EFAMA

European Fund and Asset Management Association

MARKET INSIGHTS

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PERSPECTIVE ON THE NET PERFORMANCE OF UCITS

One of the key objectives of the Capital Markets Union (CMU) agenda is to increase the level of retail participation in capital markets. Achieving this goal is expected to provide EU companies, and the EU economy in general, with much needed long-term capital and speed up the green and digital transition. It will also serve the interests of people whose savings in bank deposits are currently being eroded by inflation in an environment of very low interest rates.

Table of Contents

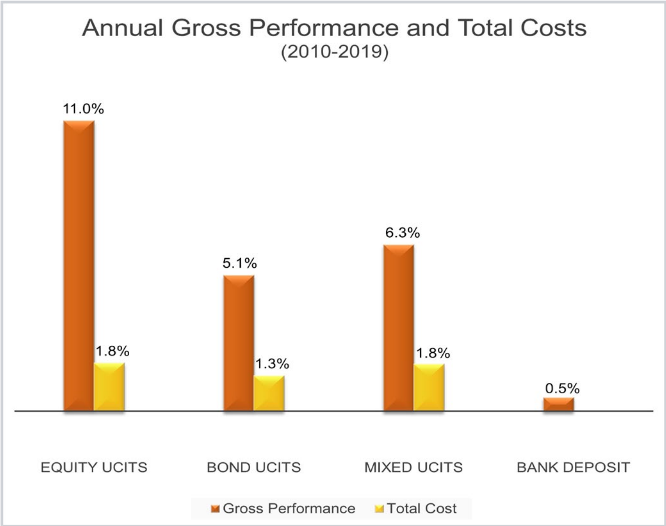
Most European households do not save directly in capital market instruments. The main reason for this is that many people are risk-averse and unaware of the potential returns generated by investment in securities and investment funds.[1] The emphasis put by prominent stakeholders and authorities on the negative impact of costs on the return that retail investors can expect to receive from investment products, whilst not emphasising the benefits, also tends to undermine consumer trust in these products.

To encourage people to save in capital markets, we need to put a much stronger emphasis on the net returns generated by market-based instruments over the long term. We need to explain that there is an opportunity cost of holding an excessive amount of wealth in bank deposits, which has meant a negative return since 2016, thus weakening people's long-term saving prospects, such as their standard of living in retirement.

This *Market Insights* aims at raising people's awareness of the advantages of investing in capital markets by highlighting the extra return UCITS have delivered compared to bank deposits over the last ten years. We also provide strong evidence that the cost of UCITS is on a downward path.

