BETTER FINANCE
The European Federation of Investors and Financial Services Users
Fédération Européenne des Épargnants et Usagers des Services Financiers

BETTER FINANCE POSITION PAPER

ON CALCULATION AND PRESENTATION OF

COSTS AND PERFORMANCE SCENARIOS IN THE PRIIPs KID

BETTER FINANCE, the European Federation of Investors and Financial Services Users, is the public interest non-governmental organisation advocating and defending the interests of European citizens as financial services users at the European level to lawmakers and the public in order to promote research, information and training on investments, savings and personal finances. It is the one and only European-level organisation solely dedicated to the representation of individual investors, savers and other financial services users.

BETTER FINANCE acts as an independent financial expertise and advocacy centre to the direct benefit of European financial services users. Since the BETTER FINANCE constituency includes individual and small shareholders, fund and retail investors, savers, pension fund participants, life insurance policy holders, borrowers, and other stakeholders who are independent from the financial industry, it has the best interests of all European citizens at heart. As such its activities are supported by the European Union since 2012.

EXECUTIVE SUMMARY

BETTER FINANCE has always strongly supported the aim of the PRIIPs Regulation: to tell potential investors what they need to know in a short, comprehensible format which they can easily compare with similar documents issued for other products. It is the first – and so far the only - "horizontal" EU set of investor protection rules on both non-insurance based and insurance based retail investment products. However, the design and execution of the PRIIPs KID run counter to its admirable objective of "e*nabling retail investors to* ***understand*** *and* ***compare*** *the key features and risks of the PRIIP*" (article 1 of the PRIIPs Level I Regulation).

Therefore, we reiterate the urgency and necessity to review PRIIPs Level 1 regulation (1296/2014) – which is legally required by end of 2019 - and the subsequent delegated Level 2 regulation (2017/593) in order to address several issues concerning the presentation of costs and performance scenarios:

- Future performance forecasts are wrong, misleading, based on last 5-year performances and only add to the confusion of retail investors, reasons why these should be eliminated and replaced by actual relative past performance of the product and of its benchmark alongside;
- Future fee estimates through the Reduction-in-Yield (RiY) method do not help retail investors understand how much a product costs, neither if it costs more or less than other similar products; therefore, these should be replaced by actual costs charged in the last year of the product.

Most importantly, any PRIIPs Regulation review must ensure that the KID:

- Enables comparability across the different types of investment products;
- Complies with the MiFID II principle of providing "fair, clear, and not misleading" information;
- Does not create unnecessary reporting burdens for issuers of securities.

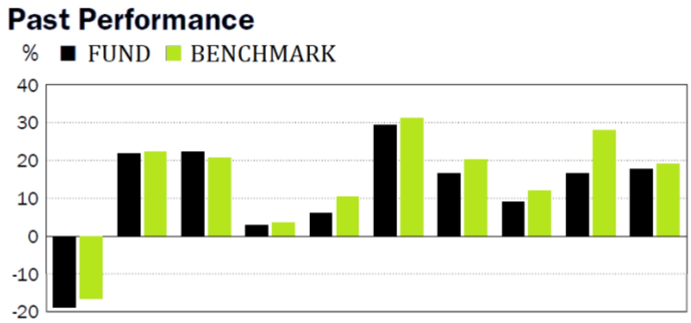
The European Federation of Investors and Financial Services Users
Rue d'Arenberg 44 | 1000 Brussels - Belgium
+32 02 514 37 77 | info@betterfinance.eu | betterfinance.eu

This position paper takes into account the modifications proposed by the Joint Committee of the European Supervisory Authorities (ESAs JC) to Level 2 PRIIPs legislation concerning the presentation and calculation of performance scenarios and of the costs section.[1]

I. PERFORMANCE DISCLOSURE

Already in 2016, BETTER FINANCE, the whole ESMA Securities Markets Stakeholder Group (SMSG) and the European Commission's Financial Services User Group (FSUG) formally warned against the disastrous mistake of eliminating the disclosure of relative past performance in the KID, contrary to what is done in the KIID for UCITS.[2]

