PRESS RELEASE

Better Finance helps investors identify potential falsely active funds ("closet indexers"), and asks regulators to investigate further:

It replicated the ESMA study on closet indexing and identified up to 165 equity "UCITS" funds that could potentially be closet indexers.

12 February 2017

Better Finance fully discloses the results of its replication of ESMA's quantitative study

ESMA would not disclose the names of the funds it identified as "*potential equity closet indexing funds*" in its investigation results released in February 2016 (see annex 3), leaving fund investors in the dark. This is why Better Finance decided to replicate the ESMA study as closely as possible and – using the same quantitative analysis performed by ESMA - to disclose the list of the sampled funds (attached), including those that are potentially "closet indexers" according to ESMA, and also those funds – more numerous - that ESMA did sample but did not analyse for lack of data. Better Finance used the same source as ESMA (the Morningstar fund database).

Replicating in December 2016 the ESMA study performed in 2015, Better Finance could sample 2,332[1] UCITS equity funds using ESMA's sampling criteria (see annex 3 for details).

Better Finance broke them down into four categories:

- 6% (147 funds) do not report any benchmark in their prospectuses according to Morningstar, making it impossible to provide the metrics used by ESMA to identify potentially falsely active funds, i.e. "active" share", "tracking error" and "R squared" (see annex 3 for definitions). For example, 5.7% of Luxembourg domiciled funds do not mention any benchmark, 12.2% in Ireland, 1.5% in the UK and 5.3% in France.
- 50% (1,172 funds) do report a benchmark but apparently do not provide enough information for Morningstar to compute the metrics selected by ESMA for those funds. For example, 34.1% of Luxembourg-domiciled funds do report a benchmark but still do

[1] Using the same sampling criteria as ESMA, the number of funds is nevertheless lower for this replication study. This is most probably due to the evolution of the Morningstar database in the meantime (some funds may have closed, merged, or no longer meet the sampling criteria).

not disclose their active share, tracking error or R-squared in the Morningstar database, 36.1% in Ireland, 60.8% in the UK and 64.0% in France.

In all, 57% of UCITS equity funds escape scrutiny because of a lack of available information in Morningstar. Only a minority of all UCITS equity funds (43%) can be analysed using the ESMA methodology and source:

- 36% (848 funds) of all funds are sufficiently transparent (regarding ESMA metrics in the Morningstar database) and – based on those metrics – do seem to be truly active.
- Up to 7% of all funds and up to 16 % of sufficiently transparent funds (165 funds) show characteristics that flag them as being potential closet index funds according to ESMA (active share below 60% and tracking error below 4%); for example, 46.4% of those funds are domiciled in Luxembourg, 7.8 % in Ireland, 7.2% in the UK and 15.7% in France.

Other worrying findings by Better Finance (detailed in annex 2)

A complementing review of investor disclosure documents revealed that more than a third (34%; or 21 funds out of 62) of the funds with the highest potential of being closet indexers according to ESMA (active share below 50%, tracking error below 3% and R square above 0,95)[2] do not disclose their benchmark's performance alongside their own performance in their KIID[3]. This does not seem to comply with EU Law and makes it impossible for retail fund investors to assess the relative performance of these funds vis-à-vis their benchmark.

Also a majority of those funds seem to have underperformed their benchmark over the last five years. Better Finance did not check their performance versus low cost index funds (such as ETFs) using the same index.

Call for more transparency from fund managers and from regulators

Better Finance calls upon the national regulators and upon the asset managers involved to provide clear reasons for charging "active" fees (from 0,75% to 3,00% per annum) to investors in these potentially falsely active funds (according to ESMA), instead of fees of between 0,05% and 0,30% typically charged for index ETF funds.

It also calls upon ESMA and national regulators to provide much more transparency on funds' metrics and to expand their investigations to the majority of EU domiciled active equity funds, including those that were not analysed by ESMA:

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[2] ESMA identified 3 "classifications" of potential equity closet indexing funds. From the broadest to the narrowest:
- Class 1: AS < 60%, TE < 4%
- Class 2: AS < 50%; TE < 3%
- Class 3: AS < 50%, TE < 3%, $R^2 > 0{,}95$

[3] KIID : this is the mandatory, standardized and supervised "Key Investor Information Document" for all UCITS funds

- the majority of active equity "UCITS" funds (not included in the ESMA study):
    - those which did not disclose a benchmark in their prospectuses (147 funds in our study),
    - and those which did disclose a benchmark, but for which Morningstar could not compute their "active share" and/or their tracking error (1,172 funds in our study);
- and all the active equity "AIF" funds that are distributed to retail investors in the EU.

