Aon Investment Research and Insights

Building Fee-Efficient Portfolios

February 2018

Empower Results®

Table of contents

About Aon Investment Research and Insights

Aon's robust portfolio of ideas, tools and researched solutions support trustees and sponsors to anticipate their future investment requirements.

By beginning to identify investment research and communicate ideas before they are needed we can shorten the implementation times for our clients and act in a timely way when opportunities are correctly priced.

To learn more and to access other research and insights from Aon's investment experts, visit **aonhewitt.com/investment**

Summary

Investment management fees are highly relevant to portfolio performance. Making portfolios more fee-efficient is not just about reducing existing fees. It is also about ensuring you are paying for things that add value, and not paying for things that don't.

Wider costs

Investors should consider "fees" in the context of overall fund expenses rather than just headline annual management charges.

Optimise

While efforts often focus on asset allocation and manager selection, it is also important to negotiate assertively and combine skilled managers in the most fee-efficient way.

Four step framework

We describe a four-step framework for making portfolios more fee-efficient that can be applied by investors with a variety of beliefs and circumstances:

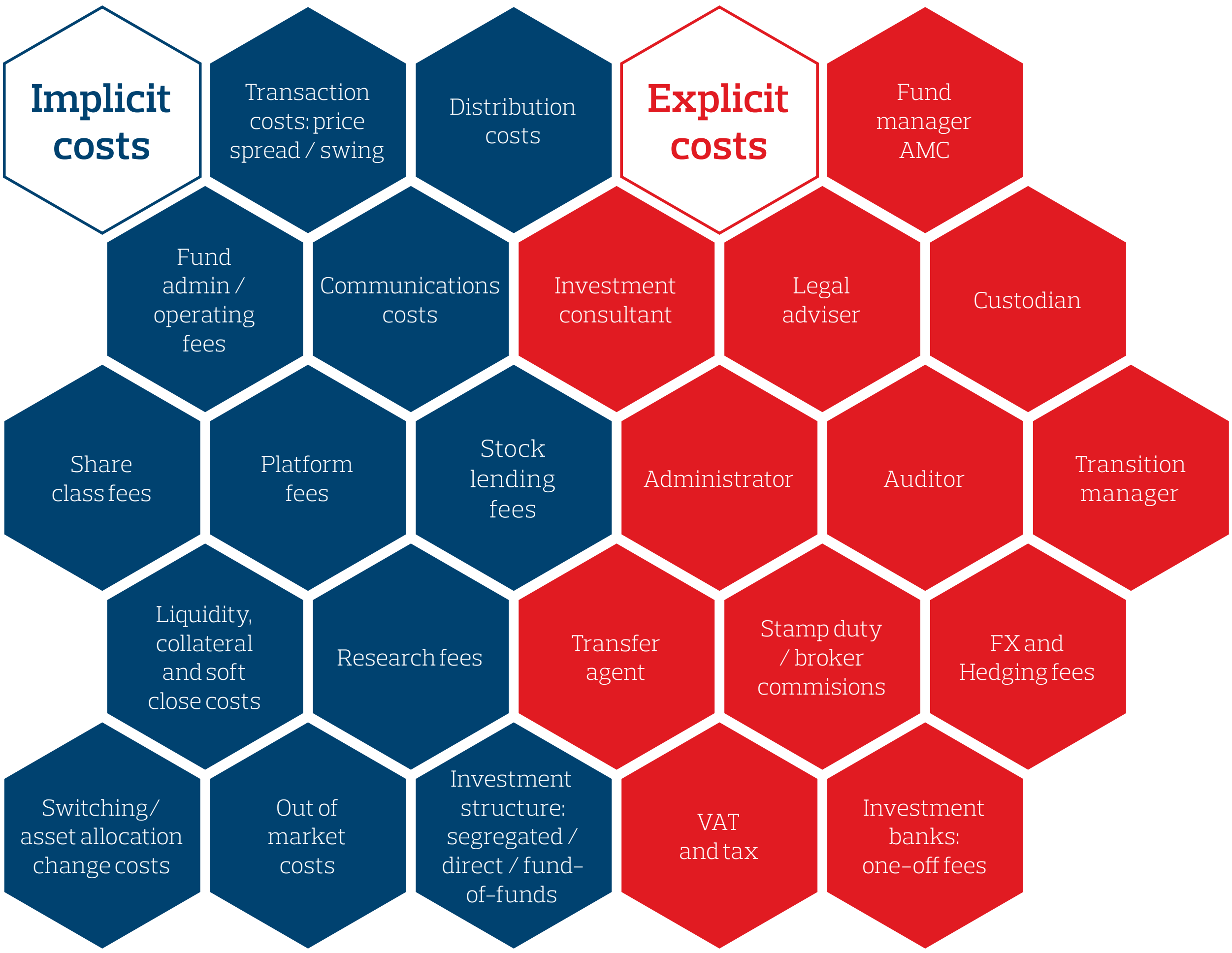
1. Get beta cheaply
2. Pay fees in line with expected value added
3. Optimise the structures and vehicles used
4. Negotiate

"Fees" versus "costs"

Manager transparency is key to ensuring investors understand the true fees charged. Annual management charges (AMC) are often quoted by managers as a headline fee. This may divert focus from the wider running costs of a fund which are ultimately picked up by investors.