Chart Ex.1. Example of UCITS KIID past performance disclosure



	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
Fund	-18.6	21.7	22.1	2.6	6.0	29.2	16.5	8.9	16.3	17.6
Benchmark	-16.3	22.2	20.4	3.4	10.2	31.0	20.1	11.8	27.7	18.9

Source: BETTER FINANCE, 2019, taken from a real UCITS KIID

The first example (Ex.1.) shows how performance information is currently presented in the *key investor information document* (KIID) prepared by UCITS[3] funds providers. The black bars show the profits or losses of the fund in comparison with the benchmark (green bar) in the past 10 years. The methodology for the UCITS KIID and the presentation or the product's **relative** past performance therein created an easily understandable document, based on actual historical data, which has proven successful with individual investors.

The PRIIPs Regulation Level 2 obliges product manufacturers not to disclose any actual past performance information, and to present in the newly *key information document* (KID) four future linear performance scenarios, at three points in the future, that are based on past performance statistical data.

BETTER FINANCE's own research (and many other papers[4]) has shown that performance forecasts are decorrelated from the reality, confusing retail investors and misleading them to believe that one or another "scenario" might occur.

---

[1] See ESAs JC Report following the Joint Consultation Paper Concerning Amendments to the PRIIPs KID (JC 2019 6.2) and Annex I of the Letter of the ESAs JC to EC DG FISMA on performance scenario options of 23 May 2019.
[2] https://betterfinance.eu/wp-content/uploads/publications/PR_-_PRIIPS_KID_Implementation_Rules_-_18052016.pdf.
[3] A UCITS (**U**ndertaking for **C**ollective **I**nvestments in **T**ransferable **S**ecurities) is the most common form of mutual funds sold to the retail sector in the EU, accounting for 75% of all their collective investments.
[4] For instance, see EFAMA Evidence Paper on PRIIP KID's Shortcomings, https://www.efama.org/Publications/Public/PRIPS/18-4008_EFAMAPRIIPsEvidencePaper.pdf.

The European Federation of Investors and Financial Services Users
Rue d'Arenberg 44 | 1000 Brussels - Belgium
+32 02 514 37 77 | info@betterfinance.eu | betterfinance.eu

PRIIPs KID future performance scenarios are always wrong

In the example below (Ex.2.) BETTER FINANCE has calculated the future performance scenarios of a fund, according to the PRIIPs Methodology, as if the KID had been provided to retail investors on 31.12.2013.

As such, the PRIIPs KID would have shown the future performance of the product on four scenarios (unfavourable, moderate, favourable and stress) at 3 points in the future: after one year (31.12.2014), after three years (31.12.2016) and after 5 years (31.12.2018).

What the example below shows is how these forecasts presented to the retail investor compare to what actually happened in the above-mentioned periods (*real scenario*).

Table Ex.2. Example of PRIIPs KID future performance vs actual outcome

Investment of €10,000				**RHP**
Scenarios		**1 year**	**3 years**	**5 years**
Unfavourable scenario	**What you might get back after costs**	€8,049.60	€7,660.98	€7.812.29
	Average return each year	-19.5%	-8%	-5%
Moderate scenario	**What you might get back after costs**	€10,903.58	€12,951.97	€15,385.17
	Average return each year	9.04%	9.0%	8.99%
Favourable scenario	**What you might get back after costs**	€14,748.70	€25.469.17	€30,256.30
	Average return each year	47%	37%	25%
Stress scenario	**What you might get back after costs**	€3,524.43	€4,073.20	€3,005.58
	Average return each year	-64%	-26%	-21%
Real scenario	**What you actually got back after costs**	€12,229.65	€13,326.61	€13,659.72
	Average return each year	23%	10%	6.4%
		(in 2014)	(2014-2016)	(2014-2018)

