



A significant drag

Martin Straub on retrocessions and undisclosed payments in Swiss asset management



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Retrocession is the German term for kickbacks, trailer fees, finder's fees and other payments made to asset managers by banks and other financial institutions in Switzerland. These payments come from client money, hence are property of the client, but are still all too often not disclosed to the client. Retrocessions, retros for short, have been a highly contentious issue over the past few years. In Switzerland, as elsewhere, a client entrusts the care of his money to an independent asset manager (IAM). The IAM works with a third party bank where the client has deposited the assets. The IAM receives a limited power of attorney to trade the account on behalf of the client. The management fee is generally about 1 per cent of assets under management (AUM) per year, though this can vary. In addition, completely separate to the management fee, most IAMs receive 'retrocessions' and other kickbacks on trading commissions, brokerage, depot administration fees, funds and structured product emissions. The IAM also often receives a finder's fee from the bank for bringing new money, ranging from 0.2 to 1 per cent. Prior to the landmark Swiss Supreme court ruling in 2006, most IAMs did not disclose these payments in any way to the client. Even the existence of retrocessions was often denied by the IAMs.

Background and statistics:

There are about 2,600 asset managers (AMs) in Switzerland with some CHF500 billion of private client money under management. Total retros paid annually is estimated at about CHF2 billion per year.

Of these 2,600 AMs, around 100 are banks and 2,500 are independent asset managers. About 80 per cent of the IAMs take retrocessions as part of revenue. Though disclosure of the existence of retros is slowly improving, the 'how much gets paid' is still generally not disclosed. Best estimates are that retrocessions make up about 35 per cent of the average IAMs total annual revenues.

Figure 1: Swiss IAM income on private client assets



Basic retrocessions paid to IAMs by one globally active private bank in Switzerland are as follows:

Trading and brokerage commissions:	50%
Fiduciary deposits:	50%
Depot account maintenance charges:	20%

Table 1

Assets under Management	Rate of return	Years Invested	Retro rate	Total return	Retro drag	Comments
Ft. 1'000'000	6.0%	20	0.00%	Ft. 2'207'135	0.00%	The clean Asset Manager, no retros
			0.20%	Ft. 2'081'258	5.70%	The relatively restrained Asset Manager
			0.40%	Ft. 1'960'084	11.39%	The Average Asset Manager
			0.60%	Ft. 1'843'446	16.48%	The IAM pushing funds and structured products
			0.80%	Ft. 1'731'183	21.56%	The IAM with an active management strategy
			1.00%	Ft. 1'623'138	26.46%	And above. More common than you would think

For every CHF1 brokerage paid to the bank by the client, the IAM receives CHF0.5 back from the bank, not disclosed to the client. The conflict of interest is not subtle; the IAM has a strong incentive to trade the account. With 50 cents on the dollar back for every trade you would expect high turnover on IAM managed accounts, which we often see in practice. Further, selection of depot bank/broker is too often driven not on the basis of best execution, cost and service quality, but the question 'who pays the highest Retros?'

Assessing the impact

Consider retrocessions as a tax, specifically a wealth tax. Assuming 'blanket' constant retro rates and ignoring management fees and charges, Table 1 below shows the effect on a CHF1 million portfolio, with an assumed 6 per cent per annum return, over 20 years with retro rates ranging from 0-1 per cent. The total impact on return we will call the retro 'drag'. This is the total loss in return directly resulting from retrocessions. Let the rate of return be 'r', the retro rate be 't' and 'N' the number of years. The assumed Future Value Interest Factor (FVIF) for our wealth tax analogy is: $FVIF = [(1+r)^N] / (1-t)^N$

Table 1: Assets under management and retro drag

The retro drag column is the percentage of total return the IAM is appropriating from his client over 20 years. The average