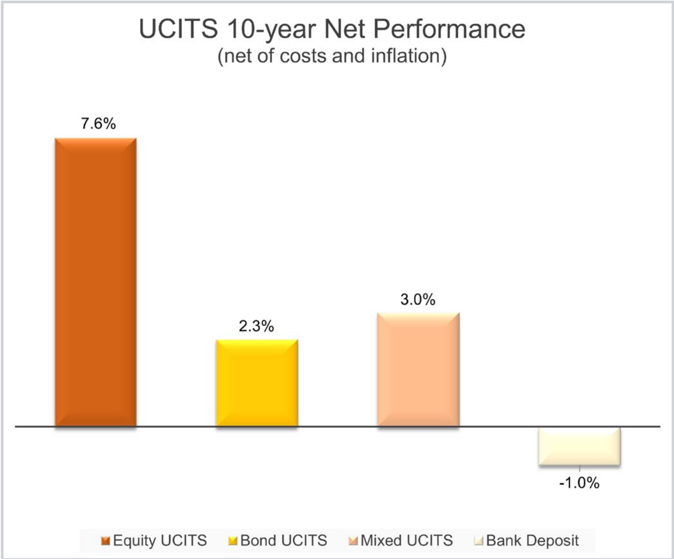
PERFORMANCE OF UCITS

Gross versus net performance. If we want retail investors to invest in capital markets, we should highlight the outcome of long-term investing rather than focusing on annual performance for one-year investments. The following analysis looks at the performance of UCITS over the ten-year investment horizon ending in 2019, using data published in the latest ESMA Annual Statistical Report. The chart below shows the gross annual performance and total costs[2] of the three main types of UCITS (equity, bond and mixed) as well as the average interest rate paid on overnight deposits and deposits with agreed maturity of over one and up to two years, during the period 2010-2019. The annual gross performance was between 11% for equity UCITS and 5.1% for bond UCITS, whereas the average interest rate paid on bank deposits was 0.5%. This means that the total gross performance over the entire period is 184% for equity funds, compared to 5% for deposits.



Source: EFAMA's calculations based on ESMA data[3]

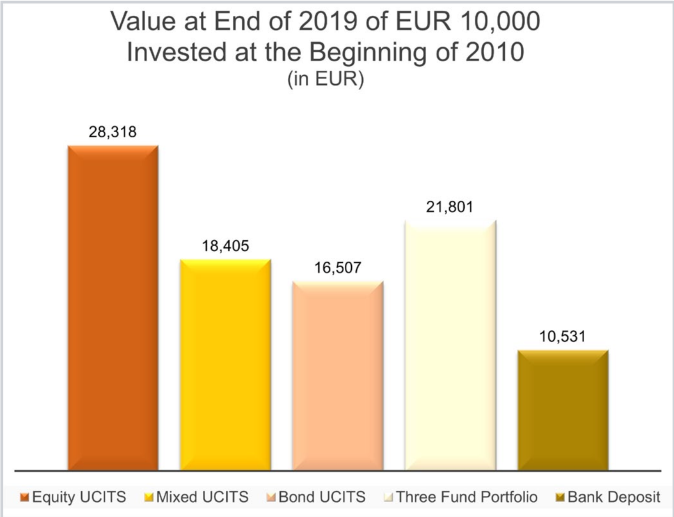
We have also calculated the average net performance of UCITS investment over the period 2010-2019, taking into account the impact of inflation on the final performance for an investor. The findings - as shown in the chart below - highlight the benefits long-term investment investors can hope for. On average, the net annual performance of equity, bond and mixed UCITS was 7.6%, 2.3% and 3%, respectively. These positive returns contrast with the 1% loss recorded on bank deposits[4].



Source: EFAMA's calculations based on ESMA data

Value of a ten-year investment. To fully appreciate the long-term benefits of investing, we have compared the value after ten years of EUR 10,000 invested at the beginning of 2010 in five different products: equity UCITS, bond UCITS, mixed UCITS, a hypothetical retail fund portfolio composed of equity (40%), bond (30%) and mixed UCITS (30%), and a bank deposit.

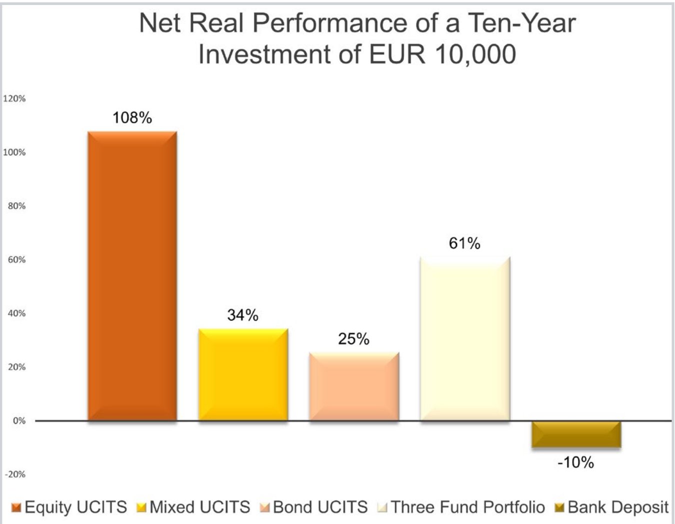
For UCITS focusing on equity, the investment would have led to a value of EUR 28,318 after ten years whereas the value of the hypothetical retail portfolio and the bank deposit would have been EUR 21,801 and EUR 10,531, respectively.



