The FM Report

Ideas for Investors

A Crock of PRIIPs?

What on earth were they thinking in letting this out? How did nobody say 'Stop'?

The PRIIPs directive took effect at the start of the year and was aimed at improving disclosure to consumers. **It could hardly have failed more miserably.** Consumers are more confused than ever. But even worse, **there is every likelihood that they are being misled.**

But before getting into the specific problems with PRIIPs there is a broader issue: it only applies to a subset of investment funds. We now have most collective investment schemes being subject to the UCITS rules and obliged to show the ESMA Synthetic Risk Reward Indicator (SRRI); investment trusts and unit-linked non-pension products are bound by the PRIIPs methodology, and as yet no mandatory disclosure regime applies to unit-linked pension products.

Most of the media comment in Ireland relating to PRIIPs has centred on the way costs are presented in the *Key Information Document* (KID) and the almost universally negative commentary is well-warranted. However disastrous that may be, it is in the other aspects where PRIIPs fails most egregiously.

Performance Scenarios

Under PRIIPs there is no disclosure of past performance and whether or not one agrees, a solid argument can be made for that stance. However it is highly prescriptive in how a range of future scenarios must be represented, using the most recent 5 years as the base. This has resulted in an Irish property fund showing 'Moderate' scenario (net) returns of 11% over the next 7 years and a 'Stress' scenario return of 5%. Given that the current yield on the fund's underlying assets is in or about 5% the 'Stress' scenario does not allow for any fall in capital values – certainly not a conservative assumption.

There is a particular difficulty using past performance in relation to Fixed Interest – one fund I picked out at random is showing a 'Moderate' scenario (net) return of 2.9% over the next 7 years and a 'Favourable' scenario return of 6%. With the yield on the underlying bonds currently at little more than 1%, a net return of 2.9% requires yields to fall significantly and the 6% outcome needs yields to turn substantially negative. (The 'Stress' scenario for this fund at minus 1.9% materially understates the possible outcomes.)

The performance side of PRIIPs has particularly aggravated the UK's investment trust sector which is now required to produce KIDs. Because of strong prior performance, the **Scottish Mortgage** investment trust is obliged to show 5 year returns of 23.1% per annum under the 'Moderate' scenario and 10.7% per annum under the 'Unfavourable' scenario. Its senior independent director has publicly urged investors to burn the KID document!

In response to the widespread criticism of the performance stipulations, the UK's **Financial Conduct Authority** has said:

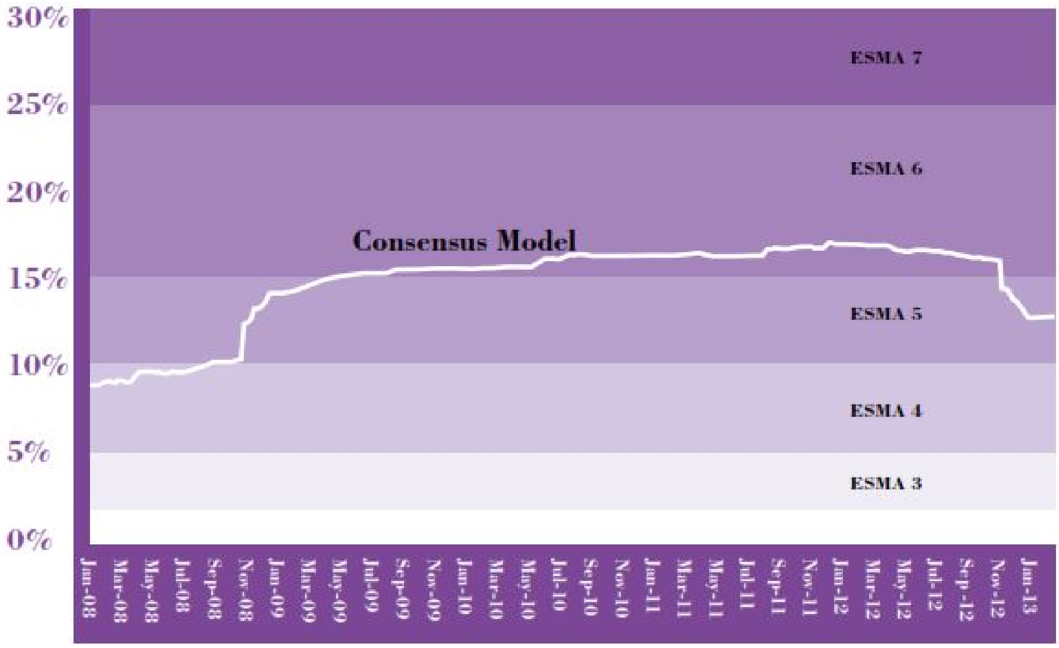
"Where a PRIIP manufacturer is concerned that performance scenarios in their KID are too optimistic, such that they mislead investors, we are comfortable with them providing explanatory materials to put the calculation into context and to set out their concerns for investors to consider." It is hard not to interpret that as acceptance that the regulations are capable of (and are) producing misleading outcomes. The **Central Bank** has said that it is:

"….aware of concerns regarding the methodologies required to be used in the performance scenarios under the PRIIPs Regulation".

Risk Representation

Like the ESMA SRRI measure, PRIIPs relies on return data over the previous 5 years. The PRIIPs measure suffers from the same fundamental flaw as the ESMA SRRI – it is not likely to be stable enough and has substantial potential to under-represent risk.

The problem is well-illustrated by the Consensus funds during the last decade:



These funds were rated in **band 4** in early 2008 – at which stage they were likely to be seen as 'medium' risk based on a scale of 1-7. As the markets moved into and through the crash the rating rose to **band 6**, at which stage investors had seen losses of c. 45%.

This potential to migrate up and down the risk spectrum over time is a huge deficiency of both ESMA and PRIIPs. Apart from this, we see raving anomalies within the same period - the PRIIPs risk measure shows the Property fund quoted in the previous section in risk **band 2** on a scale 1-7, (with '1' being the lowest risk). Most consumers would take this as being quite low risk and might be very surprised to learn that the fund dropped 70% during the last decade! Bizarrely, the Fixed Interest fund referred to earlier is rated a '3', as in, more risky than the Property fund!

Costs

How PRIIPs deals with costs could support an article in its own right. The most egregious part of the methodology is how it deals with portfolio transaction costs: these can, miraculously, be negative! This arises because the methodology captures price movements between the time orders are placed and when they are executed, surely an area subject to a great deal of randomness. The idea that transaction costs can be negative and represented as such with official sanction must leave consumers scratching their heads – and wondering how credible the other figures must be?

Some of the confusion around cost disclosure arises from life companies making different assumptions about holding periods (generally 7 years but some have gone for 5 years) and the treatment of the 1% levy. One would imagine that some form of standardised approach to these issues will evolve, at least ironing out those wrinkles. Some of the other things which obstruct comparison will probably persist, being product/provider specific.

In what probably summarises the madness of the situation, Ian Sayers, head of the UK's **Association of Investment Companies**, said:

'I must be one of the few chief executives of a trade association who has been inundated with complaints from his members that a regulator is forcing them to overstate their performance and understate their risks'.

In almost any other walk of life heads would surely have rolled over PRIIPs by now. It has rare to find something which has almost no redeeming features beyond the very good intentions with which it set out. For once I feel sorry for the life companies who were forced to commit very large amounts of time and money getting onto the PRIIPs train….to nowhere.

Author:Paul McCarville,Principal of Clarus Investment Solutions, an independent investment consulting firm regulated by the Central Bank of Ireland

Published March 2018 on the The FM Report.