The Association of Investment Companies

Burn before reading

Understanding and addressing the dangers of Key Information Documents

September 2018

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The Association of Investment Companies (AIC) represents 350 companies with assets under management of over £165 billion.

Investment companies offer their shareholders access to a diversified portfolio and the benefits of expert fund management. Assets held include listed and unlisted shares, debt, property, infrastructure and venture capital investments.

The shares issued by investment companies are admitted to trading on the stock market. Purchasers of the shares of investment companies include retail investors, wealth managers and institutional investors.

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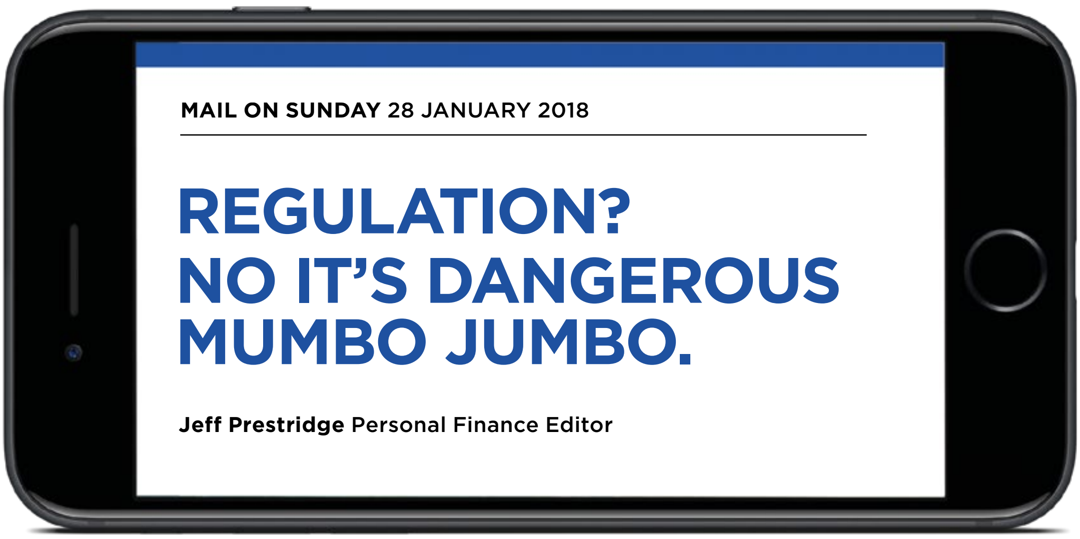


MAIL ON SUNDAY 28 JANUARY 2018
REGULATION? NO IT'S DANGEROUS MUMBO JUMBO.
Jeff Prestridge Personal Finance Editor

Burn before reading

Consumer champions, financial advisers, the media and product manufacturers have all criticised Key Information Documents (KIDs) as potentially harmful to ordinary investors. John Kay, a leading investment company director, summed up the feelings of many when, in the pages of the Financial Times, he urged:

> "Please do not Google or download this document. And if you have received a hard copy, burn it before reading."

The reason for this chorus of concern is straightforward. KIDs mislead consumers about the products they are intended to describe. In the worst cases they seriously understate the risks while giving a far too optimistic view of potential future performance. This is a toxic mix which could lead investors to make disastrous decisions which seriously harm their finances.

The principal reason KIDs are so dangerous is that they include information about the future derived from past performance.

The KID methodology tramples over a long-standing warning to the ordinary investor that the past is no guide to the future. This warning has been a central part of consumer financial education for as long as I can remember. It is astonishing that the policymakers who set the KID rules have chosen to ignore this basic lesson.

It is also striking that the only parties who have not lent their voices to an unambiguous call for reform of the KID rules are the regulators themselves.

KIDs have now been given to consumers for longer than six months. Their serious flaws are evident but regulators have not yet been persuaded that they need to act.

This report highlights the serious risks of consumers placing any reliance on KIDs. It urges regulators in the UK and Europe to recognise these problems and to take swift action.

In advance of action by the EU, national regulators should limit the use of KIDs in the broader sales process.

The EU should suspend requirements to prepare these documents and change the rules to fix the problems arising.

This is the only way to ensure that consumers will not be misled into buying products that do not meet their needs.

Investment companies are fantastic products, but they are not for everybody. If you are one of those individuals for whom investment companies are unsuitable, you should not be led to believe otherwise.

I have been told that KIDs will be the next mis-selling scandal. This is not true. It implies that the person doing the selling is at fault. KIDs are a regulatory scandal. Every day that regulators fail to act in the face of overwhelming evidence that KIDs harm investors should be the cause of universal condemnation.

If steps are not taken, and ordinary consumers are harmed as a result, the blame will be laid at the feet of regulators in the UK and Europe. And rightly so.

Ian Sayers
Chief Executive
Association of Investment Companies

SHARES 11 JANUARY 2018

"INTRODUCED ON 1 JANUARY 2018, THE KID HAS ACTUALLY LEFT EXPERTS WONDERING IF IT WILL DO MORE HARM THAN GOOD."

1. Key findings

Misleading disclosure of risk
Investment companies are excellent investment choices for many retail investors. However, they have characteristics which make them riskier than equivalent funds. Nonetheless, KID risk indicators for investment companies consistently show investment companies as lower risk than equivalent funds.

Venture Capital Trusts (VCTs) are identified as 'high-risk' by the Money Advice Service (which has statutory objectives to educate consumers). Worryingly, KIDs indicate that VCTs are the lowest risk of all investment company sectors.

KIDs also mislead consumers because of how the risk indicator is described. Investment companies with a risk indicator of 3 (out of 7) are described as "*unlikely*" to lose money. Investment company shares should not be described in these terms.

Misleading disclosure of performance
KIDs use past performance to provide consumers with scenarios that purport to tell the consumer "what you might get back after costs".

11% of investment company KIDs include a moderate performance scenario indicating year-on-year growth of 20% or more for each year of the holding period.

This is a dangerous message which does not recognise that recent performance has been very strong since the historic lows experienced during the financial crisis. The actual outcome is likely to be far less positive.

If KID performance scenarios were used in marketing material, or financial promotions, the Financial Conduct Authority (FCA) would no doubt raise serious questions. If the practice persisted it would probably take regulatory action. Yet these disclosures are required under the KID rules.

Making a bad situation worse
Using the risk indicator in combination with the performance scenarios creates more danger.

129 investment companies have KID risk indicators of 3. 15% of these show unfavourable performance scenarios which suggest the investor could get an annual return of 10% to 20% over five years. It is very misleading to tell consumers they might get very strong returns in bad markets.

Investment company risks are consistently understated. VCTs, a high-risk investment, are shown as the lowest-risk investment company sector.

Misleading in all market conditions
Had KIDs been prepared in the past, they would have been seriously misleading.

Using real data from investment products available at the time shows that KIDs prepared just before the 2008-9 financial crisis would have given a far too optimistic view of likely performance over the next five years. KIDs prepared after the crisis would have been misleadingly pessimistic.

Comparing the KID moderate scenario with actual returns after five years shows the presentation of performance is consistently misleading. Modelling one investment company's moderate performance scenario shows the indicated return would have been the opposite of the actual outcome 11 times out of 22. That is to say, half of the time, the KID would have indicated a loss when the true return was positive or the KID would have shown a positive return when the investor would have made a loss.

Confusion on costs
The KID methodology includes 'transaction costs'.

10% of investment companies with equity portfolios have KIDs showing transaction costs of nothing or which are negative (that is 'less than' zero costs).

This implies that the process of making investments is either without any cost at all or, in some way, the opposite of a 'cost'. This is nonsense.

Performance indicators of current KIDs are misleadingly optimistic. Had the KID been required in the past, performance scenarios would have been consistently and substantially different from actual investment returns.

2. Background

All retail investors will receive flawed KIDs from 2020.

Consumers wanting to buy an investment product are given either a Key Information Document (KID) or a Key Investor Information Document (KIID). Which document they receive depends on the type of product.

If an investor wants to buy a UCITS fund (investments defined by EU rules and referred to throughout this paper as 'funds') they receive a KIID. KIIDs have been used since 2011.

All other retail collective investments, which are known collectively as PRIIPs, are accompanied by the new-style KID.

The contents of the KID and KIID are defined by separate pieces of regulation. These rules mean each disclosure is superficially very similar. Each must describe certain product features (sometimes with required wording) and must include a summary of the level of risk, describe performance and provide an indication of charges.

