



Costs and charges in unit trusts

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Since the Second World War the ordinary men and women of the Western world have achieved a level of wealth beyond the dreams of their forbears. Economic growth, social advance and the widespread launch of corporate pension schemes in the 1950s – which painlessly turned the mass of ordinary people into purposeful savers – have over the last half a century delivered majority ownership of the economy to the greater part of the populations of all western nations.

These very pension schemes are now in retreat. The final salary scheme is already virtually extinct in terms of new entrants. Their replacements – skimpy “defined contribution schemes” – will not deliver the wealth accumulation to current generations which the old schemes achieved for the returning heroes of World War II and their offspring, the early baby-boomers.

Nevertheless, by any historical measure, ordinary people are astonishingly wealthy in aggregate and even reasonably wealthy as individuals. In addition to pension savings, they hold significant sums of money in insurance policies. The ordinary man who still has cash to spare after ticking those two boxes generally puts it into a unit trust: in the UK, this sector is about half the size of the pension sector.

70 years ago, 70 per cent of the UK stock market was held by a relatively few very wealthy individuals who owned shares directly. Today, 70 per cent is held by institutional investors on behalf of the population at large.

For most of the last few decades, they have been very happy (although this mood may now be on the wane). They have been so happy, that they have not spotted how badly they have been served by the investment industry.

The City of London and Wall Street are clearly the richest sectors in the UK and US economies. Other western financial centres lack the international scale of these two but emulate them in terms of economic style. Throughout the west, indeed, and – since the fall of communism and the emergence of China – throughout the world, investment bankers, corporate bankers, fund managers, private equity executives, brokers, accountants, corporate lawyers and other advisers of every hue occupy palatial offices and earn impressive salaries.

These professionals can be thought of as the “ringmaster class” in a giant circus. The ringmasters’ role is investment, or “running money”. The money they run comprises the acts which they summon into the ring. These acts are known as companies and their performers are CEOs, CFOs and chairmen (lesser corporate actors aren’t senior enough to get into the ring). Although the ringmasters are ostensibly in charge, the underlying fact is that all the performers are employees of the same circus. Therefore, there is necessarily a single pay structure and the remuneration of top corporate executives broadly matches that of top investment executives.

The business of the big top is to manage the huge aggregate wealth of the ordinary man. The privileges its performers exact for doing so are out of all proportion to its success in providing this service.

A multi-decade endeavour

Investing is a multi-decade endeavour. Ordinary man commences his investing career in his early twenties and typically completes 40 to 50 years later when he is well into his pension phase and beginning to plan the dispersal of his life-end wealth. In the meantime, he accumulates his savings with any of thousands of pension schemes, insurance companies or mutual funds.

In this cast of thousands, only the barest handful can boast a successful 50-year investment record. Success in investment requires the performer to beat the broad stock market indexes consistently. This is extraordinarily challenging to do, since the information necessary to make successful investments is available to everybody. True, its interpretation is difficult, but since the investment industry rewards employees so highly, it draws in plenty of interpretive talent. Thus competition amongst investment players is immense; and success, in terms of consistently beating the indexes, necessarily elusive.

There is a paradox here, for the common view is that the City and Wall Street are successful, and it is certainly the case that their customers have by and large done very well over the last 40 – in fact, 60 – years. What has happened over this time is not that the investment industry has performed well on behalf of its customers, but that the global economy has performed well on behalf of everybody.

Between 1900 and 1950, US equities returned 4.9 per cent a year in real terms. The UK figure was 3.0 per cent. Between 1950 and 2000, US returns rose by three quarters to 8.5 per cent and UK returns almost tripled, to 8.6 per cent.¹

These were tremendous gains. The benefits were widespread as the number of people saving meaningful amounts of money via pension schemes and life insurance multiplied.

