Origo Insights – New benchmarks a new industry challenge

New benchmark recommendations from ESMA aim to correct the way funds are using benchmarks. Since the introduction of the Benchmark Directive in 2018, many funds have effectively removed relevant benchmarks and replaced them by money market rates. Given the strong performance of nearly all financial assets since early 2019, this has led to a bonanza of performance fees.

For any industry, benchmarking is a useful exercise. They are indicators for management to evaluate whether such important parameters as product quality, efficiency of the production process, costs or customer satisfaction are at acceptable levels. ISO, the International Organisation for Standardization creates and publishes benchmarks for such diverse things as anti-bribery management systems, quality of car seats for children and food safety. Benchmarks are an everyday thing, and the world is a better place because of them.

Investment Funds and Benchmarks

The investment fund industry also uses performance benchmarks, but not any issued by the ISO. On the surface of it, it all seems simple. An investment fund investing in German shares should compare its performance to a benchmark, most often a German stock market index. If the fund performs better than the market index, the portfolio manager is a hero, if not (s)he is a zero.

Things are, however, not that simple. What about the costs incurred by the investment fund? It is not free to trade, to keep the securities in custody or pay a salary to the portfolio manager, but such things are not contained in the benchmark index. Add that a fund also pays for its own marketing and often for a part of the distribution costs. These costs often exceed 2 per cent per year. So in order to “beat the benchmark” an average portfolio manager should actually deliver an investment result 2 per cent better than the benchmark performance.

Investing outside the benchmark

How do we know that the portfolio manager actually invests in the stocks of the benchmark index? A well-known method has been since for many years and in many markets, companies too small to be included in the main index have actually performed better than the main index. The temptation for a portfolio manager to let the portfolio drift towards smaller stocks have in many cases been too big to resist.

Investing, say, 30% of the portfolio in smaller stocks have for years added performance to many equity funds, otherwise presented as a fund investing in “the main market” and compared to a “main market” index. But that is no proof that the portfolio manager is actually doing a good job. It just proves that (s)he has done something else than (s)he claimed to do.

Performance fees

Which brings us to the next issue, performance fees. If a portfolio manager performs better than his/her benchmark, surely, they should be remunerated for it? The performance fees charged by many funds are in the range of 10%-20% of the "excess performance".

And we are not talking measly monthly salaries here. A fund of EUR 1bn with a performance fee of 10% which manages to generate 1% excess performance compared to the index generates a cool EUR 1m in performance fees to the portfolio manager in excess of the percentage paid to the portfolio manager for simply going to work and doing his or her job.
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But what about years where the portfolio manager fails to perform better than the benchmark? Surely, they pay back some of the performance fees? Or at least they will have to recover the lost ground before a performance fee is paid next time.

The answer is – some do but others do not. Those who don't, simply resets the counter once a new calendar starts. If a portfolio manager has alternate years of good or bad performance, s(he) may end up not providing any benefits to the investor, while being paid a performance fee in the good years

Homemade benchmarks

Some investment funds invest in markets where no index exists. Imagine a fund investing in eg. Turkish and Azerbaijani stocks. A stock market index is available for each market, but not a joint index. The portfolio manager may then try with a home-calculated index. The two markets are listed in different currencies, so how should we take into consideration the currency movements. And how much should each market weigh in the home-made composite index? The portfolio manager may be fair-minded and taking the creation of a relevant index seriously. But at the end of the day, It is the portfolio manager who ultimately decides the key parameters of the index and can keep these parameters hidden to the investors.

EU to the rescue

Beginning on 1 January 2018 a new EU regulation entered into force. It created a new type of actors, benchmark administrators. They are the legal entities who create or publish benchmarks. Investment Funds are now mandated to publish the precise benchmarks and who the "administrators" are. Further they must have backup benchmarks available in case a benchmark administrator goes belly up.

Seen from our point of view, it is hard to see any deeper meaning with this regulation. Investors are not better protected, since they do not really suffer if a random benchmark has to be replaced by another.

The real problem

As the Benchmark regulation began in 2018, many investment funds used the opportunity to remove their old benchmarks and to replace them by money market interest rates. This made it much easier to make money through performance fees. The investment funds simple changed their investment objectives from being to "outperform an index" to "provide a positive return".

In 2019, the global stock market (as measured by the return of the etf IBCH.DE) returned 23.8% (ex. dividends). The global short-term interest rates were just about 0.5% through much of the year.

Now imagine a global equity fund returning 20% in 2019. Measure against a global market index, the portfolio manager would have received precisely nothing, since the return was inferior to the market return. But having redefied the same fund to an "absolute return fund", the portfolio manager would receive 10% of the "excess performance", which stood at an impressive 19.5%.

For a 1bn EUR fund, this would have meant a payday of 19.5m EUR. Certainly a kind of compensation for the havoc MiFID2 had wreaked on the industry.

ESMA gets it right

While having no legal standing, ESMA's new recommendations would mean the end to this entirely legal way of increasing earnings.

ESMA somehow believes that the benchmarks should reflect the actual investments in a fund, that underperformance must be regained before new performance fees can be paid again (a mechanism called high watermark). For those funds where it is legitimately difficult to find a benchmark, ESMA does not object to using a money market rate as a benchmark. But they do find it reasonable to introduce a request that a positive return should be measure up against the risk taken by the portfolio manager on behalf of the investors.

This little story proves a) that the financial markets have no intention of removing obfuscation and loopholes if doing so would lead to lower earnings, and b) that real consumer protection again has been left up to the local regulators reading of a recommendation, rather than being enshrined in the relevant legislation.

It is a déja vu, all over again.

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