) for the advised platforms in our peer group. The line represents the net flows[7] for that platform over the past two years. The colours are where it gets interesting:

- **Light grey** is where a platform has an integrated dealing desk, which means that it may be cost neutral from an asset perspective or very close to it. If, for example, you're on AJ Bell, Alliance Trust Savings, Ascentric, Raymond James or Seven IM, you'll have access to a structure where it costs the same to trade equities within a model as it does open-ended funds.
- **Dark grey** denotes that the costs of trading equities form little or no barrier. Standard Life Wrap's Investment Hub charges a pound a trade for models, while it's a few basis points on Transact, which are often aggregated away to pennies.
- **Orange** platforms are those where the cost of trading investment companies can rack up, particularly if rebalancing frequently. Costs of a tenner a trade and upwards are common on platforms including FundsNetwork, Nucleus and Zurich.
- **Red** indicates fundamental structural barriers to anything other than open-ended fund investment[8]. The majority of True Potential flows land in the VI True Potential Portfolios, while in the case of The Aegon Platform (nee Cofunds) and Old Mutual Wealth, investment companies aren't available at all.

In short, this chart makes clear that only a handful of platforms in the advised sector can boast new business both at scale and with a proposition that is truly whole-of-market from an asset perspective. And that's just the advised platform market. We've not touched on the tsunami of money directed at PruFund, Royal London Governed Range et al[9].

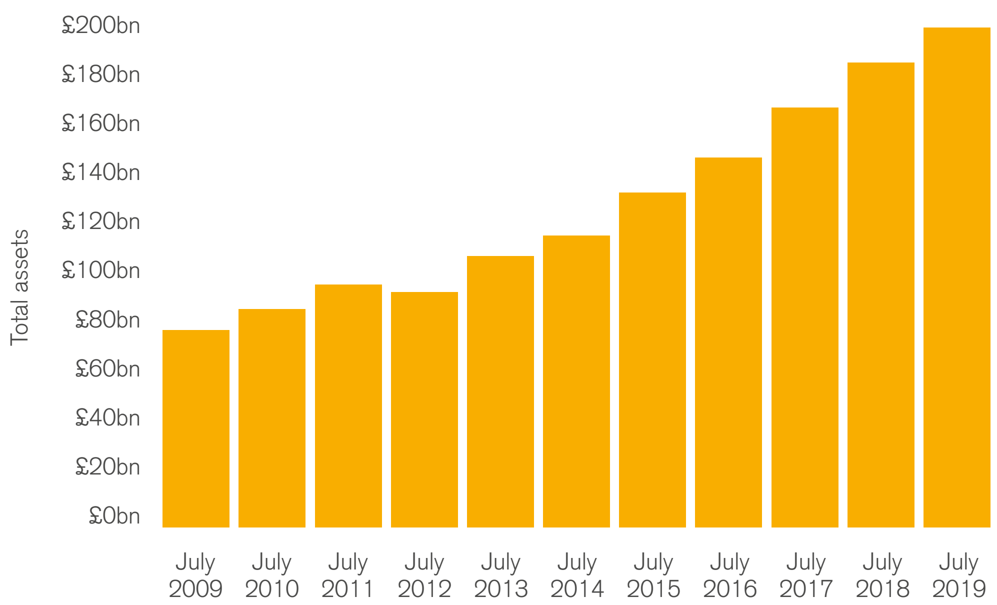
7. New business minus money that has left the platform (transfers, withdrawals etc).
8. Not that there's anything fundamentally wrong with that. A variety of business models to choose from is healthy and we're just showing the shape of the market. And anyone who says platforms are vanilla, all doing a variation of the same thing? Well, it's to the back of the class with you, Timmy.
9. Apart from that mention there. We are nothing if not self-aware.

