

# Assessing value for money with Fowler Drew

March 2023

Wealth managers deliver soft benefits of planning and communication as well as hard benefits of experienced financial outcomes, or performance. Portfolio management is a ‘credence good’, in the sense that actual outcomes will not be known for most of the time customers are paying for it and so are taken on trust. With perfect foresight, a value assessment would only need to know performance outcomes. Without foresight, the benefits will take the form of how the relationship is experienced. That includes evolving expectations of outcomes but also a lot of soft benefits. A personal wealth-management service can therefore be quite difficult for customers to value, even if progressively easier the longer the relationship.

## ‘Go figure’

That is what the FCA, our regulator, is asking us to do. An assessment of our value for money forms an important part of our required preparation for the regulator’s new Consumer Duty which takes effect in October. The FCA rules are not prescriptive. *‘Firms have the discretion to decide on the factors they use in their value assessments, provided those factors allow them to demonstrate that there remains a reasonable relationship between the total price of the product or service and the benefits the customer receives.’*

This is posing the industry quite a problem. If it is not prescriptive, what are the acceptable metrics for value for money, when only the costs are known? If the relationship between costs and benefits needs only to be ‘reasonable’, how is that to be defined and tested for?

If we in the industry have no commonly accepted approach to assessing value for money, we could always ask our customers. That’s probably what the FCA expects us to do. Since we plan to change our pricing structure, we have not one but two good reasons for doing just that.

We don’t think our clients have a clear idea of how to value our service either. That was one of the questions we posed last year, in a client feedback exercise. The purpose of this document is to offer a conceptual framework for your thinking about value and to set out what we think the individual sources of benefit are. We quantify them where we can and rank them where we cannot. But much of it is personal, so there’s only so much we can figure out for ourselves.

## A function of asset values

The core principle in this paper is that the benefits of a genuine investment management service are a function of the volume of wealth benefiting, not the costs per client of providing it.

If perceived value did not dominate economic cost, asset-based fees would have been disrupted by fixed or flatter fees. There is no sign of it. Instead, investors consistently (over time and via different service formats) act as if they expect the benefits mainly to arise from performance and hence to attach to volumes. It is not an issue for them that, if firm costs do not vary proportionately with assets, there must be cross subsidies between clients. That makes sense if they see themselves as both paying and receiving, at different stages of their accumulation of wealth. They also act as though asset-based fees are more likely to align than oppose the interests of each party, again probably because they focus on the expected benefits received by both, through good performance.

Our initial preferences for flat fees for portfolio management (not just planning) had neither empirical nor economic support. We have paid dearly for a degree of arrogance in thinking we knew better than the market. Even if we needed to be very price competitive to establish

ourselves initially, we could have done that with a lower or more regressive asset-based fee scale.

As to the cost side of the value assessment, the core principle is that it must for all firms be the all-in costs of management, including advice, discretionary portfolio management, products, transactions and custody. For competitive offerings, these elements may be bundled. Ours are separately identified for each of Continuous Investment Services fees, platform charges and product costs. Our annual cost and charges reports for each client sum these all-in costs, as both sterling amounts and reduction in performance in the period.

Annualised percentage portfolio costs are directly comparable with annualised portfolio returns, whether real or nominal. This is helpful if we want to test for reasonableness by focusing on the difference between them, or (more constructively) the probabilities associated with the differences. This is why we like to refer to the 'Cost Wedge': how deeply costs drive into returns. For instance:

- Costs of 2% pa, typical in the industry, take 57% of an expected market return pre-costs of 3.5% pa in real terms (comparable with a 'balanced portfolio').
- Even for a 100% equity portfolio, it would represent one third of the expected return.
- If those costs were expressed as a proportion of the expected risk premium, they jump to two thirds and 40% respectively.
- With 3% costs for a balanced portfolio (not typical but not unheard of), all the expected risk premium is consumed by costs: the client takes all the risk, the industry stands a 50% chance of taking all the reward.

At the extremes, reasonableness looks easier to test for. We deliver a service at the thin end of the Wedge, with typical all-in costs around 0.8% after VAT.

### A value-added approach

It helps as part of the conceptual framework to divide costs into two components:

- Utility-like elements common to all options
- Added value elements specific to a particular firm's offering.

This helps because we anticipate that when you assess our value for money you will think about the opportunity cost, or your most likely alternative to Fowler Drew.