Source: BETTER FINANCE, 2019

All PRIIPs KID performance scenarios are linear, which will never be the reality

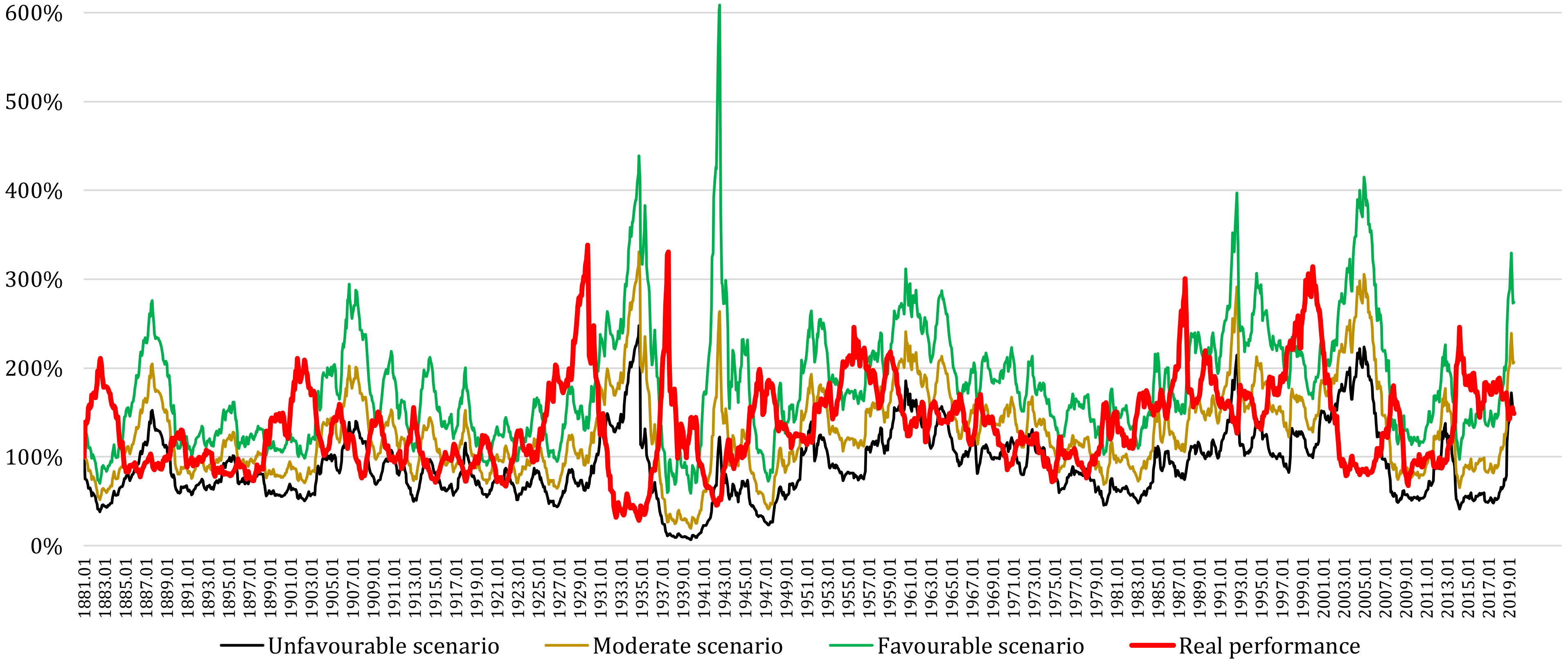
However, the methodology to forecast future performance is linear. i.e. the estimated values grow at a steady rate on a daily or monthly basis until the recommended holding period (RHP) and intermediary holding periods (in Ex.2. is 3 years) are reached. As such, these performance forecasts do not embed fluctuations of returns (volatility) inherent in capital markets.[5]

In order to eliminate market timing bias and to show how inaccurate future performance forecasts are, both from a volatility point of view and from the estimated value point of view, BETTER FINANCE has computed in the graph below (Ex.3.) *the future performance forecast* vs. *the actual performance* of the S&P 500 Composite Price index covering a timeframe of 138 years and 1,662 rolling 5-year periods (January 1881 to January 2019).

[5] See Graph Ex.7.