A better measure of fund fees is the Total Expense Ratio (TER) or Ongoing Charges Figure (OCF) which both include more of these "hidden" costs shown below.

Delving deep into fund documentation and specific questioning of managers to determine the extent to which manager costs are passed on to clients is part of Aon's operational due diligence process. Changes in legislation often provide an opportunity to check in with managers regarding their approach. For example, the update to the Markets in Financial Instruments Directive (MiFID II) aims to improve the transparency of how research costs are accounted for. Our recent publication "What is MiFID II and how does it impact on asset managers?" provides more detail on this.



Implementation

By following the four step framework, investors can identify the potential to improve fee-efficiency, both within existing structures and new investment considerations.

1. Get beta cheaply

Mix management styles with fees in mind
Look to combine traditional passive mandates and/or factor-based mandates with "high conviction" active managers to achieve a more fee-efficient balance than paying higher fees for active managers who tend to closely track benchmarks.

In many cases, factor exposures (such as low volatility, value, quality and momentum) may be the dominant driver of performance for active equity portfolios. Rather than pay active fees for these exposures, it is often cheaper to undertake factor-based investing which can be a lower-cost way to access many of the exposures active managers seek. For more detail on these "smart beta" strategies, see our recent publication "The Rise of Factor Investing – How Clients Should Invest".

Review performance fees
Where performance fees exist, look at restructuring these to reduce the amount paid for any component of a manager's performance related to passive index returns.

Ensure that hurdle rates (the rate of return that a fund manager must beat before collecting performance fees) are set appropriately.

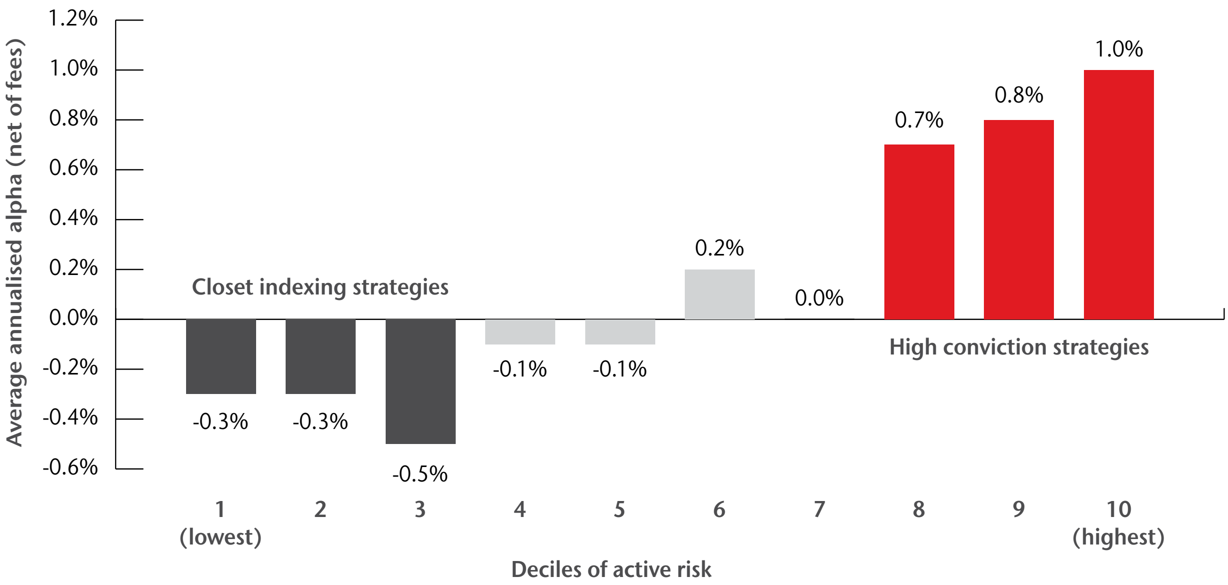
2. Pay fees proportionate with expected value added

Aon believe that "high conviction", unconstrained managers who take larger active positions away from the benchmark have greater potential to outperform than active managers who over-diversify to the point of becoming an expensive index-like portfolio.

These types of managers may charge higher fees but investors get more value from the fees paid. This is a key reason for looking at expected returns on a "net of fees" basis.

