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'Closet index trackers' must be outed, regulators urged

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Fund managers charging high fees for active management while effectively following much cheaper passive strategies must be exposed, UK and European financial regulators have been urged.

The UK's Financial Conduct Authority and the European Securities and Markets Authority are both facing calls to look into the issue after an investigation by the Danish financial services authority found nearly 30% of fund management teams may have been engaged in the practice, which is also known as "index hugging".

The Financial Services Consumer Panel – a statutory body that advises the FCA on behalf of consumers – is finalising a paper that addresses the practice, for years the subject of industry debate.

Foeke Noppert, policy officer at the panel, said: "The issue of closet indexers will be touched on in a discussion paper on wider issues surrounding the opacity of investment costs and charges that we will be publishing towards the end of October."

A spokesman for the FCA was unable to comment on closet indexing but said that the regulator believes that "asset managers should act as good agents".

In addition, Esma will this week be contacted by Better Finance for All, an independent lobby group representing four million members across Europe.

The lobby group’s managing director, Guillaume Prache, who has also previously been the chair of the Esma Stakeholder Group, said: “The problem of closet indexers is a serious one for retail investors. And based on [Denmark’s investigation] we are going to ask Esma to launch an EU-wide investigation within the next week. I will raise this issue directly with the chair of Esma [Steven Maijoor].”

Daniel Godfrey, chief executive of the Investment Management Association, which represents UK fund managers, said he suspects there may be some closet indexers and that “people should not pay active fees for something that’s pretty passive”.

He added investors should be able to spot them: “The data is available for people to see how clearly a fund replicates its composition index and draw their own conclusions.”

Danish regulator Finanstilsynet said in a report published last week it had analysed 188 mutual funds run by Danish financial services groups, and found 56 funds that “are not giving consumers the active management that they pay for”.

The Danish regulator is expecting that some of the 56 teams will have “good, and simple explanations” for why their returns resemble their benchmarks, but it will be writing to those that don’t, asking for formal explanations “within the next few months”.

Prache said: “The probability of potential dangers for investors in much bigger domiciles in Europe is very high – it’s the duty of Esma to follow suit.”

An Esma spokesman said that the organisation was in contact with regulators in Denmark about the investigation but did not want to speculate about the potential findings of the probe. He added: “For the time being, it’s a Danish issue.”

Theodor Kockelkoren, executive board member at Dutch regulator AFM, said: “The phenomenon [of closet indexers] is something that deserves attention from the asset management industry. This certainly is one of the topics that merits a European and correlated perspective.”

In the UK, 78% of funds are actively managed, according to the Investment Management Association, and most measure themselves against a benchmark.

Mark Cobley contributed to this article

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