Over on the consumer side, we see a much stronger concentration of flows into investment company-friendly platforms. Interactive Investor, one of the direct-to-consumer (D2C) champions of investing outside of open-ended funds, is gaining real momentum with asset-neutral pricing where activity drives charging. This approach rids the platform of any inherent bias towards open-ended funds in its fee structure.

AJ Bell Youinvest is also doing well and remains one of the cheapest platforms on which to buy closed-ended funds. And lastly, but never leastly, the biggest cat in the clowder – Hargreaves Lansdown – remains extremely competitive from a cost perspective (more on that in a moment).

Sticking with the positive, investment company assets in aggregate continue to demonstrate robust growth, having recently passed the £200bn mark for the first time.

GROWTH OF TOTAL INDUSTRY ASSETS



Now, we're obliged to point out that half of the growth over that period (46%) came from investment companies investing in alternative assets. However, many of these assets are comprised of property investment, an asset class prevalent in the majority of adviser portfolio construction over in the open-ended world. In other words, the investment company sector, considered niche by so many, may not be so far from the mainstream after all.

We should at this point revisit the biggest talking point of the summer. Do we think Woodfordgate will be a game changer? Will it result in a fundamental shift in how we view investment types on platforms? Will it in fact turn people off active investing completely? Maybe. Maybe not. But at the very least we reckon it scores a bit of a moral victory for the investment company sector. It may even bring about a review of the current regulatory environment that will ultimately favour investment companies. These particular barriers may – very slowly – start to come down.

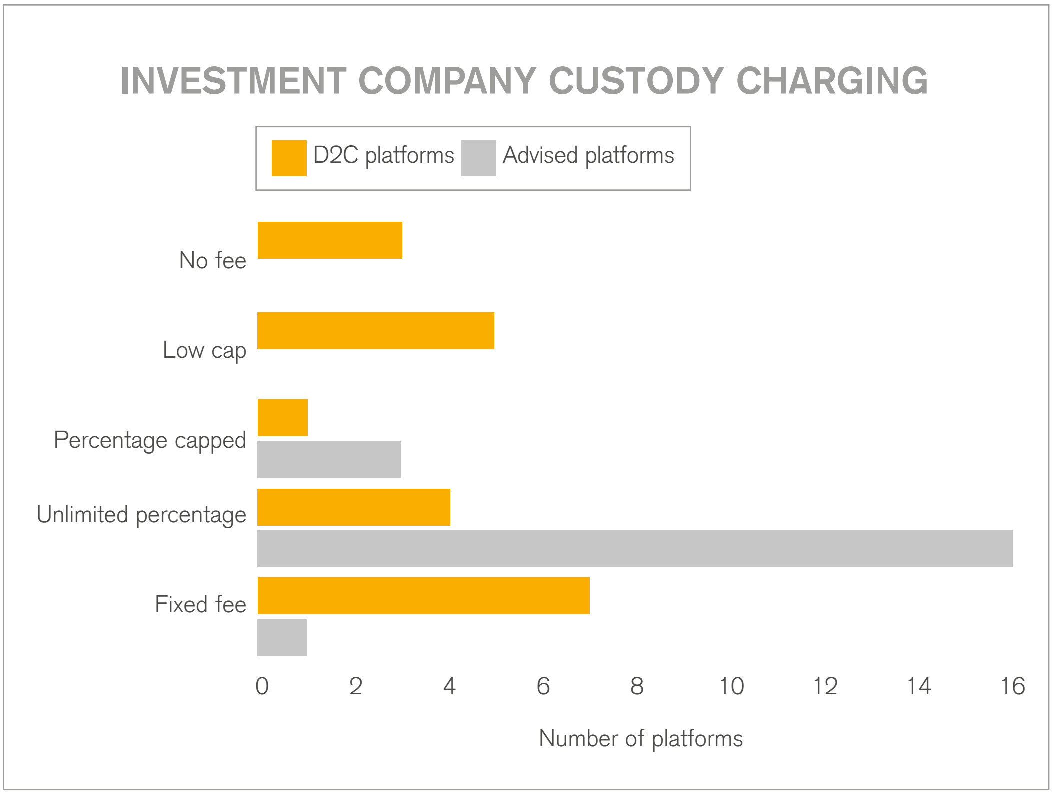
2 THE COSTS OF TRADING INVESTMENT COMPANIES ON SOME PLATFORMS CAN BE PROHIBITIVE

In our previous paper we reviewed the costs of investment companies on the major platforms. Fortuitously, these are available to all in a handy database (created by us) on the AIC website. You'll find the details on page 18.