We always expect to price our service below competitors, reflecting a genuine productivity difference from the use of quantitative techniques. That means for some clients the most realistic alternative is self-direction, or DIY. This will not avoid the utility-like elements, as there is no means for self-directed investors to harness capital-market returns without owning investment products or securities, buying and selling them through a transaction platform, having an institution 'hold' them (or register their ownership) and provide the regular information they need to monitor them and file tax returns as required.

We have used two DIY alternatives to price the minimum, unavoidable, utility cost. First, Fidelity (as a multi-product and security platform) and, second, Vanguard (as a more limited source of index trackers). For most clients, the cost of both is about 0.20% (VAT-exempt). For individual cases, we can refine this to match the scale of the assets in either, as the costs are somewhat size-dependent.

Even self-direction may require ad hoc advice from time to time, not necessarily in respect of investment choices but to avoid the elephant traps in taxation and pension rules. A retained adviser or discretionary manager is likely to provide this without separate charge. Bought separately, this is likely to be priced at flat rates, so its scale relative to other utility costs is much more dependent on size and frequency. Not only is the demand hard to anticipate but supply is itself increasingly constrained. The economics for regulated firms of providing one-

off or transactional advice (which we don't) are deteriorating rapidly. We suggest for now assuming an amortised cost of £1,000 pa.

The cost of the added-value elements can be arrived at by taking your total charges (per our most recent cost and charges reports) and subtracting the opportunity cost of the utility elements. To the extent platform and product costs exceed the 0.20% generalised assumption, the added value elements need to compensate for them. Across all our clients, the average third-party costs are 0.25% so we are close to minimising the utility-like costs as long as there is no need to supplement with occasional advice. Individual cases vary as a function of stage (risk free assets being cheaper than risky assets) and whether there are any retained legacy products with higher charges.

If, for instance, a client currently had all-in costs, including VAT, of 0.80%, the added value elements they need to identify and justify are 0.60%. We have this data for each client.

### Categorising the factors

A 'value for money' requirement already applies to Defined Contribution (DC) pension products, and the regulator has recommended a framework. It focuses on two main categories of factors that are also relevant to us, in a slightly adapted form:

- Performance – as a function of process design as well as implied by actual past returns
- Communication – as it supports decision making or informed personal choice.

These factors ought to apply generally to our clients, as a function of the design of a goal-based approach with common application of financial modelling.

### Performance

After the event, it is obvious that value for money can be most simply ascertained by comparing gross and net returns. When we started, with no track record, clients had no choice but to rely on the theoretical merit ascribed to the method, to validate its projections. Today we can point (see below) to 15 years of actual returns for a composite of all 100% equity portfolios that follow the model. The risky portfolio is the one element common to all clients that might be construed as being us 'in competition' with other managers.

	Annualised Return (adjusted for cash flows)	Annualised Standard Deviation	Maximum Interim Decline	
			2007/9	Covid
Fowler Drew Composite	7.12%	13.71%	-28.78%	-16.32%
50:50 FTSE AllShare/FTSE AWxUK	7.31%	14.60%	-31.19%	-18.23%
FD Equity Benchmark	6.67%	14.15%	-29.38%	-17.21%
ARC Equity Risk TR GBP	4.65%	12.12%	-26.22%	-14.64%

The metrics in the table are those recommended for DC pension scheme's value assessment: the annualised rate of return, the annualised standard deviation of the returns and worst 'drawdown' (the maximum peak to trough decline before reversal, which we have shown for the two significant periods of decline). The data show that we have:

- matched our own benchmark (the one that picks up the persistent structural differences in our allocations), even though it has no expenses of rebalancing to fixed weights
- matched the suggested 'typical' industry equity benchmark index with a home bias

- significantly exceeded the ARC Equity benchmark (a population of actual peer group portfolios) with only modestly higher risk.

The risk characteristics are likely to persist in the future but the returns and relative returns are less predictive, even with 15 years of data. It is still worthwhile for clients to think about the persistent features of our method that are likely both to affect our returns and to explain much of any differences relative to other managers or to particular benchmarks.

In the table below we list the structural features of our approach that we believe should shape expectations about risk and return and will, if we are right, constitute benefits of adopting this approach.

We have estimated the scale of the impact on performance, as this varies considerably. We have also estimated the predictability of the impact, as in how confident we can be that this will be the effect we suggest. Features that are ranked high (H) on both counts should dominate those ranked low (L) on both. But an activity with low expected benefit but high confidence in its achievement is potentially more valuable than one with high impact but little certainty.