The European Federation of Investors and Financial Services Users
Rue d'Arenberg 44 | 1000 Brussels - Belgium
+32 02 514 37 77 | info@betterfinance.eu | betterfinance.eu

Graph Ex.3. Forecasts vs actual performance



Source: raw data extracted from prof. Robert Shiller database; BETTER FINANCE own computations based on PRIIPs Level 2 methodology.

The European Federation of Investors and Financial Services Users
Rue d'Arenberg 44 | 1000 Brussels - Belgium
+32 02 514 37 77 | info@betterfinance.eu | betterfinance.eu

Analyzing the performance estimations in comparison with the actual return of the product in the given time frame (1881-2019), BETTER FINANCE computed a few measurements of accuracy (table Ex.4.) to show how "realistic" the performance forecasts have been.

- First, none of the 4,986 estimations over 138 years have matched the actual outcome of the fund (***Return accuracy***). Therefore, we applied a margin of error of +5% and -5% to determine how many estimations have been at least close to the reality, resulting in an error interval of 10 percentage points. We observed that only 295 out of all 4,986 estimations fitted in this interval (7.15% unfavourable scenario, 6.54% moderate and 4.54% for the favourable scenario). This means that an investor had a 6% chance (or 1-to-16) to have been close to the actual outcome.
- Second, we analysed the standard deviation between the estimated returns and the actual outcome. This measurement shows how far apart each forecasted return has been on average from the actual return of the product: the results have been **very** high for all three scenarios (favourable – 68%, unfavourable - 76%, moderate - 92%).
- Last, we calculated correlation coefficient, to determine if at least the market movement predictions and estimations of returns were correlated with the reality. The result was consistent with the previous findings: an almost a "perfect" decorrelation between the real outcome and the favourable and moderate scenarios, meaning that on average when the market moved down, estimations said it moved up, and vice-versa. For instance, during the Great Depression (September 1934) the KID would have predicted a favourable 302.7% increase of the investment, whereas the actual return was of -91.2%.

Table Ex.4. Performance measurements

Standard deviation		Correlation coefficient	
Real-Favourable	92%	Real-Favourable	-74%
Real-Moderate	76%	Real-Moderate	-68%
Real-Unfavourable	68%	Real-Unfavourable	-15%
Return accuracy		**Return accuracy (+/- 0.5%)**	
Real-Favourable	0%	Real-Favourable	4.50%
Real-Moderate	0%	Real-Moderate	6.54%
Real-Unfavourable	0%	Real-Unfavourable	7.15%

Source: BETTER FINANCE, 2019

The four future performance scenarios are not probability weighted, leaving the investor in the dark

In addition, all four performance forecasts have the same chance of occurrence since the PRIIPs Methodology does not contain any probability calculations between the four. Taking the example in table Ex.2., there is an equal chance to earn €15,385 as there is to lose €6,995 from a €10,000 investment. BETTER FINANCE believes that retail investors are prone to assume that the *Moderate scenario* is the most probable to occur, as there is no prominent warning against this. Moreover, there is no probability calculation on the likelihood of the performance forecasts: in other words, we do not know "how many chances" we have on any of the four estimations.

The European Federation of Investors and Financial Services Users
Rue d'Arenberg 44 | 1000 Brussels - Belgium
+32 02 514 37 77 | info@betterfinance.eu | betterfinance.eu

Table Ex.5. Probability weightings of performance scenarios

Likelihood of occurrence								
Moderate scenario ?	= =	Favourable scenario ?	= =	Unfavourable scenario ?	=	Stress scenario ?	=	? ?

Source: BETTER FINANCE, 2019

The PRIIPs KID future performance scenarios are not comparable even for similar products due to the discretionary choice of the recommended holding period by each provider

Whereas the UCITS KIID obliged all providers to present objectively, already established track record on the **same time period** (10 years or maximum), the PRIIPs KID allows product manufacturers to choose the recommended holding period to compute forecasts.

As seen in table Ex.6. below, performance forecasts are not at all comparable between the same type of products because the manufacturers can choose the RHP and they are not required to align it with the objectives of the product.