"*Restoring savers' and investors' confidence is key for growth and jobs in Europe as highlighted by the EU Authorities. Let's walk the talk. These findings are further clear proof that EU regulators must not eliminate the standardized and supervised disclosure of the long-term and relative past performance of retail investment products to their benchmark, as they unfortunately plan to do in the implementing rules for "PRIIPs*" said Guillaume Prache, managing director of Better Finance.

Disclaimer: Better Finance has not identified any closet index fund. It has only recreated and published the list of funds that ESMA sampled earlier, including those ESMA identified itself as "*potential equity closet indexing funds*", based on its sampling criteria and on its quantitative analysis; we refer to ESMA's 02/02/2016 press release and statement. Better Finance's quantitative study therefore bears the same limitations as the ESMA one.

The data used for the study carried out by Better Finance and based entirely on the methodology and criteria of the ESMA study, references the period from 2010 to 2014 only. It is a one shot study limited in time. Variables that formed part of the selection and filtering criteria therefore may very well have changed since then.

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Encl.:

- 1. List of all equity UCITS funds sampled using the ESMA criteria.
- 2. Other worrying findings by Better Finance
- 3. The ESMA study's limitations and methodology

ANNEX 1

Please see separate annexes 1A, 1B, 1C, 1D and 1E.

- Annex 1.A - List of All Funds (2332 funds)
- Annex 1.B - List of funds with No Reported Benchmark (147 funds)
- Annex 1.C - List of funds with Insufficient Data (1172 funds)
- Annex 1.D - List of funds that are Potential Active Funds (848 funds)
- Annex 1.E - List of funds that are Potential Closet Indexers (165 funds)

Annexes 2 and 3 are below.

ANNEX 2

Replication of the ESMA study on closet indexing

Annex 2: Other worrying findings by Better Finance

1. **The vast majority of UCITS equity funds are benchmarked (94 % of them according to Morningstar), and this is a good thing for EU savers and investors … if the current disclosure requirements last and are enforced!**

Contrary to what one could believe from hearing many statements from asset managers criticizing "benchmarked" asset management and favoring "absolute" performance and "freedom" from benchmarks, only 6 % of UCITS equity funds (as selected by ESMA) are not benchmarked.

And this is good news for savers and retail investors in Europe, since "absolute" performance has little relevance and can by highly misleading, at least over the long term, which is the horizon of most European savers. It does not - when disclosed on its own - enable savers to assess whether this absolute performance is good value for them. This is why current EU regulation requires fund managers to disclose the 10-year[4] performance of their chosen benchmark (whenever they have one) alongside to the 10-year performance of their fund.

However, this rule seems insufficiently enforced (see item 2 below). Worse, ESMA and the other ESAs propose to eliminate all past performance disclosure altogether and any reference to the benchmark performance (past or future) in the future "KID"[5] that is supposed to replace the current KIID… and this despite numerous formal warnings against such a move against investor protection, including a unanimous and public one from ESMA's own Stakeholder Group.

At the very least, the performance of retail investment products should be benchmarked against inflation, to protect investors from the "monetary illusion". This is why Better Finance, like the OECD, always analyses long-term investment returns in real terms, i.e. net of inflation.

2. **Our complementing review of investor disclosure documents revealed that more than a third (34%; or 21 funds out of 62) of the funds with the highest potential of being closet indexers according to ESMA[6] (active share below 50%, tracking error below 3% and R square above 0,95) do not disclose their**

[4] Or since the fund's inception date, if less than 10 years ago.
[5] "KID: Key Information Document
[6] These are ESMA's "classification 3" funds. See ESMA 02/02/2016 press release and statement

benchmark's performance alongside their own performance in their KIID[7] although they do disclose a benchmark in their prospectus.

Better Finance believes this does not comply with EU Law and makes it impossible for retail fund investors to assess whether and to what extent these funds have been "hugging" their benchmark.

The UCITS KIID Regulation (No 583/2010) in its article 7.1(d) requires that the 'Objectives and investment policy' section of the KIID mention "*whether this approach includes or implies a reference to a benchmark and if so, which one*".

Article 18 requires that "*where the 'Objectives and investment policy' section of the key investor information document makes reference to a benchmark, a bar showing the performance of that benchmark shall be included in the chart alongside each bar showing the UCITS' past performance*."