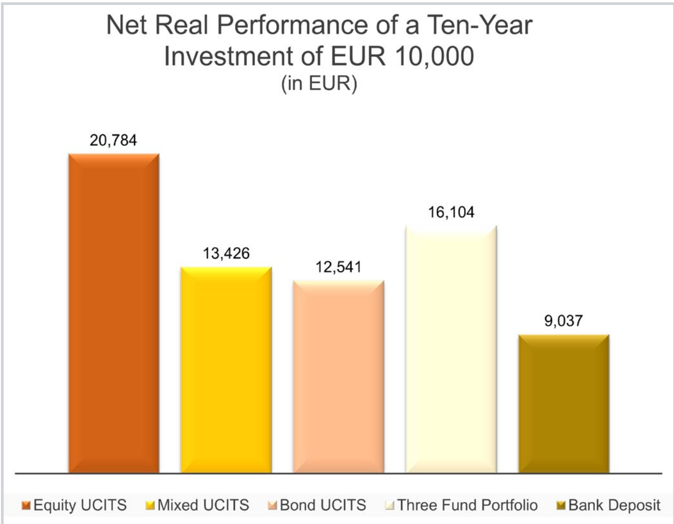
Source: EFAMA's calculations based on ESMA data

We have also calculated the value of the investment in terms of its purchasing power today taking into account all costs[5] as well as the impact of inflation; this enables us to calculate the 10-year total net performance in real terms for each investment option.

The results, shown in the chart below, send a clear and powerful message: a ten-year investment of EUR 10,000 in a portfolio composed of equity, bond and mixed funds generated a total net performance in real terms of 61%, whereas the value of EUR 10,000 left in a bank account in 2010-2019 fell by 10% in real terms. These findings illustrate the opportunity cost and financial loss that European households have incurred by saving primarily in bank deposits during the previous decade.



Source: EFAMA's calculations based on ESMA data



Source: EFAMA's calculations based on ESMA data

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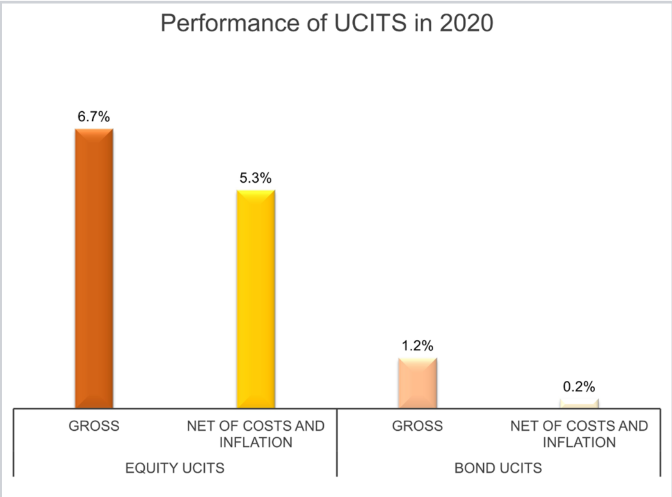
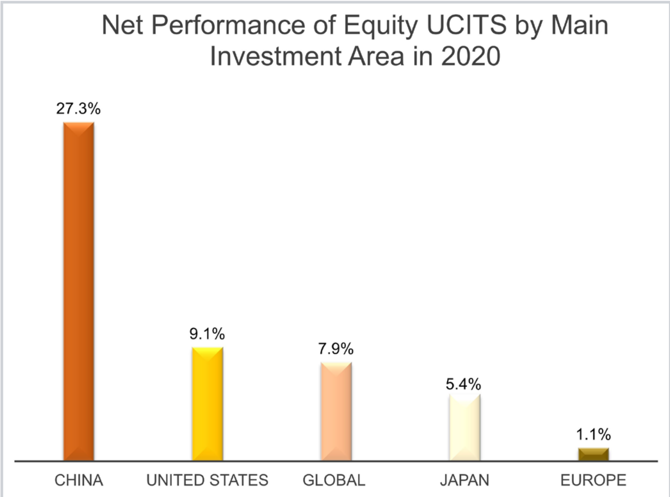
Net Performance in 2020. The calculations presented above focus on 2010-2019, which is the period of reference in the ESMA 2021 Statistical Report. The main conclusion of our analysis would remain valid if the investment horizon were extended to 2020. Indeed, despite the financial stress caused by the Covid-19 pandemic in March 2020, the net performance of equity UCITS was 5.3% in 2020. Bond UCITS also recorded, on average, a positive net return in 2020, albeit small.