Table Ex.6. Performance forecasts at RHP

Investment of €10,000	Product 1 5 years (RHP)	Investment of €10,000	Product 2 6 years (RHP)
Unfavourable scenario	€9,151.79 -1.76%	Unfavourable scenario	€9.797.56 -1.90%
Moderate scenario	€16.234.32 10.18%	Moderate scenario	€18,458.85 10.76%
Favourable scenario	€28.752.46 23.52%	Favourable scenario	€34,722.69 23.06%
Stress scenario	3,111.35€ -20.82%	Stress scenario	€2,909.69 -18.6%

Source: BETTER FINANCE, 2019;

The last five-year basis for future performance scenarios is inadequate, in particular for long term products such as life cycle funds used for pensions.

What is more, performance forecasts are based on the past 5 years' data of the product. If with past performance retail investors can compare actual results in the years where two products coexisted, future performance will look very different – even on the same product! – depending on what particular track record time frame is chosen for a product – see graph Ex.3. above.

The prominent warning required by MiFID II on the lack of reliability of such future performance disclosures (even worse if based on past performance) is missing[6]

The complete shift in key information disclosure will have (and already has) negative consequences for retail investors. Besides the fact that retail investors will no longer know whether their investment products have made any money in the past or whether the product has

[6] See Article 44(6), pt. e) of Commission Delegated Regulation (EU) 2017/565 of 25 April 2016 supplementing Directive 2014/65/EU of the European Parliament and of the Council as regards organisational requirements and operating conditions for investment firms and defined terms for the purposes of that Directive, OJ L 87/1.

The European Federation of Investors and Financial Services Users
Rue d'Arenberg 44 | 1000 Brussels - Belgium
+32 02 514 37 77 | info@betterfinance.eu | betterfinance.eu

met its investment objectives or not, it will create unrealistically optimistic or pessimistic expectations, leading to more confusion and distrust in investment products.

To **conclude at this point**:

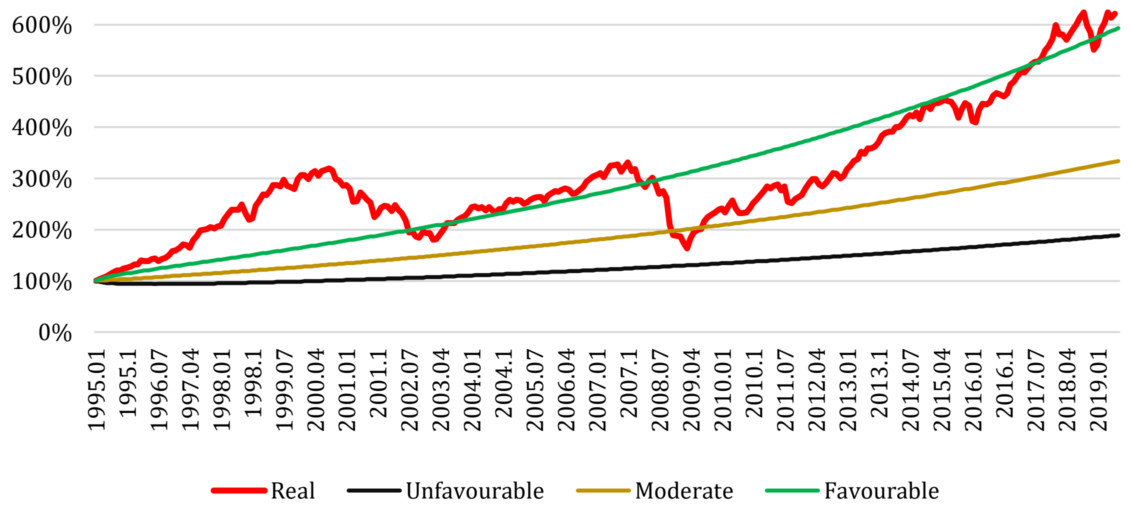
- Performance forecasts are confusing and misleading for retail investors;
- Performance forecasts are not accurate, not within error intervals;
- There is no probability weighing between the four scenarios;
- Performance forecasts are not comparable, as not even made on standardised holding periods; and
- They do not comply with MiFID II requirements.