Therefore, when a fund's benchmark is disclosed in the fund's prospectus (according to Morningstar), it should also be disclosed in the 'Objectives and investment policy section' of its KIID, and its 10-year (article 15.1 of the UCITS KIID Regulation) past performance should also be disclosed alongside the one of the fund in this document. A failure to do so, in our view, seems to violate EU Law, and certainly prejudices fund investors.

It is quite worrying that this issue was not disclosed to fund investors and to the public by ESMA following its own "*complementing review of investor disclosure documents*" last year on these same funds, a review which ""*tended to confirm the quantitative analysis results*".

This is a serious issue for investor protection. ESMA's only recommendation to investors when it released its closet indexing study last year was:

"*In order to put investors (both retail and professional) in a position to make an informed investment decision, ESMA suggests that they should make use of all the documentation available to them when selecting a product. When considering an investment in a UCITS equity fund, regardless of the style of fund management, investors may also wish to compare the key elements of the product to those of a number of other products (including some that adopt a different management style). Although past performance is not a reliable guide to future returns,* ***there may also be value in assessing whether a fund has been able to achieve the objectives referred to in the fund documentation****.*"

How can retail investors follow the ESMA recommendation if the fund's benchmark performance is omitted in the KIID? The 2-page KIID was created in 2010 precisely to enable retail investors to access key information on investment funds, the fund prospectuses being too long, too complex, and not written in plain language.

[7] KIID : this is the mandatory, standardized and supervised "Key Investor Information Document" for all UCITS funds

In the past Better Finance has even found a retail fund that does disclose its benchmark's performance in its KIID, but a false one.

Better Finance will ask ESMA for a full investigation into this matter.

To make matters worse, ESMA and the other ESAs are at the same time proposing to eliminate all past performance disclosure in the future "KID" that will replace the current "KIID" for funds, whilst also eliminating all requirements for the disclosure of benchmark performance (past and future). It will therefore be impossible for EU savers to follow ESMA's recommendation, although ESMA publicly acknowledges at the same time that past performance disclosure is indeed useful in the case of retail investors needing to assess whether their fund is really active, and – more generally - whether it has been able to achieve its objectives.

Besides, even in its case against past performance being a "*reliable guide to future returns*" (if only such a thing could exist for equity markets!), ESMA's argument is self-defeating as it intends to replace relative past performance (of products versus their benchmarks) disclosure with "future performance scenarios" that, "*based as they are on historical data, will be heavily impacted by PRIIPs past returns.*"[8] These future "scenarios" will therefore certainly be an even less "reliable guide to future returns", as they will expressly pretend to be exactly that, and nearly always be wrong as well as highly misleading.

3. **Our review also finds that a majority of those funds with the highest potential of being closet indexers according to ESMA seem to underperform their benchmark.**

The performance of those funds relative to their benchmark is difficult to evaluate since:

- Again 34% of those funds fail to disclose their benchmark's performance in their KIID;
- For some funds, the relative performance over the last five years mentioned on the public Morningstar website is different from that of the one in the KIIDs.

Yet, amongst those funds, we found only very few that did not underperform their benchmark over the last five years. Better Finance did not analyze their past performance versus that of low cost index funds such as ETFs using the same benchmarks.

4. **Better Finance requests to improve fund investor protection or, at the very least, to preserve its current level**

- Urgently amend the PRIIPS RTS[9] to avoid a major regression in investor protection in Europe and keep:

[8] Letter from the European Commission to Better Finance of 18/11/2016.