It is important to note that not all equity UCITS are the same. Whilst all are predominantly invested in stocks, they can differ according to their investment strategy, which may focus on one market sector, investment theme, or geographic region.

The difference in returns between the various types of equity UCITS reported in the chart below, as well as between equity and bond UCITS in general, highlights the importance for investors to diversify their investments. Diversification reduces the risk of one investment performing badly and damaging the return of the overall portfolio.



Source: EFAMA's calculations based on Morningstar Direct data



Source: EFAMA's calculations based on Morningstar Direct data

PERFORMANCE OF ACTIVE AND PASSIVE UCITS

A passive fund generally seeks to replicate the return of a specified financial market index. The manager of these funds buys and holds all or a representative sample of the securities in their target indices. By contrast, under an active management approach, managers are not tied to an index. They can invest in both listed and private assets, adjust their portfolios to changing market circumstances with a view to increasing returns or achieving other investment objectives such as generating income, limiting downside risk, managing volatility. To this end, managers use different tools and undertake or rely on investment research to analyse specific industries, markets, and issuers. This comes with additional costs which are typically not incurred by passive funds. This explains why actively the costs of actively managed funds are, on average, higher than those of passive funds.

The higher cost of actively managed funds leads some stakeholders to argue that it is difficult for those funds to outperform passive funds in average net terms. This suggestion should be seen in the context of the debate on whether active managers can deliver a return above the general market return that is high enough to offset the additional cost of active management.

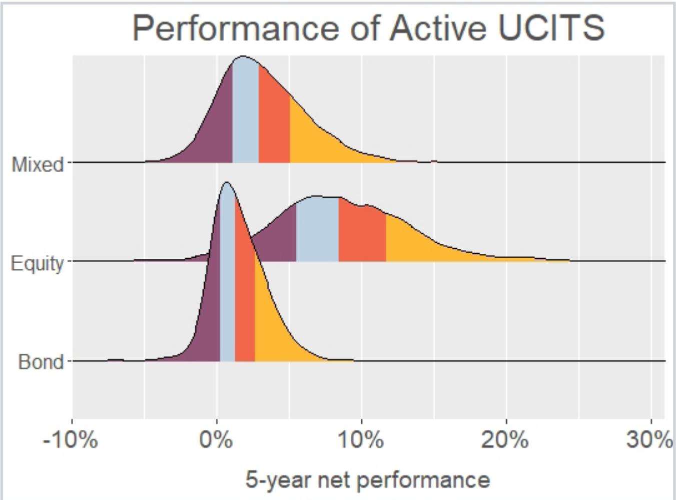
The charts below show the distributions of a risk-adjusted net 5-year performance[6] (2016-2020) of active and passive equity and bond UCITS[7]. The four vertical lines divide the distribution into four quartiles[8].