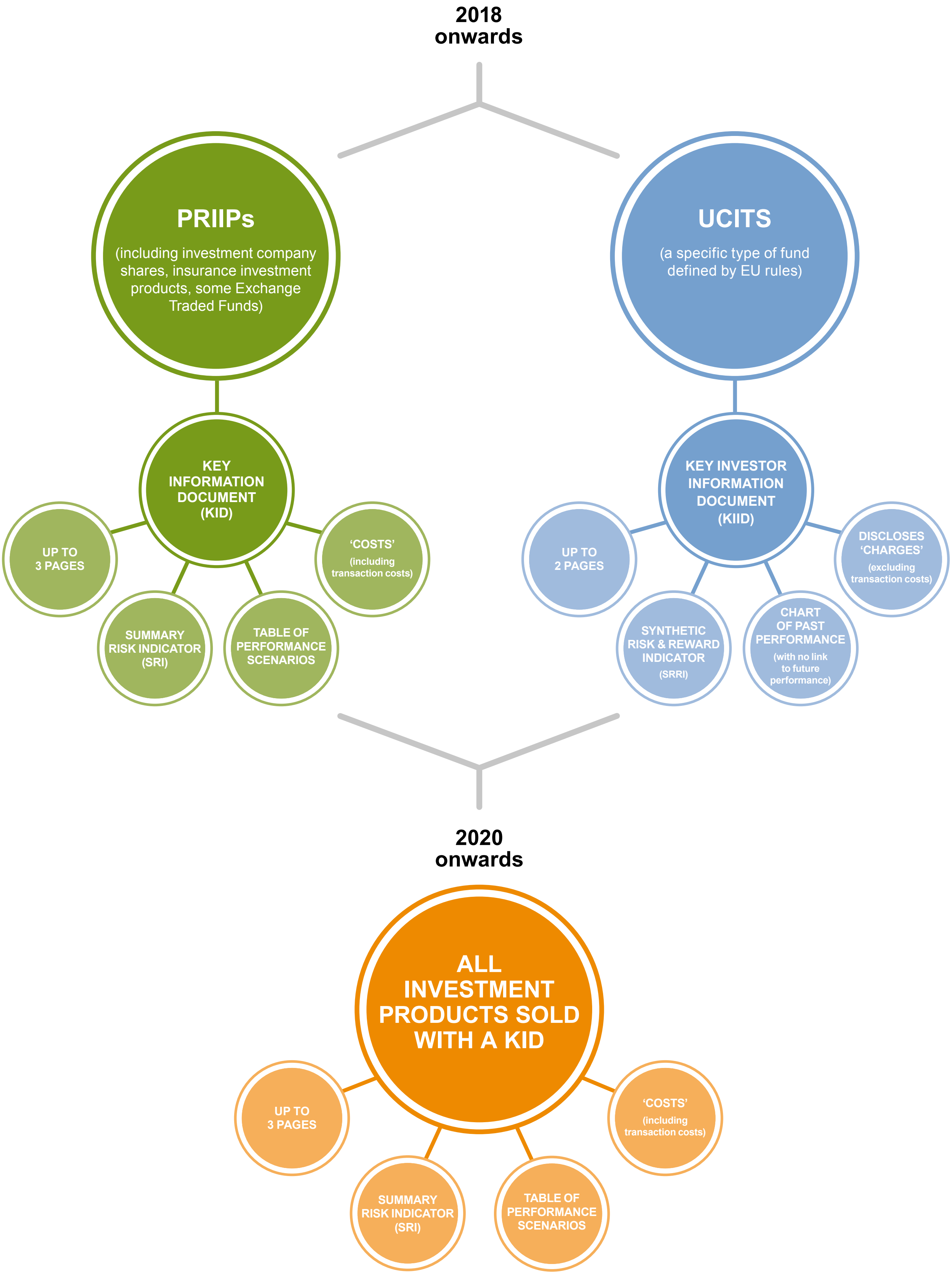
KIDs are seriously flawed. They incorrectly describe risks and likely performance. The statement of costs can also be confusing.

KIDs mislead consumers about the nature of products and how they might perform. They fail in their primary purpose of informing investors.

A further problem is that products described by a KID are likely to be compared with funds described by a KIID.

These documents look comparable so a consumer might naturally assume they are being given information on a like-for-like basis. They are not. Using KIDs and KIIDs to compare products is therefore highly misleading.

From January 2020 both PRIIPs and UCITS will be accompanied by a KID. Unfortunately, this will mean all retail investments will be sold alongside misleading information.


2018
onwards
PRIIPs
(including investment company shares, insurance investment products, some Exchange Traded Funds)
KEY INFORMATION DOCUMENT (KID)
UP TO 3 PAGES
SUMMARY RISK INDICATOR (SRI)
TABLE OF PERFORMANCE SCENARIOS
'COSTS' (including transaction costs)
UCITS
(a specific type of fund defined by EU rules)
KEY INVESTOR INFORMATION DOCUMENT (KIID)
UP TO 2 PAGES
SYNTHETIC RISK & REWARD INDICATOR (SRRI)
CHART OF PAST PERFORMANCE (with no link to future performance)
DISCLOSES 'CHARGES' (excluding transaction costs)
2020
onwards
ALL INVESTMENT PRODUCTS SOLD WITH A KID
UP TO 3 PAGES
SUMMARY RISK INDICATOR (SRI)
TABLE OF PERFORMANCE SCENARIOS
'COSTS' (including transaction costs)

3. Recognise the problem

As a matter of urgency policymakers and regulators in the UK and Europe must recognise the problems created by KIDs.

Summary risk disclosures

Risk disclosure is a major component of the KID. After a short description of the product, the KID poses the question *"What are the risks and what could I get in return?"*. It then shows a risk indicator (the Summary Risk Indicator, or SRI) marked on a scale of 1 to 7. Preparers follow a mandated formula to calculate the level of risk a product would represent were it to be held for a recommended period, say, five years.

According to the required text, a KID risk indicator of 5 is an investment with medium-high risk. A risk indicator of 4 is medium risk. A 3 shows an investment with a medium-low risk.

This SRI is the most striking element on the front page of the KID. Any consumer reviewing a KID is likely to register this number. Indeed, the KID format was consumer tested by the European Commission before the design was fixed. The intention is for the risk indicator to be as prominent as possible, including for those with lower levels of financial literacy.

KID risk indicators for investment companies significantly understate the risks.

Unfortunately, the methodology used to determine the SRI is fundamentally flawed, especially when it is compared with the risk indicator used in the funds KIID.

Understating the risk of equity investments

Investment companies have characteristics similar to other types of funds. Investment companies and funds (such as unit trusts) are traditionally seen as medium or perhaps higher-risk, depending on their investment approach.

This perspective is reflected in the view of the Money Advice Service (MAS). The MAS is a UK government-funded independent body with statutory obligations to enhance public understanding of financial matters. The MAS's 'Top tips for choosing investments' advise that *"A good rule of thumb is to start with low-risk investments such as Cash ISAs. Then, add medium-risk investments like unit trusts if you're happy to accept higher volatility. Only consider higher-risk investments once you've built up low and medium-risk investments".*

This suggests that, on a scale of 1 to 7, funds are likely to be a 4 or 5 on the risk indicator.

This is broadly how funds such as unit trusts are presented by the risk indicator in their KIIDs.

Our analysis shows that the average risk indicator for equity funds is 5.1. On a 1 to 7 scale, this number represents a sensible signal to send to ordinary investors about the level of risk.

Investment companies are typically slightly riskier than other, otherwise similar, retail funds. This is because their shares are quoted on a stock market. The price of the shares differs from the value of the underlying assets. This is a source of additional risk.

The average risk indicator shown in a KID for investment companies with equity portfolios is 4. This is one step down the risk scale from funds holding the same type of assets. This does not correctly summarise the relative risk of these products. Suggesting investment companies are lower risk than funds is the wrong impression to give investors.

90% of funds have a risk indicator of 5 or above compared to only 18% of all investment companies with equity portfolios. An ordinary investor comparing products using these two differently calculated risk indicators will be misled.

Higher-risk investment companies have risk ratings of 5 or above in only 18% of cases. Their average risk rating is 4.

90% of funds are rated 5 or above. Their average risk rating is 5.1.

Investment companies are suitable for many retail investors. Their suitability will depend on an investor's investment objectives, appetite for risk and broader portfolio. However, investment companies may not be right for everyone. The industry's priority is that those who do buy investment company shares are aware of the risks and that they have decided to make a purchase based on reliable information. The KID undermines this.