Therefore, BETTER FINANCE requests that EU authorities comply with the law and undertake with utmost urgency the PRIIPS Level 1 Regulation review by 31.12.2019. In this sense, EU Authorities and the co-legislators must replace the confusing and misleading future performance forecasts with standardised relative past performance disclosure. Any key information document provided to retail investors must comply with the principle of "*fair, clear, and not misleading*" information – Article 24(3) MiFID II.

In view of the proposed modifications to Level 2 in the meantime, BETTER FINANCE firmly suggests:

- To maintain comparability between products based on their characteristics;
- At least extend the historical data time frame from 5 to 10 years, in order to capture negative market cycles as well.

Graph Ex.7. Linearity of performance forecasts



Source: BETTER FINANCE own composition; this graph represents a simulation of the performance of the S&P 500 Composite Price Index performed using one single 5-year historical track record, as required by the PRIIPs Level 2 regulation: as it can be seen, the performance estimations are linear, while the "true" performance fluctuates.

II. PRESENTATION OF COSTS

As the only EU-level NGO dedicating to representing and defending the interests of investors and financial services users, BETTER FINANCE has raised on several occasions its concerns regarding the PRIIPs KID legislative framework in terms of investor protection. Again, the methodology to calculate and present costs for the retail investor was very clear and accurate in the UCITS KIID as presented in Table Ex.8.

Table Ex.8. Presentation of costs in the UCITS KIID

Charges

These charges are used to pay the costs of running the fund, including the costs of marketing and selling. They reduce the potential growth of your investment.

One-off charges deducted before or after you invest	
Entry Charge	0.00%
Exit Charge	0.00%
This is the maximum charge that might be taken out of your money before it is invested or before the proceeds of your investments are paid out.	
Charges taken from the fund over a year	
Ongoing Charges	1.80%

The entry and exit charges shown are maximum figures. In some cases you might pay less.

The ongoing charges shown are based on the fund's last financial year ending 31.12.20xx. It may vary from year to year. It does not include transaction costs incurred when we buy of sell assets for the fund.

You will find more details about the calculation of the charges by checking the respective part of the prospectus.

Source: BETTER FINANCE, 2019

The costs section must show the actual cost for each product in a simple and standardised manner, as shown above in table Ex.7. The PRIIPs KID methodology has a couple significant shortcomings in this respect:

- First, it is more difficult to understand than the "TER" (annual total expense ratio) approach used up to now in the EU and in the USA (combined there with a computation of the dollar impact on a typical case);
- Second, it does not present the actual costs, but future cost-estimations based on recommended holding periods;
- Third, since the estimations are based on only one of the four performance scenarios (the "moderate" one, although it does not have a higher probability of occurrence than the three others, without mentioning it in the KID), the costs presented are, in fact, an estimate of an estimate;
- Fourth, it is impossible for the individual investor to assess the cost if his own intended holding period is different from the three disclosed (which will be most cases);
- Fifth, it is impossible to compare the cost of similar products if the recommended holding period is different;
- Sixth, there is no prominent warning regarding the basis for estimating costs;
- Seventh, it obscures one-off costs, such as subscription or redemption fees;
- Eighth, it includes in the transaction costs certain elements that are not actually "costs";
- Last, but not least, the PRIIPs KID costs section will show different cost figures than those required under MiFID II.

Reduction-in-Yield (RiY)

The European Federation of Investors and Financial Services Users
Rue d'Arenberg 44 | 1000 Brussels - Belgium
+32 02 514 37 77 | info@betterfinance.eu | betterfinance.eu

The RiY is a financial concept known only by specialists and it measures the effect of fees or other factors on the return of a product. The RiY is meant to calculate how much the yield (gross return) decreases due to certain factors, in this case due to charges. The RiY is usually expressed as the relative value (in %) of fees out of the performance. For instance, a 2% fee out of a 4% yield will result in a RiY of 50%, or a reduction by 2 percentage points. The PRIIPs KID obliges providers to show *the annual impact of fees on future return*, expressed in monetary terms and in relative terms.