¹ Elroy Dimson, Paul Marsh, Mike Staunton, *Triumph of the Optimists: 101 Years of Global Investment Returns* (Princeton, 2002). Other researchers’ statistics differ in detail but confirm the overall picture of accelerating wealth creation over the course of the 20th century. (A talk by Elroy Dimson on the subject is available at http://www.arrowstreetcapital.com/pdf/triump_of_the_optimists.pdf)

Table I: Returns on equities 1900-2000*

1900-1950		1950-2000		
	Real return		Real return	Nominal return§
	3.0%		8.6%	14.7%
1900	100	1950	100	100
1901	103	1951	109	115
1902	106	1952	118	132
1903	109	1953	128	151
1904	113	1954	139	173
1905	116	1955	151	199
1906	119	1956	164	228
1907	123	1957	178	261
1908	127	1958	193	ref 1 300
1909	130	1959	210	344
1910	134	1960	228	394
1911	138	1961	248	452
1912	143	1962	269	519
1913	147	1963	292	595
1914	151	1964	317	682
1915	156	1965	345	782
1916	160	1966	374	897
1917	165	1967	407	1,029
1918	170	1968	442	1,181
1919	175	1969	479	1,354
1920	181	1970	521	1,553
1921	186	1971	565	1,782
1922	192	1972	614	2,044
1923	197	1973	667	2,344
1924	203	1974	724	2,689
1925	209	1975	787	3,084
1926	216	1976	854	3,537
1927	222	1977	928	4,057
1928	229	1978	1,007	4,653
1929	236	1979	1,094	5,338
1930	243	1980	1,188	6,122
1931	250	1981	1,290	7,022
1932	258	1982	1,401	8,054
1933	265	1983	1,522	9,238
1934	273	1984	1,653	10,596
1935	281	1985	1,795	12,154
1936	290	1986	1,949	13,941
1937	299	1987	2,117	15,990
1938	307	1988	2,299	18,340
1939	317	1989	2,497	21,036
1940	326	1990	2,711	24,129
1941	336	1991	2,945	27,676
1942	346	1992	3,198	31,744
1943	356	1993	3,473	36,411
1944	367	1994	3,771	41,763
1945	378	1995	4,096	47,902
1946	390	1996	4,448	54,944
1947	401	1997	4,831	63,020
1948	413	1998	5,246	72,284
1949	426	1999	5,697	82,910
1950	438	2000	6,187	95,098
	ref 2		ref 3	ref 5

"percent better" = 6,187 / 438

= 14.1
= 1400% ref 4

*based on: Triumph of the Optimists by Dimson, Marsh & Staunton

§ nominal return = real return of 8.6% + inflation at 6.1%

It's now necessary to review some arithmetic. With returns reinvested, a sum of money invested at 8.6 per cent a year doubles every eight and a half years (see Table 1, ref. 1). This means that over 50 years – starting in say 1950 – £100 invested in the UK stock market grew to 62 times the original investment by 2000 (ref. 3).

By contrast, UK savers in the first half of the 20th century (achieving only three per cent returns) had merely quadrupled their money over 50 years (ref 2).

Savers are only dimly aware of the arithmetic behind financial returns. Vanishingly few grasp the beauty of compound interest – how 8.6 per cent, on the face of it not that much more than 3 per cent, can produce a result 1400 per cent better (ref. 4). (The 1950–2000 investor ends up with a pot of £6,187; the 1900 to 1950 investor with one of £438. £6,187 is “1400 per cent better” than £438. The disparity is even more significant if one calculates the return excluding the initial investment).

Laid on top of the mystery of compound interest was the illusion-laden miasma of inflation. The figures quoted so far are in real (or inflation-adjusted) terms, but consider them as they appeared to the saver himself. Having in 1950 invested £100 in the FT 30 share index (and having made no further investments save for reinvesting dividends), he was by 2000 receiving statements from his stockbroker which told him his 40 year investment had multiplied to £95,000 (ref 5). He knew the millennium pound had been depreciated by inflation and that he wasn't really 950 times richer than in 1950. But if he was the man on the Clapham omnibus, he probably thought he was more than 61 times richer.