What are these risk warnings?

The risk indicators shown on page 15 are for sister funds. That is, an investment company and fund with very similar investment objectives and underlying assets, and the same asset manager. In reality, the investment company will, when all factors are considered, be higher risk than its fund sister.

A consumer comparing these two risk indicators will be given the opposite impression to the reality. The lower-risk fund is shown as a 7. The higher-risk investment company is shown as a 5. Both are retail investment products currently being sold alongside these risk indicators. An investor using the risk indicator to help choose between these investments is being given a false impression of risk.

This is self-evidently a major regulatory failure.

The KID SRI is harmful to investors because it is not what it says it is. Critically, it is not a summary of all the risks. Instead it is a measure of past volatility.

The KID says that it shows the risk of the product *"compared to other products"*. This is untrue. Where KIDs are being compared, it would only enable a reader to compare their historic volatility. KID SRIs do not allow a comparison of all the risks, which are set out in the small print below the indicator and are not quantified.

Even if a consumer understood that the numbers presented in the SRI and SRII told them different things, they could not draw a useful conclusion about the relative risks of each product. Yet they are being encouraged to do so by a presentation which is virtually identical.

Risk indicators appear to provide the basis for a fair comparison. Actually, the numbers are based on different calculations and show different things. The lower-risk fund is shown as a 7. The higher-risk investment company is shown as a 5. The problem arises for nearly all sister funds.

Systematically misleading risk disclosures

Of 56 sisters compared, no investment company had a higher-risk indicator than its equivalent fund.

Just 3 investment companies have the same risk indicator as the sister fund.

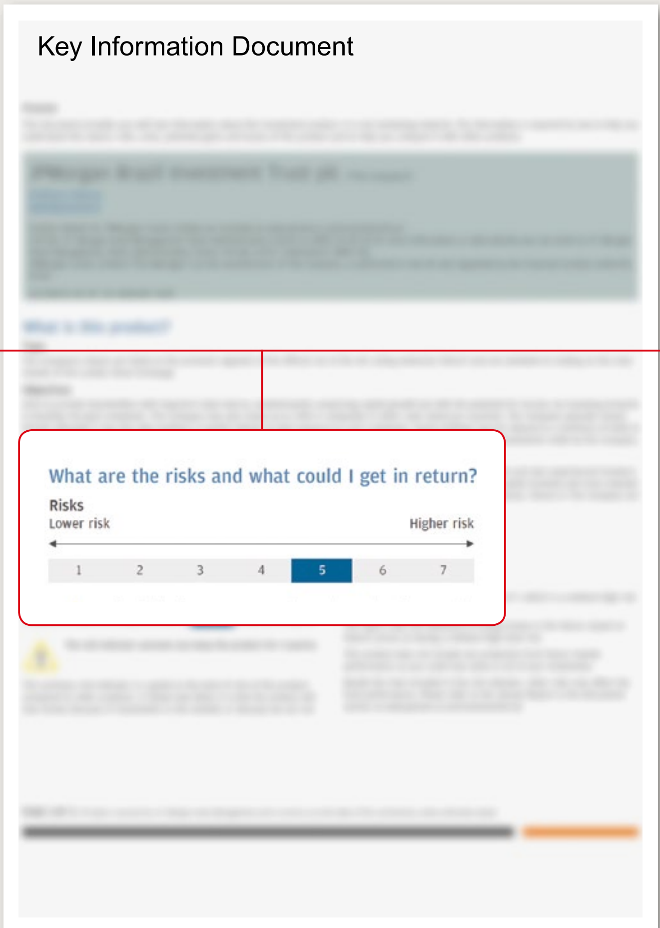
40 investment companies have a risk indicator one point lower than the sister fund.

13 investment companies have a risk indicator two points lower than the sister fund.

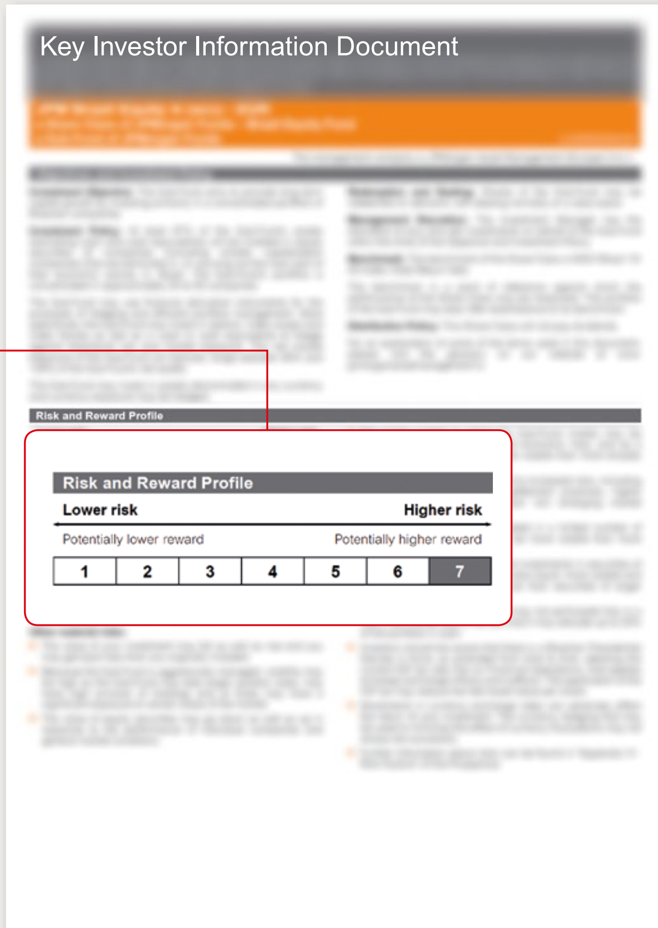
These indicators consistently show funds as higher risk than the equivalent investment company. This is misleading.

Comparing the risk indicators for sister funds gives the investor a misleading indication of the relative risks of these investments.

Investment Company



Fund



Other asset classes
The risk indicators are also misleading for property investments.

Funds holding property show an average risk indicator of 5.1.

The equivalent investment company sector has an average risk indicator of just 3.8.

86% of funds holding property have a risk indicator of 5 or above. In contrast, only 11% of equivalent investment companies are shown as 5 or above.

Nearly 14% of property funds have a risk indicator of 7 – the highest level of risk. No investment companies with property portfolios are ranked at that level.

Despite having characteristics likely to make them riskier, investment companies holding property are consistently shown as lower risk than the equivalent property funds. These risk indicators are misleading.

Compounding the error
9 investment companies have a risk indicator of 2. The KID rules define products with a risk indicator of 2 as "*low*" risk investments which *"are very unlikely"* to lose money. This is wrong.

Investment companies are stock market traded investments that have the potential to lose money.

The danger that an investor would be misled by these disclosures is compounded by the descriptions that preparers must use to explain these figures.

No investor should be encouraged to believe this is the level of risk represented by these products.

Similar concerns arise where the risk indicator shows a 3. 129 investment companies have a risk indicator of 3. These products are identified as "*medium-low*" risk and "*unlikely*" to lose money. Again, this is incorrect. Investors are being told that their chances of losing money are lower than is the case.

This is unacceptable. It is a clear danger to consumers.

Highest-risk products shown as lowest-risk

Venture Capital Trusts (VCTs) are higher-risk investments. This is because they invest in smaller, unquoted companies without a lengthy track record.

Like other investment companies, VCTs can be a good investment for many retail investors. However, before buying shares purchasers should understand the risks. KIDs do not help this process. They make the true level of risk less clear.

The nature of VCTs makes it reasonable to assume the risk indicator for a VCT would be at least 5 or 6, in other words, among the highest-risk investments available.

70% of all VCT KIDs show a risk indicator of 3. The KID rules identify a product with a risk indicator of 3 as *"medium-low"* risk. This is highly misleading for the unwary consumer.

The VCT average risk indicator is 3.4.

Despite the risks inherent in VCTs, overall this sector has the lowest average risk indicator of all investment company sectors.

These risk indicators, and mandated explanations, significantly understate the risks of VCTs and would mislead any investor relying on them.

70%

of all VCT KIDs show a risk indicator of 3. The KID rules identify a product ranked at 3 as "medium-low" risk. This is highly misleading for the consumer.