Two important conclusions can be drawn:

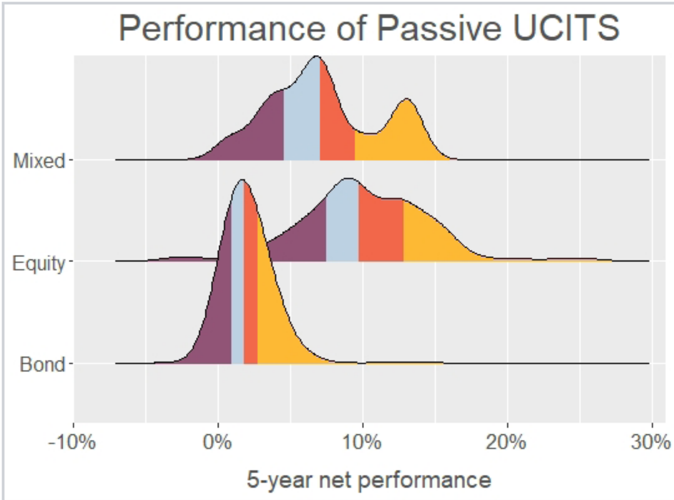
• The differences between the performance of the higher- and lower-performing active and passive funds vary, reflecting the fact that the universe of funds is made up of many heterogeneous funds in terms of investment strategies, which differ greatly across issuers, types of securities, geographical exposures, industrial sectors and currencies.

• Many active funds outperformed passive funds in net terms, and vice versa.

The results would, thus, caution against relying too much on any ‘average’. There is no such thing as an average fund and what is happening ‘on average’ hides the wide range of possible outcomes and the fact that there is a cohort of active funds that outperforms their passive peers. Unfortunately, the debate is often framed as opposing active to passive whereas, in reality, this is not a binary choice. Both active and passive funds have a role to play in a well-diversified portfolio in accordance with the objectives pursued and the clients’ needs.



Source: EFAMA’s calculations based on ESMA data



Source: EFAMA’s calculations based on ESMA data

Bearing in mind that the past performance of a fund is not necessarily a predictor of future performance, we have calculated the percentage of top-25% performing active equity UCITS remaining top performers in subsequent years, beginning with 2016.

Taking 2016 as the base year, the table below shows that 34% of the top-25% funds in 2016 remained in the top-25% in 2017, and 42% of the 25% top performers in 2016 were in the top-25% in 2018. In 2020, this percentage was 26%. Taking 2019 as the base year, 47% of the top-25% funds in 2019 were still top performers in 2020.

Based on these findings, we can conclude that a significant number of top-performing active equity UCITS remain top performers in subsequent years.

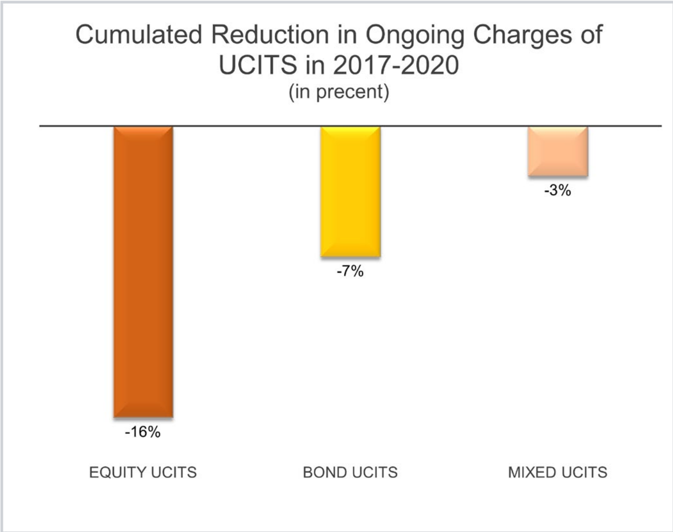
Top-25% Performing Active Equity UCITS in Base Year
Percentage of Funds Remaining in Top-25% Group in the Following Years

Base Year	2017	2018	2019	2020
2016	34%	42%	30%	26%
2017		20%	32%	42%
2018			41%	28%
2019				47%

