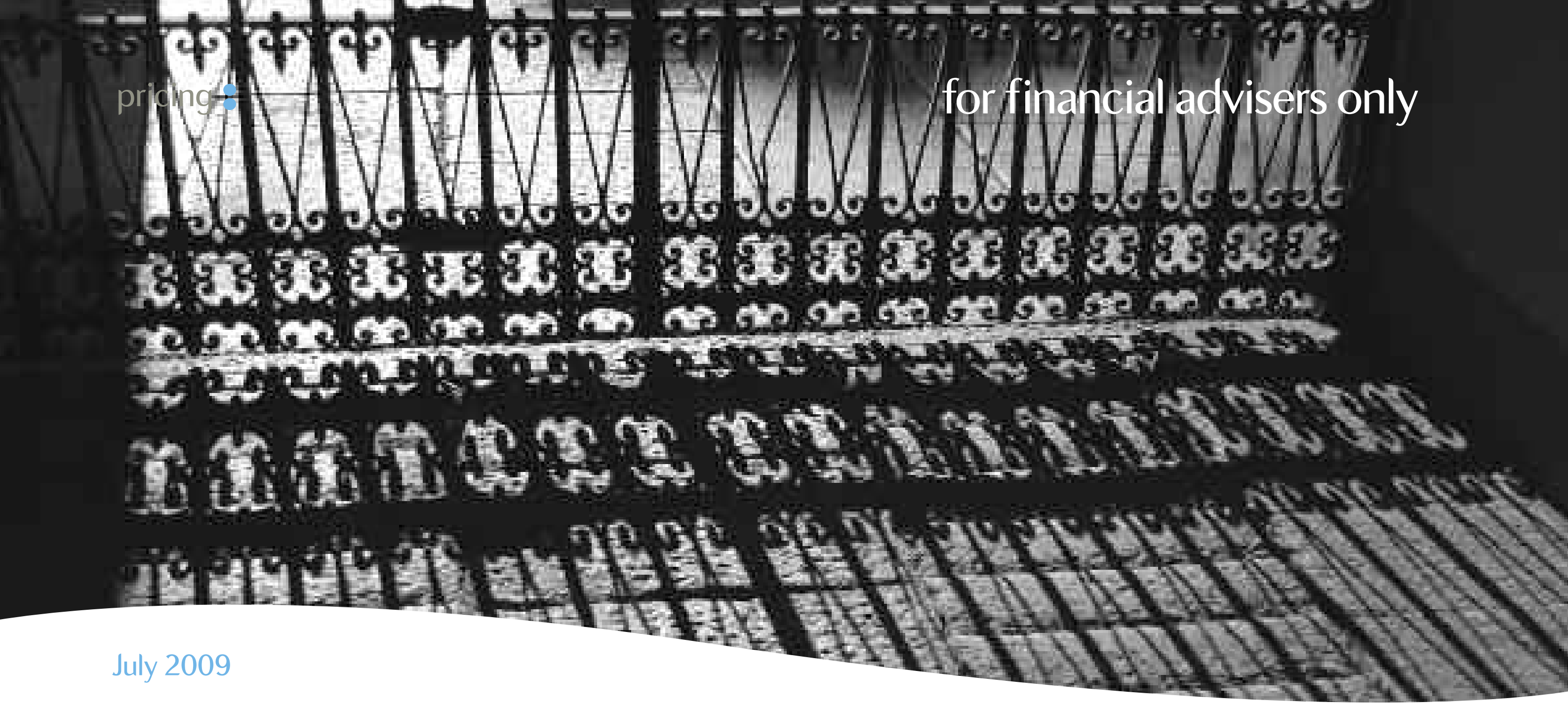

July 2009

meeting at the factory gate

A truly robust cost comparison shows that the claimed advantages of ETFs are largely illusory, writes Peter Jordan.