Table Ex.9. Cost presentation comparison (KID vs reality)

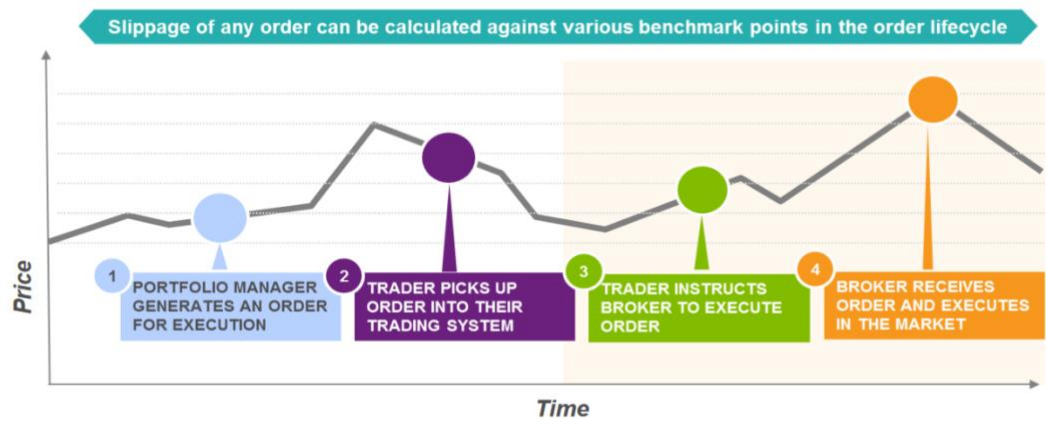
Investment of €10,000			
Scenarios	**If you cash in after 1 year**	**If you cash in after 3 years**	**If you cash in after 5 years**
Total costs	€433.61	€862.85	€1,611.29
Impact on return (RiY) per year	4.0%	2.7%	2.4%
Real total costs	€443.92	€959.67	€1,554.74
Real impact on return (RiY) per year	4.1%	5.5%	6.0%

Source: BETTER FINANCE, 2019; the assumption is that ongoing charges are 2%, the entry fee is 1% and exit fee 1%;

Transaction Costs

In October 2016, BETTER FINANCE sent a letter to the Director General of DG FISMA alerting that the calculation methodology was misleading[7], as it would lead to communicate "negative" transactions costs in several cases. Unfortunately, this early warning was not taken into account by the EU regulators. Transaction costs under the PRIIPs KID are understood as the difference between the execution and the arrival price, which basically represents the "slippage" in prices, or market movement. In many instances[8] the "slippage" might be positive, the execution order being lower than the arrival price as shown in graph Ex.9 below.

Ex.10. Slippage between arrival and execution price



Source: The Investment Association (footnote 9)

[7] http://betterfinance.eu/fileadmin/user_upload/documents/Joint_Open_Letters/en/PRIIPs-_EFAMA__Better_Finance_letter.pdf
[8] See EFAMA Evidence Paper on PRIIPs KID's Shortcomings (footnote 4).

The European Federation of Investors and Financial Services Users
Rue d'Arenberg 44 | 1000 Brussels - Belgium
+32 02 514 37 77 | info@betterfinance.eu | betterfinance.eu

In the situations where the arrival price (point 4, orange) is higher than the execution price (point 1, light blue), the investor will earn money, but the transaction cost will appear as negative, leading to confusion among retail investors.[9]

To **conclude at this point**, BETTER FINANCE points out that the new cost calculation and disclosure methodology:

- is incomprehensible to retail investors (there should not be negative costs);
- makes comparability extremely difficult;
- contradicts disclosure obligations in other regulatory documents;
- misleads and creates confusion among retail investors.

III. "QUICK FIXES" (Level 2 improvement proposals)

In light of the strong advocacy efforts from BETTER FINANCE and stakeholders, the European Commission – instead of launching the legally required and urgent Level 1 review - mandated[10] the Joint Committee of the ESAs to propose amendments to the PRIIPs Level 2 Regulation concerning the methodology to calculate and present performance scenarios and costs.

From the outset, BETTER FINANCE highlights that these amendments should have an exclusively ***temporary*** nature and should not preclude or postpone the necessary and mandatory by law[11] review of the PRIIPs Level 1 regulation.