It is therefore no wonder that the savers of the last 50 years, whatever suspicions they harboured about the investment sector to which they entrusted their savings, thought it was basically serving them well. Commentators and the government after all told them year after year how the City of London was the UK's most successful economic sector. No-one seriously questioned the charges it levied in the process of administering the public's savings.

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Extravagant to the point of munificence

It is easiest to talk about unit trusts because their charges are more transparent than those of other subsectors. Unit trust charges are higher than those paid by pension funds, because—among other reasons—account sizes are smaller. Nevertheless, the big picture is the same across the industry, and the trends in unit trust charges are a fair proxy for those incurred by the generality of ordinary investors.

When the UK unit trust sector got going in the 1930s, its fees were fixed by regulation to an initial charge of 3.25 per cent followed by an annual charge of half a per cent. The Board of Trade, which set these charges, was of course unaware of how investment returns would accelerate over future decades. Had the Board

possessed greater foresight, it might have additionally required that the annual service charge be deflated by a broad equity index. For instance, if the index doubled, then the annual percentage charge would be halved to a quarter of a per cent (thus generating the same fee in cash terms). After all, the progress of the index is entirely unrelated to the efforts of the investment industry, so it should gather no reward from such a trend. The concept is by no means one-sided: it would equally have protected the industry against falling markets, by doubling the percentage fee if equity indexes halved.

In a perfect world, the Board of Trade might also have recognised that the economies of scale in fund management are extravagant to the point of munificence. It takes hardly more manpower to run a £500m fund than a £50m fund. Yet at half a per cent a year, the larger fund brings in ten times the management fee.

The illustrations of equity returns quoted above are based on returns before investment management fees. They are essentially what were available to the direct investor in equities over the periods quoted. But unit trust investors (and others who invest via institutional methods) do not receive these returns. They receive returns reduced by the management fee. Some measure of fee is obviously unavoidable, but if the investment world shared its economies of scale meaningfully with its customers, the benefits for customers would be dramatic.

This is set out in Table 2, which compares how the impact of fees on four hypothetical investors who each invest £100 and receive the market return (with dividends reinvested) for 50 years. All illustrations are in real terms—that is to say, both fees and fund growth would be escalated accordingly if inflation were taken into account.

- * **Investor A** invests directly in the stock market and pays no fees. If he achieved the average 8.6 per cent return from 1950 to 2000, his eventual fund was worth £6,187 (the figure quoted above).
- * **Investor B** invests in a fund which levies an annual charge of half a per cent of his original investment. This arguably optimistic fee basis results in fees over the period of £25 but the final fund is £5,833, or £354 less than that of Investor A. In other words, the *impact of fees* over 50 years is £354. The disparity between “fees” and the “impact of fees” is due to the investor forgoing the aggregate cumulative return on the fees paid during his 50 year investment. This might seem a stingy fee basis, but it should be recognised that the investment manager (who is charging the fees) has not contributed to the growth of the fund, which is entirely due to the market return. Thus arguably (although, in the real world, admittedly—impossibly) the annual fee charged at the inception of the investment should not have grown either.
- * **Investor C** is charged one per cent of his fund each year. If the fund grows, the fee grows. This is the conventional basis of investment management fee (although typically, fees are in fact higher than one per cent). This investor pays £499 in fees. The impact of fees on his final fund is £2,291. He is 37 per cent worse off than Investor A.