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Now that the RDR consultation paper has arrived, the future landscape of advice is becoming clearer. In the new regulatory environment, propositions will be presented without loadings to cover advice costs (this is often referred to as 'factory gate pricing'). This means we are heading for an era in which all propositions will be presented on the same basis and this will inevitably have some critical implications for the advised market:

- A new 'bottom-up' approach to adviser charges will replace the current 'top- down' commission approach.
- Products not in the advice segment may be presented differently. It is possible they will continue to include loadings to cover distribution costs. (This is sometimes referred to as the 'high street price'.)
- Stripping advice costs out of platform propositions will also narrow any perceived price disadvantage between platform pension products and the forthcoming personalised accounts.
- Unbundled propositions (typically wrap providers that separate out all costs for the client) will face tougher questions concerning price when all propositions are presented on a factory gate price basis. The current practice of comparing factory gate with high street prices will thankfully cease.

like-for-like

This final point is of particular interest. Fortunately, we don't need to wait for 2012 to observe factory gate prices, as this can be achieved already. As a reminder, the factory gate price can be defined as the fund TER less fund rebates / trail commission plus any platform/wrap charges. In other words it is what the client would have to pay if they invested their money at the factory gate rather than through their adviser. This is of particular interest as the RDR lobbying relating to the price of fund platforms and wraps, with particular reference to Exchange Traded Funds (ETFs), has confused the position.

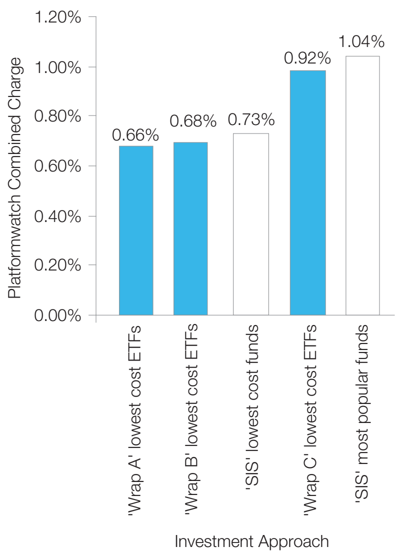
While the bare cost of ETFs (ie the TER) is usually low, this is for a reason. As ETFs are typically structured on an institutional basis we would expect the TER to be lower, however it is important to remember that ETFs do not generate any rebate payments or trail commission. This means that care needs to be taken in order to make a fair comparison of the TER of an ETF with that of a retail OEIC.

A further aspect that complicates the debate is that even though holistic advice is all about matching asset allocations to an investor's attitude to risk, most comparisons with ETFs look at single asset classes. The majority tend to focus solely on UK Equity and Gilt ETFs which conveniently enjoy very low TERs. The more expensive ETFs needed to obtain exposure to overseas markets are often ignored. This is clearly short sighted, especially in an era where risk matched asset allocation and therefore exposure to overseas asset classes will be essential.

Table 1: Investment approach detail

Risk 5 portfolio		Scenario 1		Scenario 2		Scenario 3	
Asset Class	weight	OEIC	Net TER	OEIC	Net TER	ETF	Net TER
Global Specialist	5.0%	Investec Global Gold	1.11	Newton Global Higher Income	1.17	ETFS Physical Gold (PHAU)	0.39
Property	15.0%	Aviva Property Trust	1.05	Aviva Property Trust	1.05	iShares FTSE UK Property Fund	0.40
UK Equity	14.0%	Fidelity MB UK Index	0.27	Invesco Perpetual High Income	1.19	DB FTSE All Share (UK)	0.40
Japan	5.0%	HSBC Japan Index	0.66	Neptune Japan Opportunities	1.49	DB MSCI Japan TRN Index	0.50
Emerging Markets	3.0%	Pictet Emerging Markets Index	0.73	Aberdeen Emerging Markets	1.15	DB MSCI Emerging Markets TRN Index	0.65
Europe	9.0%	Pictet Euroland Index	0.82	Cazenove European	1.08	iShares MSCI Europe Ex UK TR	0.40
Far East (Ex Japan)	3.0%	HSBC Pacific Index	0.49	First State Asia Pacific Leaders	1.07	iShares MSCI Pacific ex Japan Index	0.50
North America	9.0%	Pictet USA Index	0.80	Neptune US Opportunities	1.31	iShares S&P 500 Index TR	0.09
UK Fixed Interest (Gilt)	18.5%	Schroder Gilt and Fixed	0.56	Allianz PIMCO Gilt Yield	0.55	iShares FTSE All Stocks Gilt	0.20
UK Fixed Interest (CB)	18.5%	Threadneedle UK Corp Bond	0.59	Invesco Perpetual Corporate Bond	0.80	iShares Corporate Bond	0.20
	100%		0.68		0.99		0.31