How performance is presented

Consumers are told that the past performance of an investment is no guide to the future. As the MAS puts it *"Past performance may not provide an accurate picture of future performance of your investments, as future projections are in no way guaranteed"* ("Assessing the performance of your savings and investments" MAS website).

How a product has performed in the past does provide some useful context but retail investors should not be encouraged to put too much weight on this information when making investment decisions.

Unfortunately, the KID takes a very different approach. It includes a table of future performance scenarios based on what has happened in the past.

This table includes a so-called unfavourable performance scenario calculated by looking back at the previous changes in value of the investment. The table also shows favourable and moderate scenarios. These also have past performance data hardwired into the way they are calculated.

A stress scenario is also included. This is intended to illustrate what an investor might receive in extremely unfavourable market conditions.

The table of scenarios is presented as an annualised percentage return and as a 'pounds and pence' figure (assuming a certain amount was invested). These figures are accompanied by a note saying that these amounts are *"What you might get back after costs".*

This table gives consumers an expectation of what they might receive in different market circumstances.

This is a very long way from the convention that the past should not be considered a guide to the future.

51%

of investment company KIDs indicate annual returns between 0% and 10% in unfavourable markets.

Overstating future returns
The recent strong performance of markets since the lows experienced in 2008-9 makes the scenarios set out in KIDs completely misleading. They are, all too often, far too optimistic.

11% of investment company KIDs indicate that, in a moderate performance scenario, an investor could receive future returns of over 20% for each year over the recommended holding period.

Such strong returns are, of course, possible. Investment companies have structural advantages that allow them to generate superior returns over the longer term. They have also performed very strongly in the favourable market conditions seen in recent years.

However, returns of this magnitude are not moderate – a term investors could well equate with ‘average’. These are very favourable returns reflecting performance in recent market conditions. The KID methodology does not recognise that recent performance has been significantly influenced by the market recovery since the financial crisis.

Even more concerning are the unfavourable scenarios.

51% of investment company KIDs tell investors that they could get an annualised return of between 0% and 10% in unfavourable market conditions over the recommended holding period.

11% of investment company KIDs indicate that in unfavourable market conditions, an investor might receive between 10% and 20% annually over the recommended holding period.

One investment company KID states that, in unfavourable market conditions, investors *“might get back”* 25.8% year on year over the recommended holding period.

Any consumer using these projections to inform their investment decisions will be seriously misled. The European Commission’s own market testing was designed to ensure that these disclosures are accessible to all purchasers, including those with low financial literacy. The risk of such consumers being misled is particularly worrying.

11%

of investment company KIDs indicate annual returns over the recommended holding period of between 10% and 20% in unfavourable markets.

Are KID scenarios suitable for pensions?

The KID's approach to possible future performance contrasts starkly with more responsible approaches adopted in other areas.

The UK Financial Conduct Authority (FCA) identifies maximum rates of investment return to be used in consumer projections for pensions. Quite rightly, its aim is *"to prevent consumers being misled by inappropriately high rates"* ("Rates of return for FCA prescribed projections" Financial Conduct Authority, September 2017, page 5).

The FCA approach considers different asset classes. Its 2017 report establishes a central estimate for nominal equity returns in the range of 5.5% to 7.5% per annum. This is an authoritative, realistic and pragmatic level of return on which to base performance projections.

In contrast, KIDs identify possible future equity returns which could give consumers very unrealistic expectations. The KID includes a moderate performance scenario which ordinary consumers are likely to consider a 'central' case projection.

Using the KID methodology, in moderate market conditions 45% of investment companies with equity holdings indicate annual returns of between 10% and 20% if held for the recommended holding period (normally five years).

15% of such companies with equity portfolios indicate annual investment returns of 20% to 30% if held for the recommended holding period, in moderate markets.

Including a moderate performance scenario which is two, three or even four times higher than the FCA's central projected level of return exemplifies how misleading the KID approach is.

The problem is even worse for some unfavourable scenarios.

13% of investment companies with equity portfolios indicate that, in unfavourable circumstances, investors might receive a return of between 10% and 20%. Any consumer placing reliance on such scenarios is at risk of making very poor investment decisions.

We anticipate that the FCA, and other European regulators, would not allow performance projections for pensions to give these messages to consumers. If this is the case, then why is this information suitable for those purchasing investment products?

KIDs of investment companies with equity holdings indicate that, in moderate markets, 61% of such companies might return over 10%. Of these, 15% indicate returns of 20% – 30%.

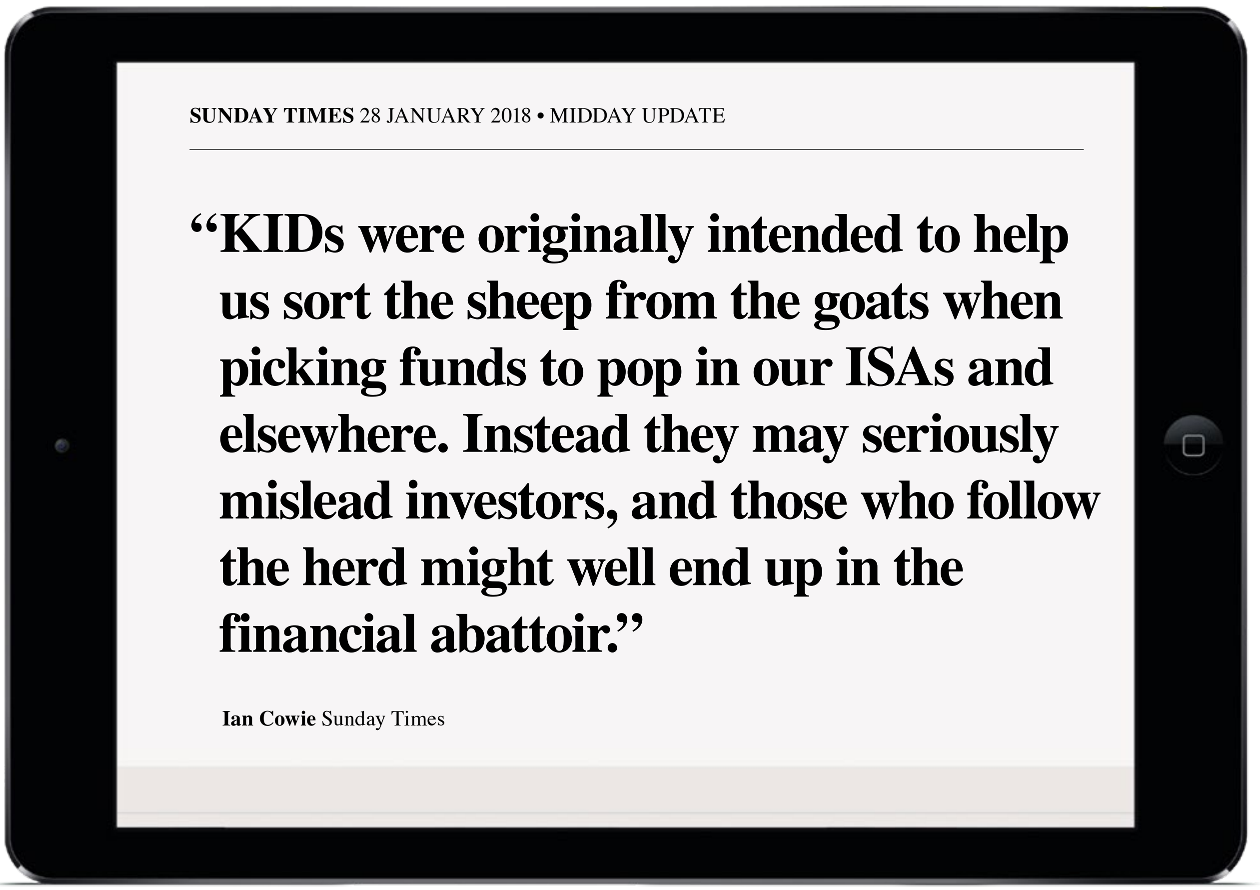
Other problems
There are examples of investment company KIDs which show the unfavourable scenario as performing worse than the stress scenario.

There are also instances of KIDs showing negative returns in every scenario.

While these perverse results are uncommon, they further illustrate the flaw in mandating an inflexible methodology, with no discretion allowed to prevent misleading or confusing information being provided to consumers.

Different problems will arise from the KID methodology when the market enters a different part of the cycle and, potentially, sees a downturn. Consumers will be given an unduly pessimistic impression of possible returns. They may be dissuaded from investment when markets have recently fallen and the potential for better returns may be enhanced.