Figure 2

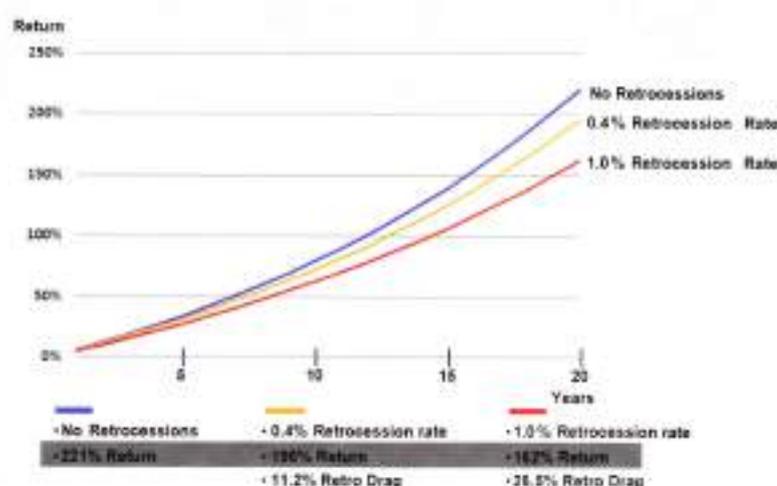


Table 2: Depot account with CHF1 million under management

Type of Cost ¹	Fees and charges paid ²		Retrocessions ³		Net fees and charges ⁴	
	%	Amount	%	Amount	%	Amount
Depot account maintenance fee (on SFr. 1,000,000)	0.25	2'500	93.00	1'250	0.125	1'250
Subtotal		SFr. 2'500		SFr. 1'250		SFr. 1'250
Market Transactions⁵						
Brokerage (10 trades @ SFr. 20,000)	1.00	4'000	50.00	2'000	0.5	2'000
Fees/brokerage (SFr. 100,000 @ 4)	1.00	1'000	20.00	200	0.80	800
Subtotal		SFr. 5'000		SFr. 2'200		SFr. 2'800
Financial Products⁶						
Mutual Funds (Holding: SFr. 400,000)	1.00	4'800	50.00	2'400	0.60	2'400
Fund Sales to client (upfront load on SFr. 100,000)	2.00	2'000	90.00	2'000	0.00	0
Structured Products (Holding: SFr. 100,000)	2.00	2'000	50.00	1'000	1.00	1'000
Hedge Funds (Holding: SFr. 100,000)	3.00	3'000	40.00	1'200	1.80	1'800
ETFs (Holding: SFr. 200,000)	0.30	600	0.00	0	0.30	600
Individual Securities (Holding: SFr. 200,000)	0.30	400	0.00	0	0.20	400
Subtotal		SFr. 12'800		SFr. 6'600		SFr. 6'200
Overall Total		SFr. 20'300		SFr. 10'050		SFr. 10'250

Source: Florian Schubiger, Vermoegens-partner AG

Explanatory Notes

- There are extra fees and charges, e.g., administration, postage, or numbered account costs. Retrocessions can also be agreed on these.
- These amounts are the effective fees and charges paid by the client, when the IAM retains all retro payments.
- Common types of retrocessions are shown in this example. IAMs may pass on retros as discounts.
- This is the true cost to the client, if the IAM would reimburse all retros to the client.
- Assumption of 16 transactions with an average volume of CHF25,000. The account is being turned over every two and a half years. Retros on Forex trades can vary greatly.
- The level of funds in the portfolio is intentional at 40 per cent. There are still IAMs who invest total AUM in actively managed funds. This sum of up-front loads results when CHF102,000 active funds with a 2 per cent up-front load (NAV100,000 plus 2,000 up-front load) are purchased annually. With structured products, emission costs are contained in the gross fee. These vary from product to product by several per cent. In general, no retros are paid on index products and ETFs.

As can be seen from the table, CHF20,300 is the cost to the client, of which CHF10,050 is passed back to the IAM as retrocessions. The real cost of services provided to the client is half what is charged: CHF10,250. Clearly, the high retrocessions on funds and structured products make it rather challenging to act in the clients best interests. Bear in mind that there are funds with up to a 5 per cent up-front load creating incentive to both purchase for and turn over these funds in client portfolios. Enabling the IAM in good years to steer the retro take to well over 1 per cent. We see this in practice with many IAMs buying large volumes of fund and structured products for their clients, even when the client is wealthy enough to achieve diversification through other means.

Furthermore, the more an asset manager trades an account, the more he earns: a clear conflict of interest. A result of this conflict of interest is that the 'retro-induced' increased account turnover often further reduces returns. Figure 3 below is from an often quoted study of turnover frequency vs investment return.

IAM takes an estimated 0.4 per cent per annum in retros. Note that the drag is far greater than the retro rate itself, a retro rate of 0.4 per cent per annum has a 11.2 per cent negative effect on portfolio performance over 20 years. The retro rate on funds and structured products ranges from 1-5 per cent, should the client end up with a 60-80 per cent allocation, with frequent rebalancing the IAM can easily move to an annual retrocession take of over 1 per cent – invisible to the client. Like a tax, retros consume a greater share of investment growth as retro rate or investment horizon increases. Today, the level of retros is still in most cases not disclosed to the client, even when their existence is disclosed. Moreover, portfolios are subject to an almost infinite variety of different retro regimes depending on asset classes held, types of funds, types of security, the depot bank holding the assets, and trading frequency/account turnover. Like a tax, retros consume a greater share of investment growth as the retro rate or investment horizon increases as shown in Figure 2 below. Unlike taxes, however, the client is generally not aware that these payments take place.