Chart 1: Factory gate price comparison



Please note: the graph shows the 'factory gate price', which we define as the fund TER less rebates/trail plus platform/wrap charges.

robust comparison

Part of the reason for the confusion surrounding price is that like-for-like comparisons are only possible by making some careful assumptions. This is largely due to the structural differences of fund platforms and wraps. However, the methodology that powers Skandia's Platformwatch tool (see pages 8-9) allows this issue to be addressed in a robust manner.

To demonstrate this we have constructed three different scenarios – each with an investment portfolio based on Skandia's asset allocation model – for a client with a risk rating of 5. This is the most common risk category among Investment Solutions (SIS) customers.

Scenario 1: lowest cost funds – this assumes an investment via SIS with the lowest cost funds selected.

Scenario 2: most popular funds – this assumes an investment via SIS with the highest selling funds of 2008 selected.

Scenario 3: lowest cost ETFs – this assumes an investment in the three wraps currently featured on Platformwatch (indicated as A, B and C with the lowest cost ETFs selected). It was assumed that each of the ETFs were available via each wrap and that they do not generate any rebate income.

Table 1 details the funds selected plus some basic fund information and Chart 1 summarises the cost outcome. The numbers provide a reasonable proxy for the factory gate price of each scenario.

grand claims

The outcomes detailed in Chart 1 encourage a number of observations:

1. The 'price advantage' of ETFs within wraps is illusory because the TER is just one component of the price and does not represent the factory gate price. When the factory gate price of investing in funds is compared to the factory gate price of investing in ETFs, the outcome does not substantiate the grand claims made concerning the 'low cost' advantage of investing in ETFs via a wrap.
2. The factory gate price of the top-selling retail funds within a fund platform is significantly lower than has been suggested.
3. Investing in an ETF via a wrap can be used to provide greater funding for advice costs, however the extent of the margin is not as significant as has been suggested. The maximum difference in factory gate price between the three wrap approaches and the most expensive outcome for SIS (investment in top-selling retail funds) varies from 0.12% to 0.38%. This is hardly indicative of the massive price differentials that have been routinely hinted at in discussions on the price of retail funds on fund platforms.

The June RDR consultation paper states that advice should be 'based on a comprehensive and fair analysis of the market'. Clearly the TER of an ETF is not the only consideration when it comes to price and advisers need to also consider the other associated costs, which are too often excluded.

what really matters

Although this article has necessarily focused on price, the important aspect for customers is of course the return they achieve after performance and charges. The efficacy of the underlying investments is crucial and this is an area we will look at in a subsequent issue. While passives can offer the benefit of performance certainty relative to an index (provided they do not incur substantial tracking error), over the last 12 months they have experienced volatility and we should not forget that the smoothness of the investment ride can be as important as the final return.

Although more detail is emerging on the post-RDR landscape, there is still a lot to do to ensure that the unbundling of costs provides absolute clarity for consumers. While it makes a great deal of sense to break down costs and bring to light how charges are shared out, it must never be at the expense of consumers understanding the total associated costs. I hope this article serves to highlight the complexities around true cost comparisons, and why a clear framework must be put in place to help consumers understand the real value of the platform and wrap market.

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