KID performance indicators would not be allowed for pensions, so why allow them for other investments?



Misleading in all market conditions and for all products

The problems with published KIDs are not an aberration. They would have arisen in the past and can be expected in the future. They will be misleading for all types of investment products, including funds.

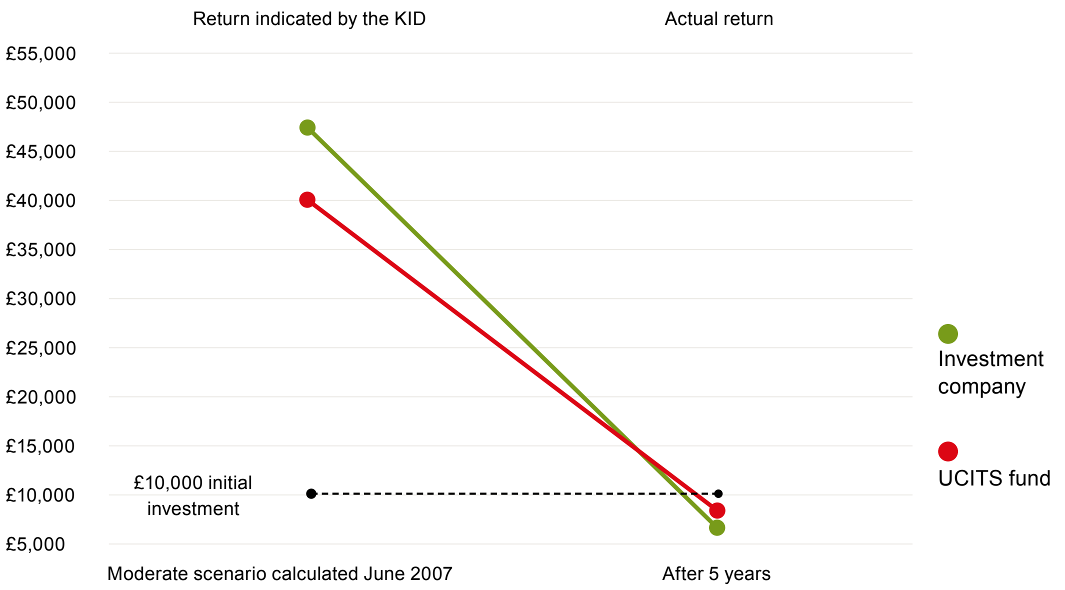
The illustrations below show that, had performance scenarios been prepared in the past, then they would have seriously misled any investor which gave them credence. The illustrations of *'what an investor might expect to get back after costs'* would have been very far from what actually happened.

The chart below shows the return that a KID prepared in June 2007 would have indicated for two investment products. Those chosen are sister funds, one an investment company, the other a UCITS fund.

According to the KID, the moderate scenario shows both returning over £40,000 after five years (including the £10,000 originally invested). This would have been an enticing prospect for an investor. In reality, the outcome was very different. For both products, the investor would have lost money after five years.

This arises because the moderate scenario was modelled on strong market performance in the run-up to when the KID was prepared. The actual investment period included the financial crisis of 2008-9. An investor using the moderate scenario to inform their investment decision would have been seriously misled.

Optimistic performance indicated by KID compared with actual return



Source: Financial Express

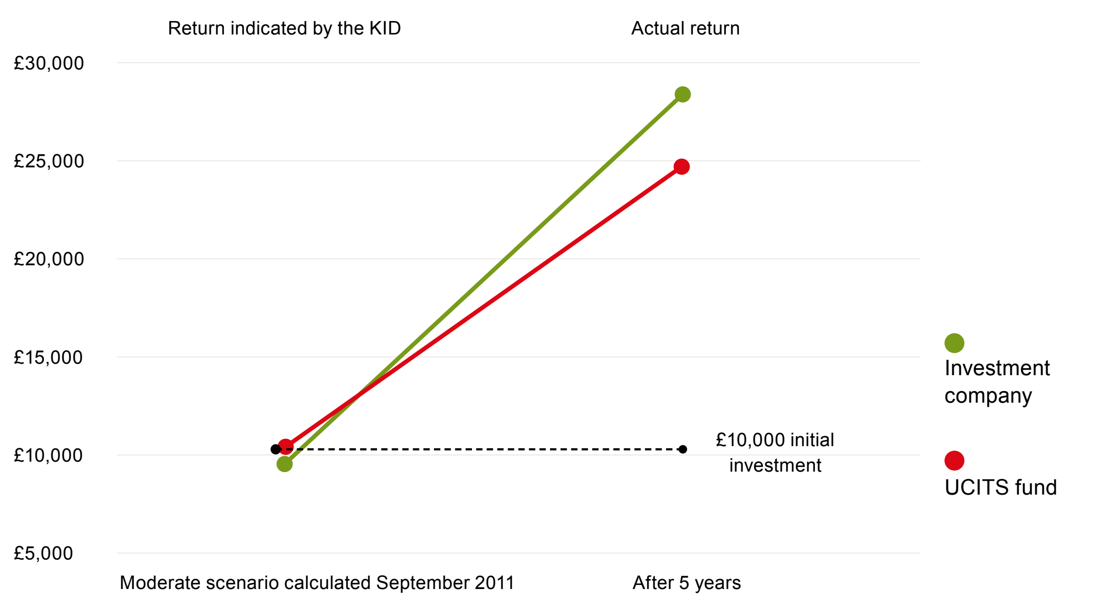
The consumer will be presented with similarly misleading information in situations where a KID has been prepared after a period of less positive market performance.

The chart below shows two real investment opportunities, one an investment company, the other a sister UCITS fund. A retail investor presented with KIDs prepared for these two products in September 2011, would have been led to believe that, in moderate market conditions, after five years they were likely to have either lost a little money or made a negligible return.

Had this been true, the consumer might well have decided not to invest. They could have deferred investing for their retirement, for example, thinking that it would be better to leave their money in cash. Placing any reliance on the KID would have been a mistake because actual returns, in both products analysed, would have allowed them to double their money – and more.

It is not right for KIDs to provide such misleading information. Performance scenarios are specifically labelled as giving an indication of what an investor might expect to receive. The moderate scenario will be seen by many as a 'central' or 'average' case for the likely return. The evidence shows that it is not merely unhelpful. It is actively misleading.

Pessimistic performance indicated by KID compared with actual return



Source: Financial Express

Consistently and significantly wrong

The fundamental flaws in the KID performance scenarios are illustrated when the scenario return is compared with the actual return over time.

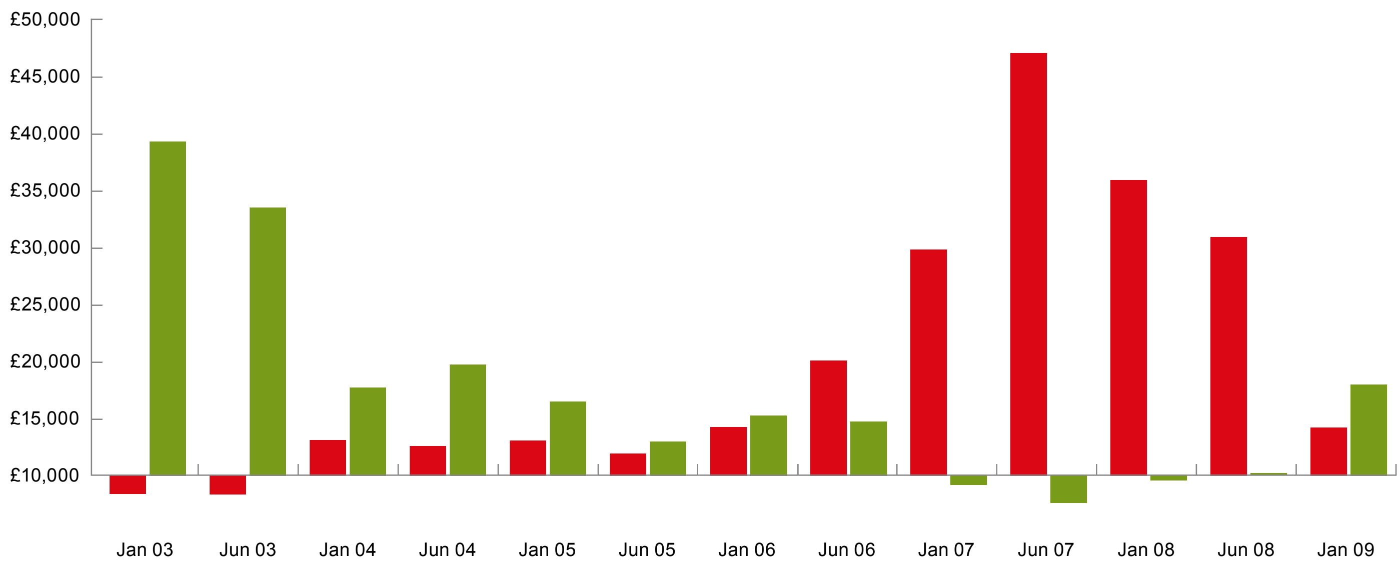
The chart below shows 22 examples of the moderate investment scenario calculated at six-month intervals for an investment company. Alongside each of these scenarios it shows what an investor would have actually received five years later.