Here we revisit the main charging shapes that apply to the platforms we look at across the advised and D2C markets. Most of the terms are self-explanatory, but for the avoidance of doubt:

- We're looking at the main headline platform and product costs only, not trading shapes.
- No fee = no ongoing fee for investment company custody[10]. Simple.
- Low cap = a percentage-based charge, capped at a moderate amount (e.g. AJ Bell Youinvest in the D2C market caps investment company charges at £30 pa for GIA/ISA).
- Percentage capped = as above but at a much higher level (e.g. Aegon Retirement Choices (ARC) caps its platform charges once the funds reach £250k).
- Unlimited percentage = less fun than it sounds. There is a percentage-based charge with no limit.
- Fixed fee = a pounds and pence charge for the product which doesn't vary with portfolio size.

THE SHAPE OF YOU (AND YOU AND YOU)

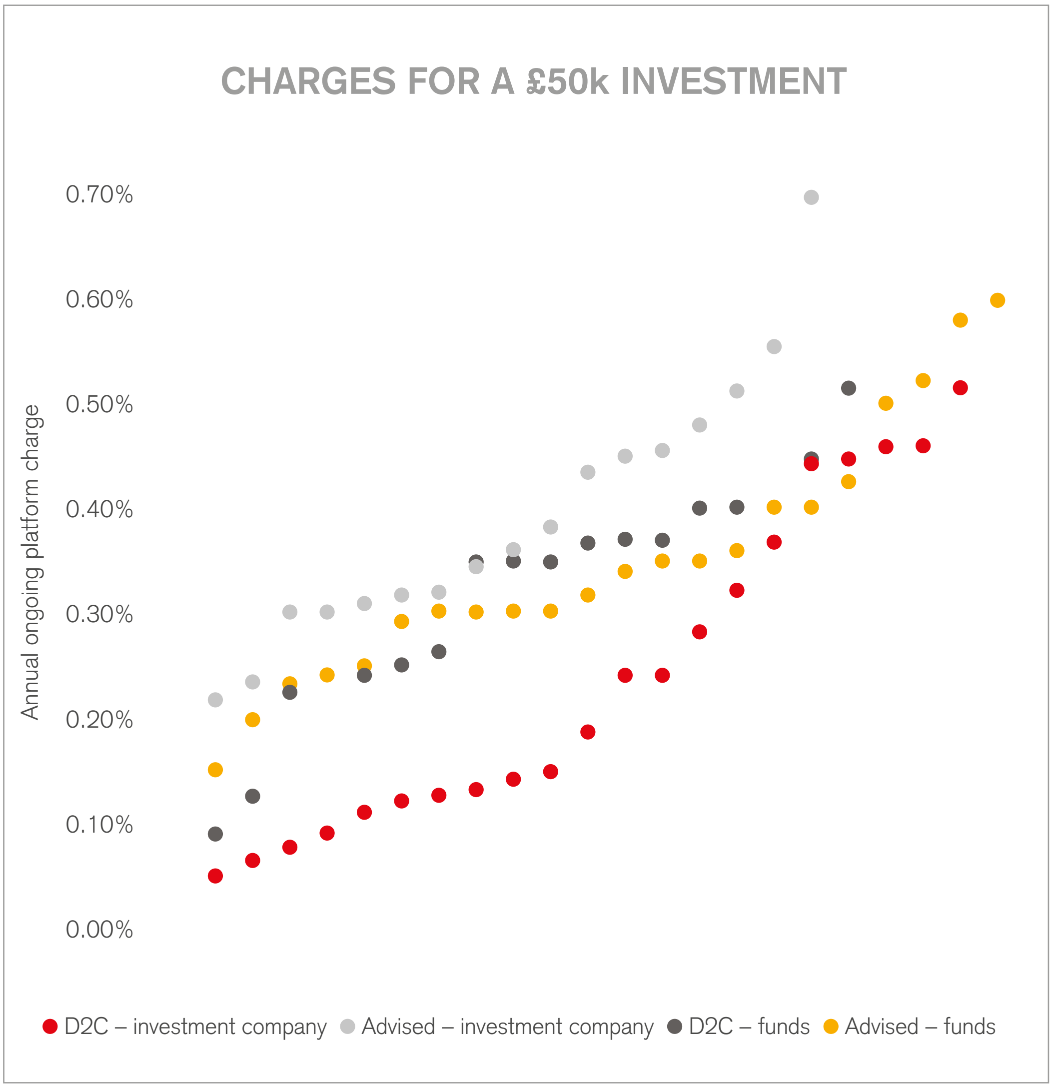


Quick headline time: we found little change from the previous paper in these results. The dominant shape in the advised market is clearly unlimited percentage-based charging. No-one is letting go of that money-spinner[11]. But, reductive statements aside, it's been a particularly fallow period within the advised sector for fundamental pricing changes. IPOs, ownership changes, regulation and all that tasty stuff has dominated the news and development agenda instead.

10. Remember this is the platform charge – naturally OCFs will still apply.
11. Notwithstanding the fact that many will cut special deals for certain case sizes. In which case for 'unlimited' read 'still quite a lot of money'.

Conversely, we continue to see considerable variation in D2C platform charging models where it is common to have little or no core platform charge applied to investment company holdings.

Let's illustrate this disparity in a pretty picture. Here we show the core platform charges applicable to a £50k ISA holding (making four ad-hoc trades in a year). Each dot is a different provider, highlighting the difference in market-level approach.