Table 2: The amazing cumulative effect of investment management fees

Year	Investor A - investing directly			Investor B - paying fee fixed at 0.5% pa of original investment				Investor C - paying fee of 1% pa of growing fund				Investor D - see text			
	Fund at start of year	Market return	Fund at end of year	Fund at start of year	Market return	Fee	Fund at end of year	Fund at start of year	Market return	Fee	Fund at end of year	Fund at start of year	Market return	Fee	Fund at end of year
0	£ 100.0	£ 8.6	£ 108.6	£ 100.0	£ 8.6	£ 0.5	£ 108.1	£ 100.0	£ 8.6	£ 1.0	£ 107.6	£ 100.0	£ 8.6	£ 1.0	£ 107.6
1	108.6	9.3	117.9	108.1	9.3	0.5	116.9	107.6	9.3	1.1	115.8	107.6	9.3	1.1	115.8
2	117.9	10.1	128.1	116.9	10.1	0.5	126.4	115.8	10.0	1.2	124.6	115.8	10.0	1.1	124.7
3	128.1	11.0	139.1	126.4	10.9	0.5	136.8	124.6	10.7	1.2	134.0	124.7	10.7	1.2	134.2
4	139.1	12.0	151.1	136.8	11.8	0.5	148.1	134.0	11.5	1.3	144.2	134.2	11.5	1.2	144.6
5	151.1	13.0	164.1	148.1	12.7	0.5	160.3	144.2	12.4	1.4	155.2	144.6	12.4	1.3	155.7
6	164.1	14.1	178.2	160.3	13.8	0.5	173.6	155.2	13.3	1.6	167.0	155.7	13.4	1.3	167.8
7	178.2	15.3	193.5	173.6	14.9	0.5	188.0	167.0	14.4	1.7	179.7	167.8	14.4	1.4	180.8
8	193.5	16.6	210.1	188.0	16.2	0.5	203.7	179.7	15.5	1.8	193.3	180.8	15.5	1.5	194.8
9	210.1	18.1	228.2	203.7	17.5	0.5	220.7	193.3	16.6	1.9	208.0	194.8	16.8	1.6	210.1
10	228	20	248	221	19	0.5	239	208	18	2.1	224	210	18	1.6	226
11	248	21	269	239	21	0.5	259	224	19	2.2	241	226	19	1.7	244
12	269	23	292	259	22	0.5	281	241	21	2.4	259	244	21	1.8	263
13	292	25	317	281	24	0.5	305	259	22	2.6	279	263	23	1.9	284
14	317	27	345	305	26	0.5	330	279	24	2.8	300	284	24	2.0	307
15	345	30	374	330	28	0.5	358	300	26	3.0	323	307	26	2.1	331
16	374	32	407	358	31	0.5	389	323	28	3.2	347	331	28	2.2	357
17	407	35	442	389	33	0.5	422	347	30	3.5	374	357	31	2.3	386
18	442	38	479	422	36	0.5	457	374	32	3.7	402	386	33	2.4	416
19	479	41	521	457	39	0.5	496	402	35	4.0	433	416	36	2.5	450
20	521	45	565	496	43	0.5	538	433	37	4.3	466	450	39	2.7	486
21	565	49	614	538	46	0.5	584	466	40	4.7	501	486	42	2.8	525
22	614	53	667	584	50	0.5	634	501	43	5.0	539	525	45	2.9	567
23	667	57	724	634	55	0.5	688	539	46	5.4	580	567	49	3.1	613
24	724	62	787	688	59	0.5	747	580	50	5.8	624	613	53	3.2	662
25	787	68	854	747	64	0.5	810	624	54	6.2	672	662	57	3.4	716
26	854	73	928	810	70	0.5	880	672	58	6.7	723	716	62	3.6	774
27	928	80	1,007	880	76	0.5	955	723	62	7.2	778	774	67	3.7	837
28	1,007	87	1,094	955	82	0.5	1,036	778	67	7.8	837	837	72	3.9	905
29	1,094	94	1,188	1,036	89	0.5	1,125	837	72	8.4	900	905	78	4.1	978
30	1,188	102	1,290	1,125	97	0.5	1,221	900	77	9.0	969	978	84	4.3	1,058
31	1,290	111	1,401	1,221	105	0.5	1,326	969	83	9.7	1,042	1,058	91	4.5	1,144
32	1,401	121	1,522	1,326	114	0.5	1,439	1,042	90	10	1,122	1,144	98	4.8	1,238
33	1,522	131	1,653	1,439	124	0.5	1,562	1,122	96	11	1,207	1,238	106	5.0	1,340
34	1,653	142	1,795	1,562	134	0.5	1,696	1,207	104	12	1,298	1,340	115	5.3	1,450
35	1,795	154	1,949	1,696	146	0.5	1,842	1,298	112	13	1,397	1,450	125	5.5	1,569
36	1,949	168	2,117	1,842	158	0.5	2,000	1,397	120	14	1,503	1,569	135	5.8	1,698
37	2,117	182	2,299	2,000	172	0.5	2,171	1,503	129	15	1,618	1,698	146	6.1	1,838
38	2,299	198	2,497	2,171	187	0.5	2,357	1,618	139	16	1,741	1,838	158	6.4	1,989
39	2,497	215	2,711	2,357	203	0.5	2,560	1,741	150	17	1,873	1,989	171	6.7	2,154
40	2,711	233	2,945	2,560	220	0.5	2,779	1,873	161	19	2,015	2,154	185	7.0	2,332
41	2,945	253	3,198	2,779	239	0.5	3,018	2,015	173	20	2,168	2,332	201	7.4	2,525
42	3,198	275	3,473	3,018	260	0.5	3,277	2,168	186	22	2,333	2,525	217	7.8	2,735
43	3,473	299	3,771	3,277	282	0.5	3,558	2,333	201	23	2,510	2,735	235	8.1	2,962
44	3,771	324	4,096	3,558	306	0.5	3,864	2,510	216	25	2,701	2,962	255	8.6	3,208
45	4,096	352	4,448	3,864	332	0.5	4,195	2,701	232	27	2,906	3,208	276	9.0	3,475
46	4,448	383	4,831	4,195	361	0.5	4,556	2,906	250	29	3,127	3,475	299	9.4	3,764
47	4,831	415	5,246	4,556	392	0.5	4,947	3,127	269	31	3,365	3,764	324	9.9	4,078
48	5,246	451	5,697	4,947	425	0.5	5,372	3,365	289	34	3,621	4,078	351	10.4	4,418
49	5,697	490	6,187	5,372	462	0.5	5,833	3,621	311	36	3,896	4,418	380	10.9	4,787