On 11 occasions the KID would have indicated a return that was the opposite of the real outcome. That is, it would have shown a loss when the investor would have made a positive return. Alternatively, the KID moderate scenario would have shown a positive return when the investor would have lost money after five years.

Some of these outcomes are hugely different. In June 2007, the KID indicated that, in moderate markets, the investor could have sold their stake and walked away with over £47,000. In reality, they would have lost just over £2,000.

The extent of inaccurate returns indicated often amount to tens of thousands of pounds.

KID moderate scenario vs actual return over time



Source: Financial Express

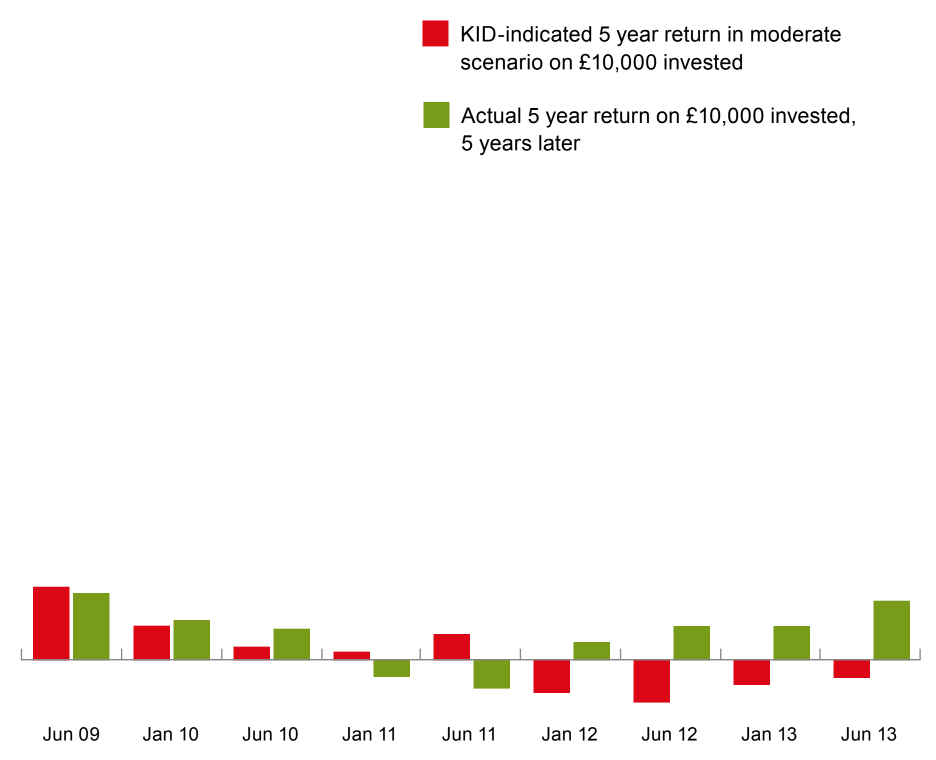
Where the error is the opposite way, the figures are almost as substantial. In January 2003, the KID moderate scenario indicated a loss of just over £1,600. Had they invested, consumers would have received nearly £40,000, including their original investment.

Even when the KID moderate scenario return is in the same direction as the actual outcome, the disparities are often significant. The fact that, in some cases, the KID moderate scenario is not too far off the actual return is no defence. Even a stopped clock is correct twice a day.

The KID performance scenarios are consistently misleading, often substantially, in all market conditions. Given the frequency and length of bull and bear market cycles, these failings are built into the KID approach and will continue in all market conditions indefinitely.

These are not minor discrepancies. They are huge failings.

These are not minor discrepancies. They are huge failings.



Making a bad situation worse

Consumers are most likely to be misled where they use the different elements of the KID in combination to inform an investment decision.

Risk-averse investors might use the risk indicator to filter out investments. So, they might decide to invest only in an investment company with an indicator of 3. After all, the KID describes these as "medium-low" risk. As discussed elsewhere in this paper, this investor is already considering options likely to represent a higher-risk than they are being led to believe.

33% of investment companies have a risk indicator of 3.

Although these hypothetical investors are cautious about risk, they also want the best possible return. They might use the KID performance scenarios to help choose an investment.

In the unfavourable scenario, 15% of investment companies with risk indicators of 3 suggest they could generate an annual return of 10% to 20% over the recommended holding period (customarily five years).

36 investment companies with risk indicators of 3 offer equity exposure. 22% of these companies show that, in unfavourable market conditions, they might receive an annualised return of 10% to 20%.

These disclosures are too optimistic and misleading.

No reputable adviser would encourage an investor to rely on these risk indicators or performance scenarios. They would, rightly, take a more cautious view.

The KIDs analysed above are suggesting that certain investment companies are lower-risk products that can give very strong performance, even in poor market conditions. This is wrong. Were a firm to issue a financial promotion making claims of this nature there is no doubt that it would face serious questions from the FCA. Potentially, the regulator would apply sanctions.

Investment company shares can be suitable for a wide range of retail investors. However, individuals buying based on the information set out in these KIDs will not be properly informed when they make their purchases. These disclosures, when taken at face value and used in a reasonable way, create significant risk of consumer harm.

KIDs are suggesting that investment companies are lower-risk products that can give very strong performance in unfavourable market conditions. This is wrong.

MONEY OBSERVER 2 JULY 2018

"WE AGREE WITH THE AIC THAT THE KIDS ARE EXTREMELY MISLEADING FOR INVESTORS. THE DIFFERENCES IN CALCULATION FROM THE KIIDS PRODUCED BY OPEN-ENDED FUNDS ALSO CREATE CONFUSION FOR INVESTORS."

CHARLES CADE HEAD OF INVESTMENT COMPANY RESEARCH, NUMIS

Confusion on costs

The costs of investment products are under scrutiny from consumers, advisers, the media and regulators. Better visibility of reliable cost information could support competition in the public interest. Unfortunately, KIDs undermine this. They include cost disclosures that are confusing and misleading. Much of the problem arises from the way that so-called “transaction costs” are calculated.

Transaction costs
The KID calculation of transaction costs includes an estimate of explicit costs. These represent money which is likely to be paid out of the assets of the fund.

They also include so-called ‘implicit costs’. These are more problematic. Implicit costs for products with investments in liquid securities include the ‘slippage cost’. The slippage cost captures any movements in the price of a security which may arise during the investment process. This is calculated by taking the market price of an investment when an order is made and comparing it with the actual price paid when the deal is completed.

If the price has risen in the time between an order being placed and the transaction being completed, the difference is added to the other costs. If the price has gone down in this period, the difference is subtracted from other costs. Where downward movements in the price paid are large, or consistent across many orders, the amount subtracted from the total of the transaction costs can result in negative costs.

To put it another way, if the total ‘slippage’ is in favour of the investor and is large enough, the level of transaction costs can be reduced to zero. It can cancel out the amount paid out of the assets of the fund. It can even create ‘negative costs’, implying that the process of buying the assets has actually been a source of revenue.

10% of investment companies invested in equities have KIDs showing total transaction costs of nothing or which are negative (that is, ‘less than’ no costs). This is misleading.

10%

of investment companies with equity exposure show transaction costs of nothing or which are negative (that is, ‘less than’ no costs).

Comparing apples with pears

Unwary consumers comparing the KID and KIID risk being misled about the relative costs of competing products.

Both disclose entry and exit charges. Both include information on one-off charges, such as performance fees.

However, the fund KIID discloses an "*ongoing charge*", which does not include transaction fees.