We reckon this brings the issue to life in one image. Note in particular the huge disparity between customers enjoying the benefit of minimal custody and trading charges for investment companies in the D2C market, compared to 1) their advised equivalents and 2) those investing in funds. Now contrast this with the flow and AUA data we looked at earlier.

One of the guiding principles behind the formation of the platform market was to open up a whole-of-market approach to asset and investment types. In that context, this image of the market in aggregate just doesn't *feel* right to us.

3 THERE ARE LINGERING MISCONCEPTIONS ABOUT INVESTMENT COMPANIES AMONG ADVISERS

Advisers come up with a number of persistent gripes about investment companies: they're complex, the information isn't widely available, they don't fit with model portfolios. Our last paper looked at some of these concerns and asked whether they were more perceived than real.

What we found was a combination of uncertainty and a lack of consensus. Some gently slot investment companies into the 'too complex' box. Why spend time researching them when the world is geared towards open-ended options? Other studies reinforce this position: 57% of advisers are discouraged from recommending investment companies because of a lack of knowledge and 36% due to perceived complexity, according to a survey published earlier this year by Cicero Research[12].

4 INVESTMENT COMPANIES DON'T FIT NEATLY WITH MODEL PORTFOLIOS AND THEREFORE DON'T MEET SUITABILITY REQUIREMENTS

It's clear that some advisers really don't see this as a problem and, importantly, there are also issues with open-ended funds that advisers seem to be neglecting.

Simon Munday points out: "After the EU referendum in 2016 we saw most property unit trusts close their doors to trading. Clients trying to take an income from those property funds lost the ability to maintain the goals of their portfolio. Investment trusts offer a point of difference here in having better liquidity."