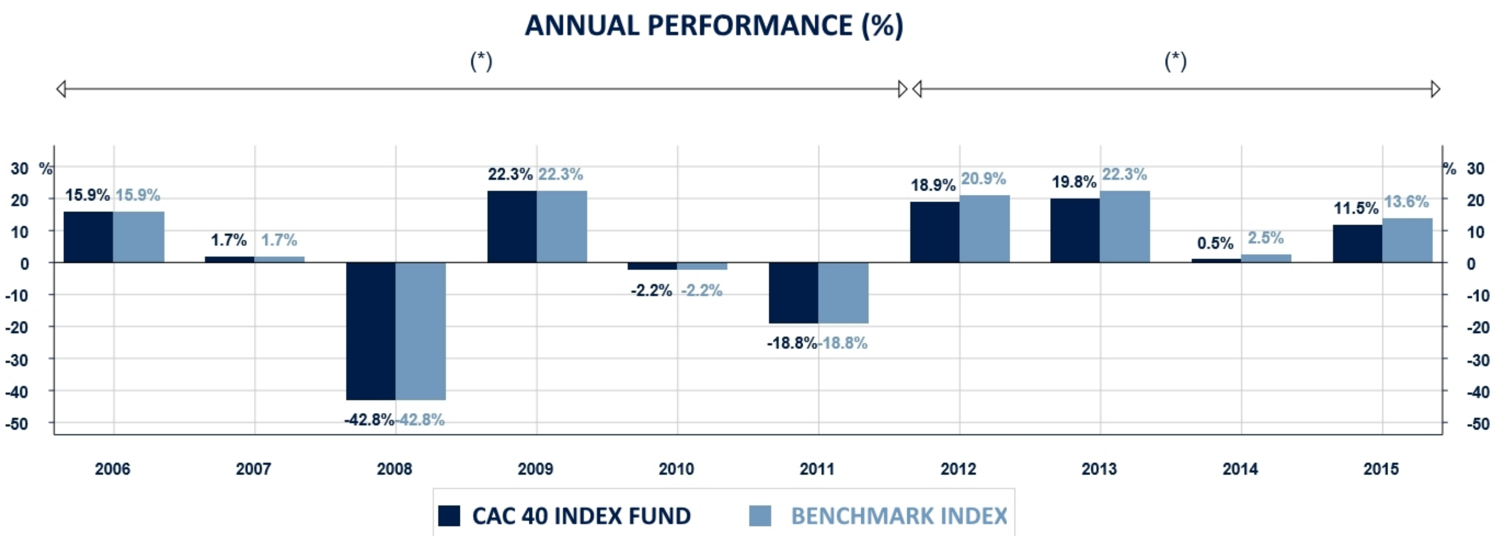
- standardized,
- supervised,
- long-term (at least the 10 year minimum currently required for UCITS funds, although this should be longer for pension investment products)
- and relative to the manager's benchmark past-performance disclosure (net of fees unlike in the current draft RTS for "future performance scenarios").

- In the KIID and in the future "KID", mention the exact name of the benchmark and provide the web address (url) where the retail investor can cross-check the performance data with an independent source. This of course implies that index providers need to be transparent and accessible with regard to the past-performance data of the indices used in retail funds. This is a long-standing request from BF that has remained unanswered so far.
- Make the current KIID compliant with MiFID information rules by replacing annual performance histograms (bar charts) with 10-year cumulative return line charts.

Indeed, OECD surveys confirm that only a minority of EU citizens is able to compute simple compounded returns. Therefore most are unable to figure out - from annual bar charts - whether a fund significantly over or under-performed its benchmark over the last 10 years. In compliance with MiFID, which rightly requires for investment information to be intelligible to readers, fund managers should be required to compute and disclose the cumulative 10-year return lines of their chosen benchmark alongside that of their fund, so that retail investors can really see whether, and to what extent, the fund over or under-performed its benchmark.

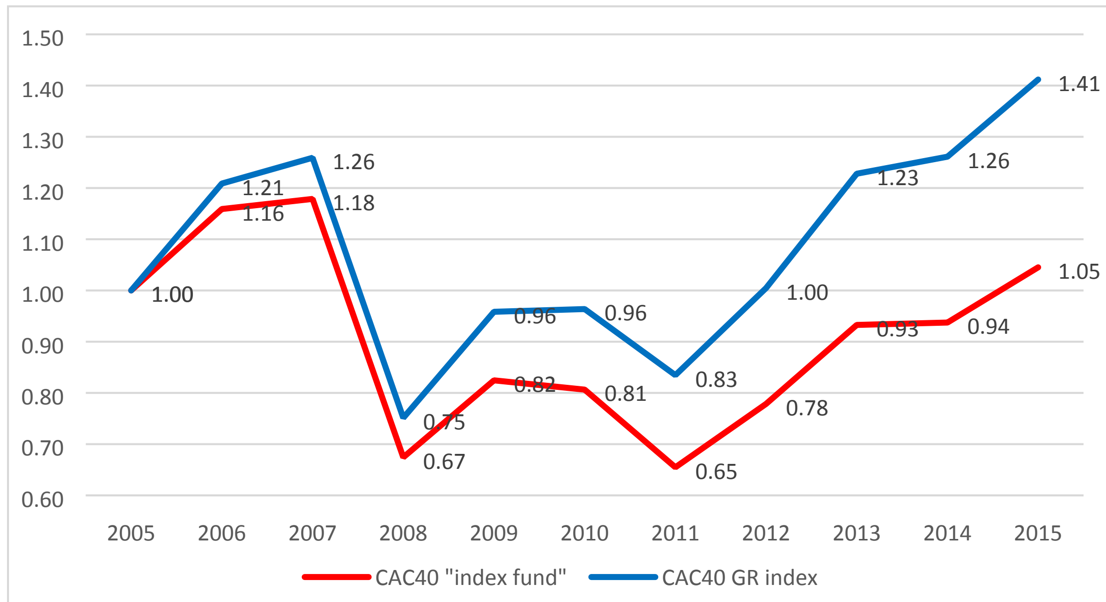
Actual example:

- Current KIID disclosure (annual bar charts):



[9] Regulatory Technical Standards (RTS) for implementing the PRIIPs (Packaged Retail Investment and Insurance-based Products) EU Regulation

- Cumulative relative returns disclosure:



Sources: Fund KIID, Euronext (index)
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It is only through the use of a cumulated line chart that retail investors can actually understand that this fund massively underperformed its benchmark[10] and, in our view, misleads retail investors by claiming it is an index fund, i.e. that it aims to replicate its index performance, which obviously it does not.

- Better enforce the current EU rules for product disclosures (KIID) so that all the funds that do have a benchmark actually disclose it in their KIID, along with relevant, accurate and non-misleading disclosure of the 10-year performance of the benchmark alongside the one of the fund, so that retail investors can see - among other things - whether a fund has been "hugging" its benchmark or not, and whether it has delivered value over a cheaper index fund or not.

[10] This fund had a "price" index reference before 2012 instead of a "gross return" one, in contradiction with the EU guidelines asking to use a "return" index when the fund does not distribute dividends. Besides, the index evolution in the KIID is sometimes not correct. Better Finance has pointed it out several times to the national competent authority. The cumulated line graph uses the right index performances.

Annex 3

Replication of the ESMA study on closet indexing

THE ESMA STUDY: METHODOLOGY AND LIMITATIONS

Following a Better Finance request from October 2014, ESMA started to investigate potentially falsely active equity "UCITS"[11] funds (also called "closet indexers"). On February 2nd 2016, ESMA released some of the long-awaited results of its investigation. Closet indexers are funds that claim to be "actively" managed whereas in reality they merely follow market indices, charging far higher fees than low-cost index-tracking funds such as ETFs do. The promotion and distribution of such funds as "active" is very misleading to the investor and causes detriment because the investor is paying for a service that he or she is not receiving.

1. ESMA METHODOLOGY AND FUND SELECTION CRITERIA

On 2 February 2016, ESMA issued a statement highlighting the issue of closet index tracking funds and describing the analysis it undertook to "*determine whether any indication of closet indexing can be found at an EU-wide level*".

The ESMA analysis was twofold:

- It used quantitative metrics, which indicated that up to 15 % of the UCITS funds ESMA sampled were potentially falsely active,
- and reviewed the investor disclosure documents of the funds concerned, and "found they tended to confirm the quantitative analysis results".

ESMA, however, did not disclose the funds that were uncovered by its investigation as being potentially falsely active, nor did they disclose in which countries they are domiciled, leaving EU investors in the dark. When a request by Better Finance for ESMA to release the results of its investigation and actually disclose the names of the dozens of funds suspected by ESMA of engaging in "closet indexing" was declined, Better Finance took the decision to replicate the ESMA study and release the results.

In this respect the key objective of the study is to replicate to the extent possible the quantitative methodology and the fund selection criteria of the ESMA study.

ESMA explicitly specified that the Morningstar commercial database was used as the data source for their study. Using specific criteria, ESMA then filtered the universe of available funds limiting the study to "*UCITS with a significant size, a proven track record and a management fee in the typical range of funds with an active management style*".

[11] UCITS funds: investment funds that have a European distribution passport, by complying with the EU UCITS funds Directives.

Having applied these filtered criteria to the Morningstar database, ESMA was left with a sample size of over 2600 funds. It then removed those funds for which it could not retrieve the necessary data (Active Share ("AS"), Tracking Error ("TE") and R-Squared) during the period 2010-2014[12] inclusive, which led to a final sub-sample of 1251 funds to be analysed.