The KID used for other investment products discloses "*ongoing costs*". This includes a separate disclosure of "*portfolio transaction costs*".

The disclosures presented in the KID and KIID are not comparable. The KID includes transaction costs. The KIID does not. This difference is difficult for the ordinary consumer to recognise. After all the terminology, "*ongoing charge*" and "*ongoing costs*", are similar and easily confused.

A fund and investment company might have the same costs, but the consumer will be left with the impression that the fund costs them less.

Only from 2020 will the summary information for all retail investments compare like with like. Until then, the position is very confusing and will mislead consumers.

4. Reduce harm

The UK and other national regulators cannot unilaterally change the KID rules.

The EU regulatory framework deliberately leaves very little scope for Member States to interpret the rules in different ways.

As discussed in the next section, the best way to protect consumers is for action to be taken at a European level. While the evidence to do so is compelling, there is a risk that this may not be done, or that it may take some time to be agreed.

In the meantime, European regulators should recognise that they are not powerless to act. They can prevent flawed KIDs contaminating the broader process of distribution.

Educate consumers
Regulators should warn consumers about the shortcomings of KIDs.

They should make clear that KIDs may not give an accurate impression of the product or provide the basis for making true comparisons between products. They should emphasise the value of considering other information.

KID preparers and distributors should be advised about their own capacity to warn consumers about the downsides of relying on these disclosures and/or using them to make comparisons between different types of investment products.

Prevent cross-contamination
Regulators should prevent data included in KIDs being extracted and used in other parts of the distribution chain.

For example, summary risk indicators, cost disclosures and performance information might be used alone, or in combination, by financial advisers, robo-advisers, platforms or in financial promotions issued by firms. Regulators should prevent data derived from KIDs being used in ways which might harm consumers.

Regulators should also consider how consumers can be dissuaded from making misleading comparisons between KIDs and KIIDs. For example, risk indicators from these different products should not be compared.

The flaws in the KID should not unfairly limit consideration of retail investment products. Investment company shares can provide excellent opportunities for ordinary investors to save for their retirement or other long-term financial needs. What is critical is that those considering a purchase do so with the correct information about the potential risks and returns. Problems with KIDs should not prevent consumers accessing these investments – whether they are buying with or without advice.

Regulators must maintain, and enhance, effective competition between funds and other investment products.

Act now
These matters can be addressed by regulators without changing the KID rules. Steps should be taken now to reduce the harm that KIDs present for consumers.

Regulators can educate consumers about flawed KIDs and prevent these disclosures affecting the wider distribution process.

5. Suspend the rules and tackle the problem

The key institutions involved in the process, including the European Commission, European Parliament, Member State governments and national regulators, as well as the European Supervisory Authorities, should commit to making changes to the KID regime as soon as possible.

The process to review and change the KID rules should start immediately.

Suspend the KID requirements
The PRIIPs Regulation requires that the European Commission review these rules by 31 December 2018. This process must be undertaken rigorously and promptly.

This process will provide the evidence required to justify suspending the KID rules. That is, the requirement to prepare and distribute a KID to retail investors before they make a purchase. Suspending the KID requirements will prevent significant consumer harm. National measures to protect consumers would continue. Suspending KIDs would be a temporary measure which would allow the serious underlying faults with KIDs to be corrected.

Other investment funds are due to be offered with a KID in 2020. The suspension could be extended to those funds if the process of repairing the KID rules is not complete by 2020.

Problems with the KID have already led to suggestions that funds should not be required to provide KIDs in 2020.

It would not be acceptable to suspend the requirement for funds to be sold alongside a KID without similarly suspending the rules for other investment products.

It would be a regulatory scandal to prioritise the protection of fund buyers over other investors.

Ordinary consumers will be exposed to much greater detriment if KIDs continue to be prepared and distributed on the current basis than if they were suspended. After all, products now distributed with KIDs were sold for many years relying on other mechanisms to protect consumers without harm arising.

Correct the rules

Suspending the KID requirements will allow European policymakers to make changes to address their flaws.

Reform of KIDs should address problems with risk disclosure, the presentation of performance and the calculation of costs. It should ensure that the KID rules achieve core objectives of fairly describing individual products and allowing comparisons.

When the rules are revised, they should be applied to all retail investment products at the same time. The date of implementation should allow for a suitable transition period to allow preparers time to develop the systems required.

Introducing effective reform in a sensible timetable should be prioritised over a swift response which may not address the problems and could otherwise disrupt the market.

The AIC will be pleased to engage with policymakers to offer specific proposals to resolve the serious problems identified with KIDs.

Europe should act swiftly and suspend the KID rules for all investment products.

6. Glossary

Investment company: For the purposes of this paper, “investment company” refers to closed-ended collective investment vehicles with their shares admitted to trading on a public stock market. Investment companies are PRIIPs.

Investment product: For the purposes of this paper, this term has been used to refer to PRIIPs and UCITS, which are required to be sold alongside a KID or KIID, respectively.

Funds: The term “funds” is used in this paper to refer to UCITS.

Key Information Documents (KIDs): KIDs are regulated disclosures which must be prepared for PRIIPs and provided to a retail investor by the distributor before the consumer can purchase that investment product.

Key Investor Information Documents (KIIDs): KIIDs are regulated disclosures which must be prepared for UCITS and provided to a retail investor by the distributor before the consumer can purchase that investment product.

Money Advice Service (MAS): The MAS is an independent statutory body with duties including enhancing consumer understanding of personal finance issues and providing information and advice to the public.

Ongoing costs: These costs are shown in a table prepared for the PRIIPs KID. They include portfolio transaction costs (the costs of buying and selling underlying investments for the product) and other ongoing costs. These include, but are not limited to, recurring costs for paying a fund manager, and a depository or custodian, audit costs and regulatory charges.

Ongoing charges: These costs are shown in a table prepared for the UCITS KIID. They include recurring costs. Most significantly the ongoing charge excludes transaction costs (except in the case where the UCITS is buying/selling another collective investment undertaking).

Packaged Retail Investment-based Investment Products (PRIIPs): PRIIPs are all collective investment products available to retail investors that are not UCITS. The PRIIPs Regulation requires the preparation of the KID and mandates how the disclosures should be presented and calculated. It also requires that the distributor must provide this information to retail investors before a purchase can be made.

Risk indicator: This term is used in this paper to refer to the SRI and/or the SRRI.

Summary Risk Indicator (SRI): This is presented in the PRIIPs KID. It is presented on a 1 to 7 scale and accompanied by a short narrative explaining the headline number. The underlying methodology used to calculate the indicator is different from that used for UCITS.

Synthetic Risk and Return Indicator (SRRI): This is presented in the UCITS KIID. It is shown on a 1 to 7 scale and accompanied by a short narrative explaining the headline number. The underlying methodology used to calculate the indicator is different from that used for PRIIPs.

UCITS: Undertakings for Collective Investment in Transferable Securities, or UCITS, is a fund structure defined by EU rules. A KIID must be prepared for each UCITS. The KIID must be provided to a retail investor by the distributor before the consumer can purchase that investment product.

Venture Capital Trusts (VCTs): VCTs are a type of investment company that invests in smaller higher risk businesses. Retail consumers receive tax incentives to encourage them to invest in this higher-risk asset class.

7. Data tables

Risk

Funds (Equity)		
SRRI Score	by number	%
1	0	0%
2	0	0%
3	6	0.37%
4	162	10.11%
5	1117	69.73%
6	313	19.54%
7	4	0.25%
Total	1602	
Average	5.09	

Funds (Property)		
SRRI Score	by number	%
1	0	0%
2	1	2.78%
3	1	2.78%
4	3	8.33%
5	25	69.44%
6	1	2.78%
7	5	13.89%
Total	36	
Average	5.08	

Investment companies (All)		
SRI Score	by number	%
1	0	0%
2	9	2.32%
3	129	33.25%
4	177	45.62%
5	58	14.95%
6	15	3.87%
7	0	0%
Total	388	
Average	3.85	

Investment companies (Equity)		
SRI Score	by number	%
1	0	0%
2	1	0.51%
3	36	18.18%
4	125	63.13%
5	33	16.67%
6	3	1.52%
7	0	0%
Total	198	
Average	4.01	

Investment companies (Property)		
SRI Score	by number	%
1	0	0%
2	1	2.86%
3	10	28.57%
4	20	57.14%
5	2	5.71%
6	2	5.71%
7	0	0%
Total	35	
Average	3.83	

Investment companies (VCTs)		
SRI Score	by number	%
1	0	0%
2	0	0%
3	40	70.18%
4	13	22.81%
5	3	5.26%
6	1	1.75%
7	0	0%
Total	57	
Average	3.39	

Sister funds comparison		
Total	56	100%
No difference between risk indicator	3	5%
1 integer difference between risk indicator	40	71%
2 integer difference between risk indicator	13	23%

Except where separately attributed, data tables are based on KIDs and KIIDs available up to 30 July 2018.