Source: EFAMA’s calculations based on Morningstar Direct data

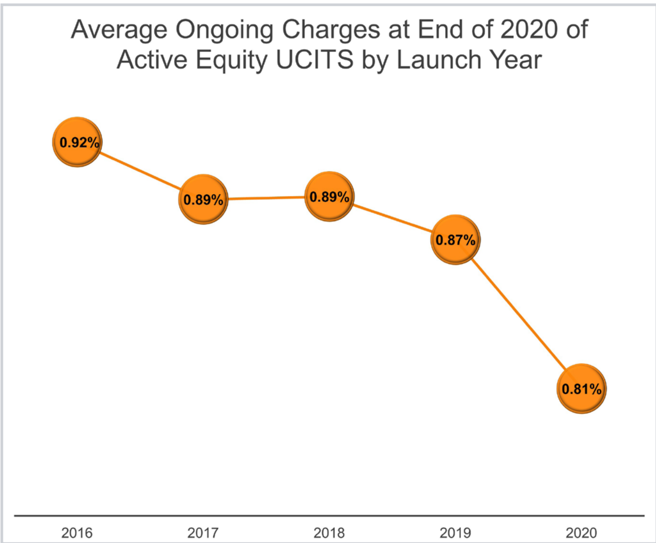
COST OF UCITS

The performance of UCITS in recent years has been positively impacted by the reduction of their costs to investors. The chart below confirms this by showing that the cumulated decrease in the ongoing charges of UCITS over the last four years reached 16% for equity UCITS, 7% for bond UCITS and 3% for mixed UCITS.



Source: EFAMA's calculations based on Morningstar Direct data

The measures taken under MiFID II and the UCITS Directive to enhance the quality of cost disclosure have contributed to this evolution by facilitating the comparison of costs of similar UCITS, which has led to increased competition between fund managers. This competition is particularly intense between fund managers who seek to attract investors into their new funds. This is confirmed in the chart below, which shows the downward trend in the ongoing charges of recently launched UCITS. By way of illustration, while the average ongoing charges calculated for the whole universe of active equity UCITS was 1.39% in December 2020, the average cost of the group of funds launched last year was 0.81%, compared to 0.92% for those launched in December 2016.



Source: EFAMA's calculations based on Morningstar Direct data

CONCLUDING REMARKS

To ensure that retail investors participate more in capital markets, they need to be aware not only of the costs but also of the benefits of investments and, more broadly, the value of the investment solutions on offer. Narratives that stress only the costs and not the benefits of investing risk putting people off from investing altogether which goes against one of the main objectives of the CMU agenda.

Investors are willing to pay for a service that delivers sufficient value. From this perspective, the overall goal for policymakers to facilitate increased household participation in capital markets should not be to highlight how much retail investors stand to lose because they must pay for a service. It should rather be to show how much they can gain from investing and to ensure that fees reflect the value of the products and services that fund managers commit to deliver to investors. It would also be useful to stress the huge opportunity cost of holding a significant share of financial wealth in bank accounts, as most European households unfortunately still do.

Authors:

Bernard Delbecque, EFAMA Senior Director for Economics and Research

Vera Jotanovic, EFAMA Senior Economist

FOOTNOTES

[1] A report published by EFAMA last year (Household Participation in Capital Markets) looked into this problem and highlighted a number of drivers, which alone or in combination can explain why the vast majority of EU citizens keep a disproportionate amount of their savings in bank deposits.

[2] Total costs include ongoing charges, subscription and redemption fees, as defined in ESMA Annual Statistical Report.

[3] See statistical annex in ESMA Annual Statistical Report.

[4] This estimation does not take into account banking charges due to lack of data availability.

[5] Except for the bank deposit, due to the lack of reliable data.

[6] Morningstar 5-Year Gross Return representing excess return relative to the return of the 90-day Treasury Bill over 5 years.

[7] The data were gathered from Morningstar Direct and include passively managed UCITS as well as ETFs.

[8] The quartiles measure the spread of the performance above and below the median, which divide the groups of funds into half so that 50% of the funds lies below the median and 50% lies above it. The quartile breaks down the funds into quarters so that 25% of the funds are less than the lower quartile, 50% are less than the median, and 75% are less than the upper quartile.

Rue Marie-Thérèse 11 | B-1000 Bruxelles | T +32 2 513 39 69 | info@efama.org

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