In order to replicate the ESMA study as closely as possible, Better Finance also used the Morningstar database and filtered the full universe of funds using the same criteria as ESMA, both explicit and implicit. The following criteria were therefore used to filter the Morningstar database to produce this study:

Explicit Criteria from the ESMA statement:

- UCITs only
- Equity funds only
- Only funds domiciled in EU Member States
- Not categorised as index-tracking
- With inception date prior to 1 January 2005

Implicit ESMA study criteria:

- Surviving funds only
- Oldest share class only
- Fund size > 50 million
- Management fee starting > 0.65%

In order to faithfully present the findings of the study, the same criteria and time period were used as those by ESMA. Better Finance also disclosed the funds that ESMA excluded from its analysis because it could not retrieve the necessary data.

Active Share represents the proportion of portfolio holdings that differ from those in the benchmark index. **Tracking error** is a measure of the volatility of excess returns relative to a benchmark and **R-Squared** reflects the percentage of a portfolio's movements that can be explained by movements in its benchmark.

The relevant period of time in which the analysis took place was between 1st January 2010 to 31st December 2014 (again, this is the period chosen by ESMA). Over this 5-year period, TE and AS figures were calculated based on one-year intervals. The funds were then split into the different categories mentioned below, depending on whether they met the AS, TE and R-squared thresholds for at least three of the five years used in the analysis.

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[12] The ESMA Statement mentioned the period 2012 – 2014, but following exchanges with ESMA it was confirmed that the data was out of 5 years.

In line with the ESMA methodology, the analysis for this report was conducted against each fund's Primary Prospectus Benchmark (source: Morningstar). The Active Share figures for each year were calculated using the end of year portfolio holdings compared against the primary prospectus benchmark of the fund. For the TE and R-squared figures, data on monthly total returns was used, compared against the primary prospectus benchmark of the fund. The TE statistics have been annualised to make it comparable to the ESMA figures.

This report therefore separates the results into four different categories; the last two being the same as ESMA's:

- Equity funds that do not report a benchmark
- Equity funds that do report a benchmark but do not provide Morningstar with the necessary data to compute AS, TE and R2

These first two categories were not included in ESMA's analysis.

- Potential actively managed equity funds (within the list of those which do report a benchmark and for which Morningstar has sufficient data)
- Potential equity closet indexing funds (ESMA's "classification 1": Active share < 60% + tracking error < 4%).

Using the same sampling criteria as ESMA, the number of funds is nevertheless lower for this replication study. This is most probably due to the evolution of the Morningstar database in the meantime (between 2015 and end of 2016, some funds may have closed, merged, or no longer meet the sampling criteria). Therefore, some funds that may feature in the Better Finance sample may not appear in the ESMA sample and vice versa.

2. LIMITATIONS

The results disclosed by ESMA confirmed that investor detriment is potentially severe since ESMA found that up to 188 funds, i.e. 15 % of the UCITS funds it analysed, could potentially be falsely active based on quantitative measures available.

A complementing review by ESMA of investor disclosure documents "*tended to confirm the quantitative analysis results*".

This already alarming number would probably have been even higher if ESMA had:

- not excluded more than half of the active equity UCITS funds it sampled (1,349 out of a total of 2,600; this was due to the lack of necessary data in the Morningstar fund database);

- included also the equity funds that are widely sold to retail investors in major markets like France or Germany, i.e. "AIF"[13] funds, not only the Pan-European "UCITs" ones.

ESMA - unlike the Norwegian regulator – refused to disclose the funds that were uncovered by its investigation as potentially falsely active, nor did it disclose in which countries they are domiciled, leaving EU investors in the dark. Moreover, despite having already taken more than a year to perform a quantitative and qualitative investigation, ESMA then left it up to the National Competent Authorities to deal with this huge case of potentially wronged investors. A year later, none of them[14] have so far publicly identified any falsely active fund, either from the list of up to 188 UCITS funds identified by ESMA, or elsewhere.

However, investors holding those funds have waited long enough and can certainly not wait any longer for any hypothetical action, with no timeline to rely on, from unidentified national regulators and unidentified fund managers.

[13] AIFs: « alternative Investment funds ». Despite their name, these funds are mostly ordinary funds that are widely sold to individuals, but that did not apply for a European distribution "passport".

[14] The Swedish regulator very recently disclosed more than a dozen funds with an active share below 60%, but stopped short of disclosing whether those funds were indeed potential closet indexers or not.