Total fees**25****499****209**

Compared with Investor A:

Impact of fees in £

354

2,291

1,400

Impact of fees in %

-6%

-37%

-23%

Note 1: The effect of inflation is stripped out of all columns. The effect of including it would be to escalate all figures - both fees and funds - accordingly

Note 2: The market return for all four examples is assumed to be 8.6% pa.

* **Investor D** is “an unhappy medium”. His fee escalates, but only at five per cent per annum in real terms, based on his original investment. In other words, he pays £1.00 in year 1, £1.05 in year 2 and £1.1025 in year 3. Thus his investment manager reaps only a part of the “undeserved benefit” of the generalised rise in share values. This saves the investor £290 in total fees over 50 years, or nearly 60 per cent of the fees incurred by investor C. Nevertheless, the result of the inescapable laws of compound interest is to cost him 23 per cent of his final fund, as compared with Investor A.

In the 1930s – admittedly not a conspicuously prosperous decade in the City – half a per cent a year generated adequate fees to run the unit trust industry. By 1938, 98 unit trusts had been launched and had attracted a total of £98m of the public’s savings. These generated annual fees for their promoters of £400,000. Rendered in current money, whilst leaving out investment growth and the flow of new savings into the industry which will be considered separately, these figures may be represented as £2.6bn of funds invested in unit trusts, and annual fees of £13m (this is based on an average inflation rate between 1939 and 2007 of 4.8 per cent).

Had the half a per cent annual charge stuck, then 70 years of advances in investment indexes would by themselves have made the unit trust industry as rich as Croesus. Instead, it ended up much, much richer.

Imagine the unit trust industry had never gathered another penny from investors, and maintained its fees at half a per cent. Between 1938 and 2007, equity indices rose 89-fold. This would have multiplied unit trust funds from £2.6bn (in 2007 money terms), to £230 billion.

It need not have taken any more people to run the £230bn of 2007 than it took to run the £2.6bn of 1938. (One could argue that the headcount could have shrunk, because computers substituted for clerks over this period. However, those new compliance departments might have taken up the slack.) Half a per cent of £2.6bn is £130m, which is a hundred times more than the £13m (in 2007 money) of fees levied on the 1938 funds under management.