Our paper from 2012, "Conviction in Equity Investing" later published in the Journal of Portfolio Management, provides more detail behind our belief in high conviction, unconstrained equity investment. The following chart, taken from that paper, illustrates that, whilst an unconstrained active strategy is likely to have higher fees, it is expected to deliver a higher net return than a manager essentially following an index but masquerading as an expensive active strategy.

Alpha by Level of Active Risk (Manager's Chosen Benchmark)



Source: Aon (M. Sebastian and S Attaluri), "Conviction in Equity Investing", Journal of Portfolio Management (Vol. 40, No. 4, 2014)

3. Optimise the structures and vehicles used

Look into reducing the number of managers or pooling assets

Fewer and larger mandates can create a number of efficiencies/economies of scale to assist with governance budgets in general but can also provide an opportunity to drive down fees, particularly where sliding fee scales can be optimised.

The same concept can be applied to investors who access collective scale by consolidating or pooling assets with others. Fiduciary managers are able to apply the benefits of increased negotiating power to investors who would otherwise struggle to bring down fees based on their own mandate size.

Consider share classes with longer "lock-in" periods

Some managers (particularly in the hedge fund arena) offer lower fees for share classes with longer "lock in" periods. Practical limitations may be small as it is unusual to fire a manager in the short term and it might reduce the temptation to do so in the event of short term underperformance.

Use the same managers in multiple asset pools

Consider asset values in aggregate. Investors can attract more bargaining power where they have managers overlapping other arrangements, e.g. both DB and DC plans.

Vehicle choice

Where investment products are offered in multiple vehicles such as funds with several share classes, collective investment trusts and separate accounts, fees can vary considerably. Always consider whether the vehicle is the most fee-efficient for your arrangement and target the lowest fee vehicle wherever appropriate/possible.

Look for secondary market opportunities to access funds

Particularly relevant for closed ended funds, the secondary market can offer a considerable cost saving on entering. For many real estate funds, entry on the primary market can cost an additional 6% of the Net Asset Value (NAV) price. Brokers can assist in matching buyers and sellers on the secondary market to achieve a deal on the exchange of units closer to NAV.

4. Negotiate hard

Identify opportunities where you may have leverage to negotiate on fees. Some examples:

- Short-listed managers can be encouraged to improve on quoted fees in order to win business
- Seeding new products. The early bird catches the worm!
- Where assets under management have or are intended to be increased significantly
- Premium fees but less than premium performance (or if a stated target performance is reduced)
- Mandates in place for a long time with no fee review (over time, fees can trend downwards. Are you paying the current market rate?)
- When Aon downgrades a manager's rating from "Buy" to "Qualified"
- Ask the question! Even where clauses exist to restrict managers in providing better terms to new investors (Most Favoured Nation clauses), these may not apply to your situation.

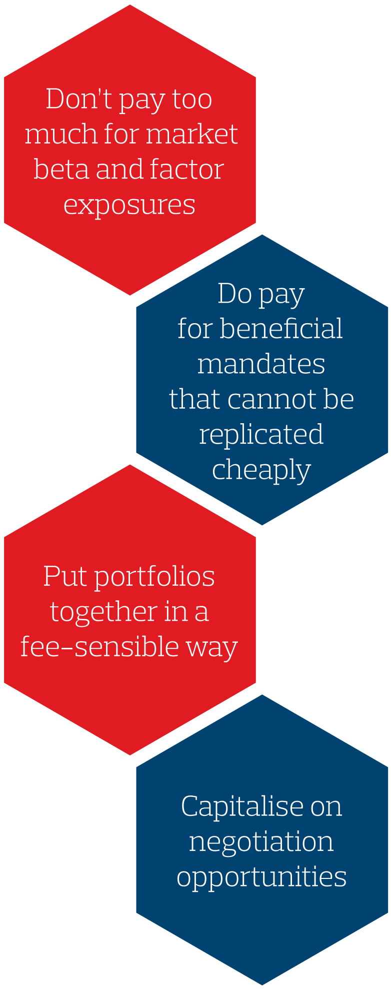
Beyond fees paid by clients, managers can also generate additional revenues from managing your money, e.g. stock-lending, commissions from trades using an in-house brokerage, and benefitting from price spreads between buyers and sellers of a fund rather than matching trades.

It is good practice to ask a manager to declare ALL the aspects where it does or could derive an income from managing your money. These then become further areas for potential negotiation.

Conclusion

Review fees not just with a view to reducing them but to use the four-step framework set out to the right, to help look for efficiencies.

Striving for more fee-efficiency should clearly not be the main determinant of asset allocation and manager selection. Fee considerations should be considered alongside investment risk and return drivers, such as diversification and liquidity as well as conviction in a manager to meet their target performance. Your Aon consultant can help you weigh up these different considerations.



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About Aon

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