Until the review and revision of the Level 1 Regulation is undertaken, BETTER FINANCE strongly advises the ESAs and the European Commission to consider:

- Adding past performance disclosure under the "What are the risks and what could I get in return" section of the PRIIPs KID; that is, to add the historical track record graph before the table with performance forecasts;
- Adding alongside the past performance of the benchmark chosen by the provider, in line with the UCITS rules on benchmark disclosures
- Maintaining the future performance estimations individual and particular to each investment product, and not generalising across products;
- Expanding the basis track record data of past performances for the calculation of the performance scenarios from 5 years to 10 years;
- Including ***three prominent warnings***:
    - that future performance is not a reliable indicator of future results;
    - that these scenarios are themselves based on past performances, and
    - that the Reduction-in-Yield (RiY) is based on the moderate scenario and is not a reliable indicator of actual costs.

[9] Source for Graph Ex.10: The Investment Association, "Disclosing Transaction Costs – The Need for a Common Framework" (August 2018) p.7, https://www.blackrock.com/corporate/literature/whitepaper/viewpoint-disclosing-transaction-costs-august-2018.pdf.
[10] European Commission request to the ESAs here.
[11] According to Art. 32 of the PRIIPs Level 1 Regulation, the review was supposed to be performed by the European Commission by 31 December 2018; however, as that deadline was sure not to be met, the European Parliament and Council decided, through legislative procedure, to postpone the review by 31 December 2019.

The European Federation of Investors and Financial Services Users
Rue d'Arenberg 44 | 1000 Brussels - Belgium
+32 02 514 37 77 | info@betterfinance.eu | betterfinance.eu

IV. POLICY RECOMMENDATIONS

In light of the arguments put forward in this paper, BETTER FINANCE urges the European Parliament and the Council of the European Union to ask the European Commission to comply with its legal obligation enshrined in Article 33[12] of the PRIIPs Regulation and immediately start the review process of the said Regulation.

In addition, with respect with the potential modifications to the Level 1 Regulation, BETTER FINANCE urges EU authorities to:

1. Eliminate the wrong, highly misleading and confusing future performance forecasts from the PRIIPs KID;
2. Reintroduce and standardise across investment products presentation of actual past performance of the product and of its benchmark on 10 years or since the product inception (if the product is younger);
3. Reintroduce and standardise across investment products the accurate presentation of one-off and recurrent (ongoing) costs, but add the combined impact of one-off and ongoing cost in monetary terms on a typical example;
4. Eliminate the incomprehensible and not reliable *Reduction-in-future-Yield* as a measurement of costs from the PRIIPs KID;
5. Expand the material scope of PRIIPs to include personal pension products (PPPs) and ensure harmonisation of the PRIIPS KID with of the PEPP KID, as already some personal pensions products are included in the PRIIPs scope (for example life cycle funds);
6. Eliminate the double reporting burden for securities issuers and remove the confusion for individual investors, in particular for issuers of corporate bonds to the retail sector: the summary prospectus is enough;
7. Simplify the estimation of implicit transaction costs (market movements) in order to avoid "negative" cost disclosures to individual investors.

In absence of all these modifications, the EU cannot achieve a "fair, clear, and not misleading" key information document for individual investors that would provide transparency, clarity, comparability and, ultimately, trust in the financial industry.

[12] The deadline of 31 December 2018 referred to Article 33 of the PRIIPs Level 1 Regulation has been modified by the Article 17 of the Regulation (EU) 2019/1156 of the European Parliament and of the Council of 20 June 2019 on facilitating cross-border distribution of collective investment undertakings and amending Regulations (EU) No 345/2013, (EU) No 346/2013 and (EU) No 1286/2014; OJ L 188, 12.7.2019, p. 55–66, to 31 December 2019, which will entry into force on 1 August 2019.

The European Federation of Investors and Financial Services Users
Rue d'Arenberg 44 | 1000 Brussels - Belgium
+32 02 514 37 77 | info@betterfinance.eu | betterfinance.eu