However, the charge of half a per cent with which the industry was launched did not stick. Charges rose, especially in the late 1980s when the government attempted to stamp out a few Spanish practices in the administration of unit trusts which had been used by promoters to fortify their income. Many mainstream UK equity trusts currently charge one and a half per cent, or three times the figure from 70 years ago. Perhaps this should be shaded modestly downwards to allow for the introduction of low-charge index funds, which represent five per cent of the unit trust market. Let’s be generous, and assume that the average annual charge for comparable mainstream unit trusts is 1.25 per cent.

And then, of course, there has been the inflow of new money. According to the Investment Management Association, as of December 2007, the aggregate value of UK unit trusts stood at £440bn. 1.25 per cent of £440bn is £5.5bn.

The following table draws these figures together.

The UK Unit Trust sector

	1938 in 2007 money	2007	Increase in real terms
Funds under management	£2.6bn	£440bn	168x*
Comparable fee rate	0.5%	1.25%	
Aggregate annual charges (2007 charge at 1938 fee rate £2.2bn)	£13m	£5.5bn	422x

*The greater part of this gain was due to advances in investment indices, not to an improved quality of service.

It is surprisingly difficult to obtain long term average earnings data for the UK to compare with this table, but a 2003 review from the Office of National Statistics ("A Century of Labour Market Change: 1990 to 2000", Lindsay), suggests strongly that between 1938 and 2000 the increase in real income experienced by the ordinary man was less than tenfold.

The table shows that fees extracted from customers have grown at two and half times the rate of funds under management (422/168). Given that index gains rather than investment skill or the inflow of new money generated much the greater element of growth in funds under management, and that this industry displays very significant economies of scale, there can be absolutely no doubt that the unit trust industry has served its customers poorly.

Oligarchy served by ordinary men

Unit trusts are not an isolated island of super-prosperity within the City. Fund managers move between unit trusts, pension funds, insurance companies and hedge funds. The latter is a standout, and individual stars will always command spectacular packages, but below them pay is similar across the three traditional branches of institutional investment. Thus the escalation in the charges made by – and cost of running – unit trusts has occurred equally across the whole of the City.

Other City subsectors have achieved parallel increases in prosperity. Investment bankers, accountants, CEOs, headhunters and lawyers have their own pay scales – some more generous than those of fund managers. But collectively, all these City professions comprise an oligarchy with a single macro pay structure.

The £1m a year CEO does not want to deal with a £100,000 a year lawyer or a £150,000 a year auditor. It is a natural state of affairs for these professionals to be earning broadly similar amounts to their clients.

In theory, institutional investors should have kept the lid on CEO pay. But to believe this to be practical would be naive. When push comes to shove, fund managers might despatch a woeful CEO. But the members of oligarchies do not attack each other, at least not in the normal course of events. In any case, the big CEO pay rises waved through in recent years by institutional investors are not paid with their own money. They are paid with their customers' money.

It's impossible to say which City subsector is the source of the rapid pay inflation of recent years in these circles. At different times, no doubt, different subsectors have driven it.

But it is clear that it is the ordinary man, who owns 70 per cent of the stock market, who is paying the high salaries and bonuses to all these players. And equally clear that he can do almost nothing about it.

Salaries in the unit trust sector have not escalated by 422 times in real terms. Some of the extra income has been deployed into marketing campaigns, more costly premises, and the input of a plethora of extra services unknown in 1938 – the price of which reflects (as is natural in such circumstances) the income available to provide them. The City is an expensive place to do business. But that is not because it needs to be expensive. It is this way because it has found the means of extracting high fees from its customers. This has inflated the cost of everything the City does.

Wrong number!