Performance (specific, measurable, <i>ex post</i> benefits)	Impact	Confidence
<b>Structural differences affecting expected risk and return</b>		
<i>Behavioural effects - manager</i>		
Better portfolio decisions with discipline of quantitative methods	H	H
Long-term rewards to contrarian strategies	M	M
Removes peer-group performance pressure	L	L
Prevents concealment of unavoidable tradeoffs	M	L
<i>Risky Portfolio</i>		
Optimised on horizon-specific real risk/return	H	H
Exploiting mean reversion in absolute/relative real returns	H	M
Better country diversification	M	L
Removing home bias	H	L
<i>Risk Free Portfolio</i>		
Cash-flow matching (amounts, dates)	H	H
Inflation protection for medium-dated liabilities	H	H
Holding to maturity (indifferent to volatility)	H	H
<i>Combined Portfolio</i>		
Risk as probabilities for horizon-specific, real, goal outcome	H	M
Equity plus liability matching improves risk control	H	H
Reduces need for complex diversification (risk and cost)	H	H
Less dependent on uncertain correlations	H	H
Removes assets with inflation risk (nominal bonds)	H	H
Implementable with low-cost investments	H	H
<i>Tax optimisation</i>		
Building tax-rate assumptions into models	L	M
Optimal use of tax-differentiated wrappers	L	M
Optimal contribution strategy	L	H
Optimal draw-source strategy to minimise tax	L	H
Annual tax housekeeping exercises	L	H
Collaborative decisions involving tax tradeoffs	L	M
Anticipating potential tax changes	L	L

The behavioural effects are the most important, whether the opportunity cost is another manager or self-direction. The performance benefit of excluding emotion is very high. Vanguard have estimated the damage to returns from poor investment decisions by comparing US mutual fund returns with the return earned by investors in those funds when weighted by their exposures. The gap arises from buying and selling decisions, not from persistence with a holding (which would have earned the fund manager's return). Vanguard's estimate of 1.5% pa loss of return is probably applicable to retail investors in other markets since the behaviours reflect our common psychological traits. Nor are professional investors immune. They too are vulnerable to emotions, over-confidence and other cognitive biases. That probably partly explains the underperformance against other benchmarks of the ARC universe of professional managers.

In the other categories, most of the listed impacts are a function of the specific form of our quantitative approach. They depend, for instance, on a real-return model and on portfolio optimisation methods that, though standard, are unique in optimising the portfolio using changing expected real returns and risk measures that are specific to every time horizon.

After the behavioural effects, it is risk control that tends to dominate the high-confidence sources of benefit, both within the risk-free portfolio itself (the assets it relies on and those it rejects) and in the combination of risky and risk-free assets to match the desired and required real outcomes resulting from planning.

We have always been cautious about estimating the potential incremental return or 'alpha' from dynamically rebalancing the country weights to harness mean reversion in relative returns. It is intentionally not a component of the projected portfolio outcomes, for greater prudence. At outset, when we felt we needed an estimate, we suggested 0.50% pa as realistically achievable. The actual increment against our own cost-free benchmark is, we note, almost exactly in line with that, at 0.45%. It disappears when compared with the 50:50 UK/International benchmark but that is likely to be explained by persistent rather than dynamic exposure differences.

Though the standard deviation of the composite is about 1% pa less than the 50:50 benchmark, we do not suggest assigning high importance to this as a permanent construction feature of the risky portfolio. We have certainly tried to improve the diversification effects through the distribution of weights (rather than simply the number of markets) but this will not necessarily make a lot of difference to the risk numbers. During the past 15 years there have been times when clients have commented on the very low exposures to certain markets but we have always been able to point to the broad spread of other exposures to demonstrate that the goal of good diversification was still being met. The Fowler Drew composite standard deviation bears this out.

A home bias is an optional modelling constraint, but we prefer to minimise externally imposed constraints on the weights except when necessary to achieve a broad enough distribution of weights.

The low-yielding but high-confidence activities lie mainly in the tax area. These are less specific to Fowler Drew (the decision logic being common to all and requiring less judgement). They are beneficial, however, and would not necessarily be exploited as thoroughly by self-directed investors. You can expect anticipatory judgements about tax strategy to be more of a differentiator as major tax initiatives under a Labour government loom larger.