Figure 2: Impact of retrocessions on portfolio return over 20 years

Note that a 1 per cent annual 'retrocession rate' costs the client a quarter of his real return over 20 years. As Einstein once said, 'Compound interest is the most powerful force in the universe'.

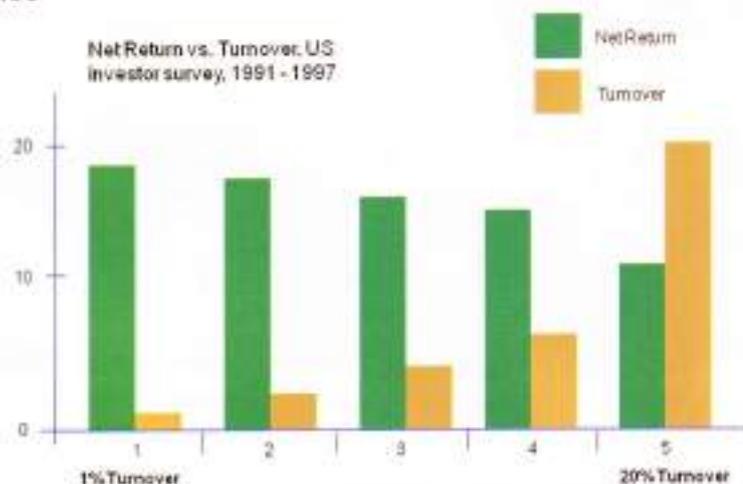
Table 2 illustrates the ease with which a 1 per cent annual retro rate can be achieved on an individual account. The asset classes have been chosen intentionally to illustrate the effect and potential income to an IAM. Figures do not include the IAM management fee, which comes on top.

Figure 3: Negative impact of trade frequency on returns

Regulatory issues and some perspective.

IAMs are self-regulated in Switzerland, subject to the Swiss Financial Markets Authority (FINMA). There are 11 recognised Self-Regulatory-Organisations

Figure 3



Source: Barber & Odean, *Journal of Finance*, 2000.

thought may be, is probably not feasible. Increased disclosure, transparency and better investor education seems the best answer.

Conclusion

The basic problem with retros is not that they exist, it is that they are not disclosed and not transparent. Raising disclosure and better transparency will probably make them go away of their own accord over time. FINMA's point of view also seems to be that through requiring full disclosure of retros, clients will either migrate over time to other providers or will demand better deals. More IAMs are indeed offering and switching over to 'retro-free' models – admittedly at a glacial pace. Following the global trend, the Swiss market is moving slowly toward increased transparency. Over the long term, retros should vanish or be transformed into other forms of disclosed compensation, without the need for heavy handed regulation, which often creates crazy incentives, distorts market signals and can lead to unexpected results contrary to what was originally intended. There is an opportunity for some IAMs to distinguish themselves through better service levels, as clients are demonstrably willing to pay for better service. FINMA appears to be taking the approach of requiring increased disclosure to enable both client and IAM to act in their own self-interest to finally consign retros to the dustbin of history or make them a legitimate, disclosed, service-level linked component of compensation. ■

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(SROs) and each IAM is obliged to join one. In October 2008, FINMA released a guidelines document, 'Eckwerte zur Vermögensverwaltung', or 'Corner values of asset management'. This document contained concrete recommended minimum standards for disclosure, transparency, reporting, fees, content of the asset management contract, and detailed requirements for the treatment and disclosure of retrocessions. Unfortunately the standards are recommendations only and in no way enforceable, so clients must still take care.

From an Anglo-Saxon point of view, self-regulation appears to have failed. However, Switzerland has never experienced the big blow-ups that plague hyper-regulated Anglo-Saxon systems. There has never

been a Bernie Madoff, Michael Milken, Ivan Boesky, or a Dennis Levine. Big financial blowups like Lehman, Bear Sterns, AIG, Enron and numerous others where investors lose their shirts don't tend to happen here. The Swiss consensus way does seem to protect the investor – at a cost. In the last 80 years, there has not been a single major bank failure in Switzerland – where investors have lost serious money. Consider the cost to investors in the wake of the S&L crisis, the petrodollar crisis, or the recent sub-prime debacle. Participants seem to understand that there are lines not to be crossed and act to restrain themselves in collective self-interest. These unwritten rules, the spirit of the law rather than the letter, are broadly respected. Simply abolishing retros, attractive though the