Why are customers unable to recognise that they are paying through the nose for investment services? Three broad reasons stand out:

- 1 1.25 per cent is a small number. But it is the wrong number! Customers erroneously believe the charges are small because they relate them not to what they are receiving, which is the investment return, but to what they have invested. Expressed in terms of returns, investment charges typically amount to between 10 and 20 per cent. (For instance, 1.25 per cent is 14.5 per cent of 8.6 per cent—which is the figure quoted above for UK equity returns since 1950). If this formulation was in widespread use, customers would be less willing to pay the charges levied by unit trusts.
- 2 Customers would perhaps be able to grasp the above if the investment industry was compelled to express charges in terms of returns instead of capital invested. But without basic financial knowledge they will never appreciate how compound interest works to make small differences in annual fees mount up over time into huge differences in long term investment outcomes. A £100 investment which compounds at 8.6 per cent over 50 years generates a final fund of £6,187. One that compounds at 7.6 per cent generates a final fund of £3,896, or 37 per cent less. If customers could grasp this fact they would surely beat the investment industry about the head with it. Sadly, they do not.
- 3 Underlying investment returns have been so good over the last 60 years that customers have never stopped to think whether the fees they are charged to access these returns might be unreasonable.

Times are changing

We are entering a period of leaner investment returns. Even if returns are maintained, they will have to be spread more thinly. Rapidly increasing longevity, combined with the escalating cost of old age health care, will significantly reduce the disposable income of pensioners. Ordinary man is getting this message well in

advance of feeling its effects. He knows that the closure of final salary pension schemes is a financial blow.

Ordinary man will be more inclined over the next 50 years than he was over the last 50 to examine and question what he is charged to invest his savings.

Governments should encourage this process, because it will be a key factor in alleviating the coming pension squeeze.

Here are two policy suggestions for future governments:

- 1 Institutional investors should be required to take account of their customers' views on pay and other matters and to reflect those views in their voting. This need not be a complex process.

For instance, insurance companies, unit trusts and pension funds could be required to pose the following question to their clients and members every year.

“Please indicate the stance you would like us to take when voting the interest we hold on your behalf in respect of director pay proposals. If the average director pay in a company over the last five years has exceeded its earnings growth, and we can identify no ameliorating circumstances, should we vote FOR or AGAINST director pay proposals which would have the effect of increasing average director pay at a faster rate than the consumer price index? Please tick either for or against”.

This 85 word question will provoke mirth, but it's far simpler than a lot of the small print foisted on investors. It contains three important and clear features.

- It contains the principle: “vote for or against director pay”. That's the essence of it. Everyone knows what that means.
- The trackback to earnings means pay in successful companies would be unaffected.
- It allows institutional investors to go with their own judgement where they wish to do so.

Institutions could split their votes, routinely voting say 13 per cent of its holding in favour of the remuneration report, if that was how its clients had voted, and 87 per cent against.

- 2 In the retail sector, the expression of investment charges as a percentage of the funds being managed should be forbidden. Investment charges should be expressed as a percentage of average annual return over the last five years. New funds should express their charges in the same manner, using indexes as a proxy.

The investment management business harbours two characteristics which have given its operators an exceptional free ride for many decades.

The first is that a huge component of its increasing income is not due to its provision of useful services, but to the increasing prosperity of the global economy. Traditionally, only monopolies stood in this position. Other sectors of the

economy also benefit from growing prosperity, but only by selling more goods and services. Investment managers reap a double whammy: they do sell more services, but the services they previously sold generate increases in income beyond any original expectations.

The second is that customers simply do not understand how they are charged for the services provided.

Imagine the electronics industry was charging the same price per byte now as it did 50 years ago. Therein, you have a fair parallel.

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The RSA is an Enlightenment organisation devoted to finding innovative practical solutions to today's pressing social problems. Through its 27,000-strong Fellowship it pursues its mission: to help people be the people they need to be to see the change they want in the world.

The citizens of the future will need to be self-reliant, engaged and other-regarding if they are to create a principled and prosperous society. This is nowhere more true than in financial matters. The Tomorrow's Investor project, the first stage of a prolonged RSA engagement with these issues, aims to facilitate this goal, both practically and intellectually.

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More information can be found at the RSA website: www.theRSA.org.uk