Yes, we need to mention Woodford again, because if advisers can't get their income or capital out when they need it, it's going to throw out their model portfolios anyway. At the very least that presents a case for considering investment companies for areas such as smaller companies, private equity, emerging markets or property. Liquidity isn't a problem, until it is. Let's not forget that the Woodford portfolios started out meeting all the regulatory criteria – it was outflows that forced the problem. How many advisers had seriously considered this risk?

12. https://www.moneymarketing.co.uk/how-to-make-sense-of-investment-trust-jargon/

5 INVESTMENT COMPANIES ARE TOO ILLIQUID. I CAN'T GET ALL MY CLIENTS IN AT THE SAME PRICE

Investment companies have limitations on liquidity, but again, the liquidity problems of open-ended funds shouldn't be overlooked. Equally, there are ways to resolve them – by ensuring, as far as possible, that investors buy and hold.

Andy Parkes says: **"We generally try and use investment companies where the money is longer term, and we're not going to need to pull down on the cash with any urgency. We also manage position sizes carefully; generally, the position size will be smaller in the investment companies than we would have in an open-ended fund. On top of that, we'll have a diversified mix of investment companies."**

6 THEY'RE HARDER TO ANALYSE AND THERE ISN'T AS MUCH AVAILABLE INFORMATION

Are they harder to analyse? The assertion of a lack of available research is also difficult to square. Ample investment company research providers – from Winterflood (albeit for a charge) to Kepler to Hardman & Co to Marten & Co to Edison – make their research widely available. All the major analytics firms also provide investment company data in much the same way as they do for open-ended funds.

Peter Adcock of Adcock Financial says: **"Our research process isn't hugely different [between open-ended and investment trusts], although you have to look at slightly different things because of the nature of investment trusts; the gearing and discounts. I suppose the standard tool we use is Morningstar, but we also use FE Trustnet. Citywire, New Model Adviser and the AIC are also good sources of information. We tend to use independent tools because model portfolios on platforms ignore ETFs and investment trusts because they assume everyone is going into funds."**

Again, the problem of research may be more perceived than real.

7 THEY'RE HUGELY COMPLEX

Investment companies undoubtedly have complexities that open-ended funds don't. Gearing introduces a potential risk and, while the AIC shows the gearing of each trust, wannabe investors may have to delve into the accounts to find the structure of that gearing. Discounts and premiums may work out over time, but they can be difficult to explain to clients. Perhaps not as difficult as explaining why their open-ended fund has gated, but difficult nonetheless. So yes, complexity can be a problem.

However, Colin Low of Kingsfleet Wealth believes it may be overstated: "The net result over time is that it makes no difference; these things even themselves out. There are short-term issues to be managed, but that's what you employ a manager to do. Just a bit of extra understanding of how trusts work can illustrate how these various issues are handled by investment trust managers. It's about looking for opportunities as well – there can be very good trusts out there trading at big discounts, but opportunities are being missed because of laziness and a lack of understanding. Too many advisers find reasons not to go down a certain route just because they don't understand it."

8 THEY DON'T FIT WITH MY TECHNOLOGY AND RISK SYSTEMS

This is a legitimate problem. For any adviser who relies on tools such as Dynamic Planner, it's tough to get investment companies into the mix. They tend to be categorised as high risk and can have a distorting effect on portfolio volatility.

As Colin Low says: "In terms of technology, it's not ideal. We have to take an educated position and allow more leeway from a risk perspective. The various tools often don't really cater for investment trusts, which means that we are then having to make something of a judgement call."

This, perhaps, sums up the problem. Investment companies require a judgement call and many people are too nervous, in this highly regulated world, to make that judgement call. This seems to misrepresent the regulations, which place client needs ahead of uniformity.

CONCLUSIONS

And so we approach the end of our whistle stop tour of the main issues we uncovered back in the halcyon days of, erm, last year. A turnaround time for a sequel that would surely impress even the makers of the seemingly omnipresent Fast and the Furious[13] franchise.