### Communication

The communication category of benefits is where we place all the features of our approach that are specific to our methodology and that support clarity, confidence and composure.

We are not including here the communication of information that would form part of a platform's obligations, or the FCA quarterly reports that (for most firms) are effectively generated by a platform or data aggregation service. You should treat these as part of the utility-like elements explaining the minimum unavoidable cost of investing. In the table below, we only list the service elements that we believe provide added-value benefits, even if 'soft' in nature. We list the benefits but have not ranked them. That is something you could do for yourselves.

### Communication supporting decision making (soft benefits)

#### Relationship

- Informed personal responsibility vs dependency on proxies
- High-level control of decisions most impacting outcomes
- Evidence basis for trust in integrity of method
- Not dependent on personal chemistry

#### Planning

- Structure of individual goals: mental accounting benefits
- Planning each goal: intuitive and motivating
- Focus on real spending outcomes: engaging and relevant
- Interaction with modeling to identify tradeoffs
- Using modeling to reveal 'true' risk preferences
- Contributions model when saving
- Draw model when spending
- Modeling plans that will eventually use both

#### Journey management

- Benchmarking actual returns
- Forward-looking progress reports with new model runs
- Interaction with model to check goal parameters still optimal
- Interaction with model to reflect changes in personal circumstances
- New information re contributions
- New information re draw rate
- Using increased visibility to refine tax assumptions

#### Composure effects

- Clarity of goal structure
- Constant framework of goal plan to ease decision making
- Visible technical competence to engender trust
- Involvement and engagement of spouses

#### Impacts on performance

- Likely to choose to take more risk than if not planning with us
- Likely to persist and not ask manager to change approach

#### Impacts on outcomes

- Identifying what denotes satisfaction means more likely to achieve it
- Unlikely to suffer regret
- Expectations of both mean experienced as a benefit before the event

---

The goal structure, for instance, communicates clarity of intention. But it does it better if the primary goal is one that benefits from the constant reprojection of outcomes, because that can modify the experience of market volatility. Or if that information feeds into immediate decisions about how much to spend or save, when to retire or when to gift.

The table also attributes some performance impacts arising from the goal-planning, rather than directly from the investment method, that can potentially be quantified, as hard benefits. We often observe that clients end up, after planning, taking more risk than they did before they came to us. There is something in the goal planning, either dependent on the numbers generated by modeling or just a function of modifying biases, that changes people's preferences. Taking more risk will lead to better outcomes over the typical time frames of our clients' goals.

We have referred here to the idea of 'persistence': sticking to the plan. This is the practical impact of the quantitative advantage listed in the performance table earlier, avoiding the Vanguard wealth destruction of 1.5% pa. It belongs here too because, without the communication of the goal progress and the reprojection of outcomes, there might not be the persistence our model projections assume.

### Individual differences in value assessment

Though we can identify the individual benefits in each category, they will not apply equally to each client. In the last table we identify why applicability may vary between clients.

The same benefit of, for instance, communication about the sustainability of a draw rate will be valued more highly by someone in or close to draw. Yet this could be to some extent offset by another difference: dependence on the resources. Sufficiency can excuse a lot of inefficiency in the allocation of capital (even if it offends our own obsession with capital efficiency), whereas anyone with tight capital adequacy faces significant regret if they either overspend or underspend. These circumstantial differences in benefits are shown in the first panel.

All clients could in theory have the same expectations of the benefits from our service, yet not all will value it relative to the opportunity cost to the same extent. Clients who are either less interested in the detail of our methodology, or find it hard to take in, will probably enjoy fewer soft benefits and value it less highly. That may be the case even if they are the ones most likely to derive hard benefits relative to the opportunity cost. Idiosyncratic differences not explained by circumstances are shown in the second panel.

#### Personal valuation differences

##### *Differences in individual circumstances with common impacts*

- Single or multiple goals
- Differences in goal importance (eg spending > bequest)
- Number of associated individuals
- Number of associated wrappers
- Presence of complicating fiscal or investment factors
- Stage of spending goal (eg drawdown more important than accumulation)
- Dependence on outcomes (via resource adequacy and consequences)

##### *Idiosyncratic differences in valuation*

- Vulnerability to behavioural errors
- Comprehension or engagement limitations on enjoyment of soft benefits
- Mental accounting benefits of our goal-based approach
- Importance of need for comfort of surviving spouse
- Educational benefits for children