Source: AIC/Morningstar

Performance

	Investment companies								Investment companies (Equity)							
	Stress		Unfavourable		Moderate		Favourable		Stress		Unfavourable		Moderate		Favourable	
Projected Returns	#	%	#	%	#	%	#	%	#	%	#	%	#	%	#	%
80 - 90 %	0	0%	0	0%	0	0%	0	0%	0	0%	0	0%	0	0%	0	0%
70 - 80 %	0	0%	0	0%	0	0%	1	0%	0	0%	0	0%	0	0%	1	1%
60 - 70 %	0	0%	0	0%	0	0%	1	0%	0	0%	0	0%	0	0%	0	0%
50 - 60 %	0	0%	0	0%	0	0%	9	2%	0	0%	0	0%	0	0%	7	4%
40 - 50 %	0	0%	0	0%	1	0%	7	2%	0	0%	0	0%	0	0%	6	3%
30 - 40 %	0	0%	0	0%	3	1%	43	11%	0	0%	0	0%	2	1%	31	16%
20 - 30 %	0	0%	1	0%	38	10%	99	25%	0	0%	0	0%	30	15%	73	37%
10 - 20 %	0	0%	44	11%	143	37%	158	40%	0	0%	26	13%	89	45%	67	34%
0 - 10 %	7	2%	198	51%	167	43%	68	17%	0	0%	108	55%	69	35%	12	6%
-10 - 0 %	104	27%	117	30%	27	7%	3	1%	25	13%	54	27%	7	4%	1	1%
-20 - -10 %	214	55%	19	5%	6	2%	2	1%	134	68%	8	4%	1	1%	0	0%
-30 - -20 %	46	12%	7	2%	2	1%	0	0%	34	17%	1	1%	0	0%	0	0%
-40 - -30 %	7	2%	2	1%	0	0%	0	0%	2	1%	0	0%	0	0%	0	0%
-50 - -40 %	4	1%	2	1%	0	0%	0	0%	1	1%	0	0%	0	0%	0	0%
-60 - -50 %	1	0%	2	1%	0	0%	0	0%	0	0%	1	1%	0	0%	0	0%
-70 - -60 %	0	0%	0	0%	0	0%	0	0%	0	0%	0	0%	0	0%	0	0%
-80 - -70 %	0	0%	0	0%	0	0%	0	0%	0	0%	0	0%	0	0%	0	0%
< - -80 %	6	2%	0	0%	0	0%	0	0%	1	1%	0	0%	0	0%	0	0%
Total	389		392		387		391		197		198		198		198	
Arithmetic Average	-15%		1%		10%		19%		-16%		2%		12%		24%	

	Investment companies (Alternatives)								Investment companies (VCTs)							
	Stress		Unfavourable		Moderate		Favourable		Stress		Unfavourable		Moderate		Favourable	
Projected Returns	#	%	#	%	#	%	#	%	#	%	#	%	#	%	#	%
80 - 90 %	0	0%	0	0%	0	0%	0	0%	0	0%	0	0%	0	0%	0	0%
70 - 80 %	0	0%	0	0%	0	0%	0	0%	0	0%	0	0%	0	0%	0	0%
60 - 70 %	0	0%	0	0%	0	0%	1	1%	0	0%	0	0%	0	0%	0	0%
50 - 60 %	0	0%	0	0%	0	0%	2	1%	0	0%	0	0%	0	0%	0	0%
40 - 50 %	0	0%	0	0%	1	1%	1	1%	0	0%	0	0%	0	0%	0	0%
30 - 40 %	0	0%	0	0%	1	1%	9	7%	0	0%	0	0%	0	0%	3	5%
20 - 30 %	0	0%	1	1%	6	5%	17	12%	0	0%	0	0%	2	4%	9	16%
10 - 20 %	0	0%	12	9%	33	25%	64	46%	0	0%	6	11%	21	38%	27	49%
0 - 10 %	6	4%	64	46%	73	55%	40	29%	1	2%	26	46%	25	45%	16	29%
-10 - 0 %	51	38%	45	33%	13	10%	2	1%	28	50%	18	32%	7	13%	0	0%
-20 - -10 %	60	44%	7	5%	4	3%	2	1%	20	36%	4	7%	1	2%	0	0%
-30 - -20 %	11	8%	5	4%	2	2%	0	0%	1	2%	1	2%	0	0%	0	0%
-40 - -30 %	4	3%	2	1%	0	0%	0	0%	1	2%	0	0%	0	0%	0	0%
-50 - -40 %	1	1%	1	1%	0	0%	0	0%	2	4%	1	2%	0	0%	0	0%
-60 - -50 %	1	1%	1	1%	0	0%	0	0%	0	0%	0	0%	0	0%	0	0%
-70 - -60 %	0	0%	0	0%	0	0%	0	0%	0	0%	0	0%	0	0%	0	0%
-80 - -70 %	0	0%	0	0%	0	0%	0	0%	0	0%	0	0%	0	0%	0	0%
< - -80 %	2	1%	0	0%	0	0%	0	0%	3	5%	0	0%	0	0%	0	0%
Total	136		138		133		138		56		56		56		55	
Arithmetic Average	-13%		-1%		7%		15%		-15%		0%		8%		15%	

Costs

	Investment companies (Equity)	
	by number	%
Transaction Costs	198	-
Negative costs	16	8.08%
No costs	3	1.52%

Charts modelling 'historic' KIDs

	Mod Scen 5yr KID return (on 10k)	Actual 5yr return (on 10k)
Investment company	£47,394.90	£6,947.20
Fund	£40,001.40	£8,647.16

Source: Financial Express

	Mod Scen 5yr KID return (on 10k)	Actual 5yr return (on 10k)
Investment company	£9,217.59	£28,271.00
Fund	£10,058.89	£24,467.00

Source: Financial Express

			Profit/Loss	
Month	**Mod Scen 5yr KID return (on 10k)**	**Actual 5yr return (on 10k)**	**KID expected 5yr return on moderate scenario on £10,000 invested**	**Actual 5yr return on £10,000 invested**
Jan 03	£8,390.66	£39,390.94	-£1,609.34	£29,390.94
Jun 03	£8,356.26	£33,589.66	-£1,643.74	£23,589.66
Jan 04	£13,146.30	£17,766.99	£3,146.30	£7,766.99
Jun 04	£12,614.19	£19,770.21	£2,614.19	£9,770.21
Jan 05	£13,100.81	£16,523.10	£3,100.81	£6,523.10
Jun 05	£11,965.86	£13,001.62	£1,965.86	£3,001.62
Jan 06	£14,304.97	£15,297.78	£4,304.97	£5,297.78
Jun 06	£20,117.25	£14,778.96	£10,117.25	£4,778.96
Jan 07	£29,916.16	£9,174.42	£19,916.16	-£825.58
Jun 07	£47,180.27	£7,601.30	£37,180.27	-£2,398.70
Jan 08	£36,003.76	£9,602.20	£26,003.76	-£397.80
Jun 08	£30,981.09	£10,154.13	£20,981.09	£154.13
Jan 09	£14,227.79	£18,022.64	£4,227.79	£8,022.64
Jun 09	£16,468.48	£15,894.52	£6,468.48	£5,894.52
Jan 10	£13,067.05	£13,529.21	£3,067.05	£3,529.21
Jun 10	£11,200.89	£12,810.10	£1,200.89	£2,810.10
Jan 11	£10,759.38	£8,519.63	£759.38	-£1,480.37
Jun 11	£12,302.14	£7,532.87	£2,302.14	-£2,467.13
Jan 12	£7,116.76	£11,592.39	-£2,883.24	£1,592.39
Jun 12	£6,291.52	£13,030.70	-£3,708.48	£3,030.70
Jan 13	£7,843.44	£15,882.62	-£2,156.56	£5,882.62
Jun 13	£8,448.59	£15,269.33	-£1,551.41	£5,269.33

Source: Financial Express

Burn before reading

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September 2018