Now the financial services community is often furious, but rarely can wholesale developments be described as fast (*that* pension freedoms announcement[14] back in 2014 aside).

So, with that very much in mind, we revisited *Trust Issues* with a healthy dose of realism.

And, sure enough, we found that charging structures remain much of a muchness, while underlying asset splits and new business flows on platforms also remain there or thereabouts. Much like trying to move through Edinburgh during the Festival, this stuff takes its sweet time to get anywhere.

IT DOESN'T MATTER IF YOU WIN BY AN INCH OR A MILE

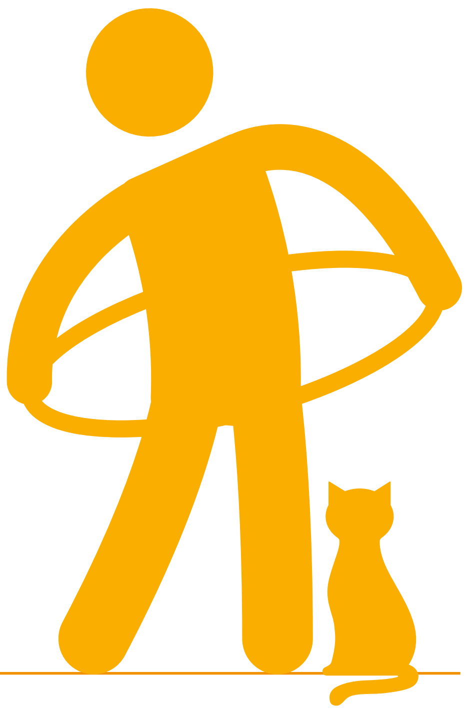
That said, we found many reasons for the investment company community to be cheerful. Headline charts of subscriptions, assets and all those important metrics continue to point in the right direction. Not only that, but two of the biggest platform success stories of the past couple years – AJ Bell and Interactive Investor – are champions of open-architecture investment. That's good for choice and, consequently, good for the sector as a whole.

We also reckon that Woodfordgate has, in its own way, served a positive purpose. It's helped to kick off a meaningful conversation around some of the inherent sector biases towards collective funds and the wider issues around best buy lists. And not before time.

TOO SOON, JUNIOR?

There is, however, a counterbalance to this optimism. Adviser firm consolidation continues apace, and one doesn't have to join many dots to conclude that this demonstrably increases the likelihood of advised clients ending up in either mechanised centralised investment propositions, where open-ended funds are king, or multi-asset fund ranges.

Consolidation aside, we think perceived barriers to investment company usage persist. But the best way to find out for sure was by speaking to advisers who are using investment companies and hearing about their views, philosophies and processes.



13. Quite literally as we write this paper, the latest episode of the indefatigable cultural phenomenon is being filmed just up the road from lang cat HQ. Steve remains disappointed he didn't bump into Dwayne 'The Rock' Johnson.
14. SURPRISE!

ASSEMBLING THE ASSETS

That sounded like a seamless link to those case studies you've been referencing…

Quite. So, much like the Avengers[15], we reckon this market analysis becomes something altogether more meaningful and powerful when read alongside its sister publications – the case studies themselves.

We asked four different adviser firms, each with their own nuances, philosophies and customer propositions, the same set of questions, including:

- Does your use of investment companies influence provider/platform choice? Or the other way round?
- How do you articulate investment companies to your clients?
- How do you research them?
- What barriers have you found to using investment companies?
- How do you integrate your use of investment companies into other parts of the advice process i.e. tooling and software?

You get the picture.

Our advisers were extremely generous with their time and we heartily thank them for both that and their insight. They gave us much to think about and a real sense of optimism that, whatever barriers there may be to using investment companies, some advisers are putting them to one side and focusing on how to best meet their clients' needs and goals. Which is just as it should be.

All that's left to say is a big 'thank you' for reading this paper. We hope you've found it interesting and, at the very least, that it's provided food for thought. You will no doubt disagree with some of it, but wouldn't the world be a dull place if we all agreed on everything?

15. We may be leaning on popular cultural references in a vain attempt to sound hip. Saying things like 'hip' doesn't really help, does it?

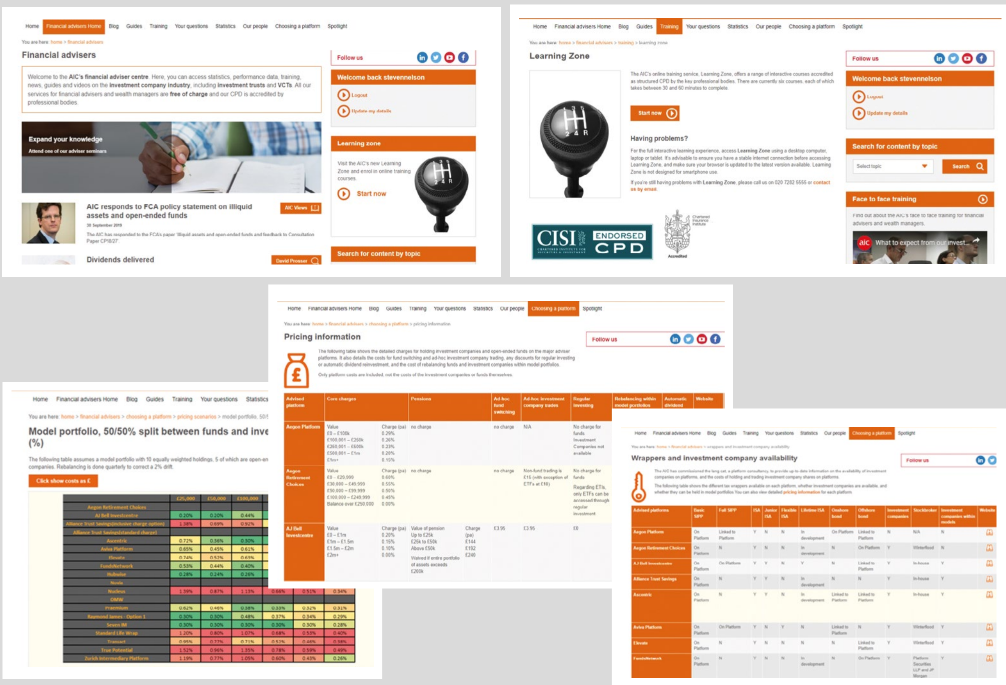
WITH GREAT LINKS COME GREAT RESOURCES

We've talked a great deal about them and now you can read our case studies for yourself.

Or, you may wish to start at the beginning (which can be a very good place to start).

All this good stuff is available to download for free from our dedicated web page: www.langcatfinancial.com/AIC

The AIC's financial adviser centre offers a range of data, resources, and accredited CPD online training courses. There's even lang cat pricing and proposition analysis, if you like that sort of thing. It's all free to access – you just need to register as a financial adviser, which we are assured only takes a minute[16].



16. The lang cat is in no way liable for the registration process taking in excess of one minute.

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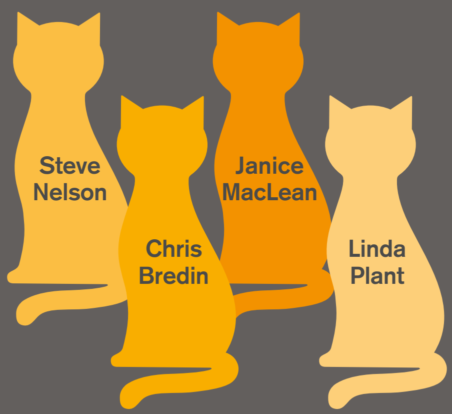

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