MiFID II: costs and charges Q&A

The introduction of MiFID II regulations in January 2018 has changed the way costs and charges are presented for funds.

At LGIM, we believe our fees have always been competitive and we are mindful that this new regulation has caused widespread confusion amongst investors at all levels. It is clear that one of the issues investors now face is how they compare investment products. Different firms have used different methodologies, making comparisons based on costs impractical.

Over time there will be some convergence of methodologies across the industry and we will continue to provide support and clarity directly to platforms and our clients, whilst fulfilling our regulatory obligations.

We have produced a Q&A (below) to help address some of the questions you may have but if you require any assistance about costs and charges or assessing the products at LGIM, please contact the Sales Support Team on **0345 070 8684** or email **fundsales@lgim.com**

WHAT DO THE MIFID II REGULATIONS MEAN FOR COSTS AND CHARGES DISCLOSURE?

The regulations have changed the way costs and charges are presented for funds. These changes apply to all asset management transactions where there is a cost of investing money in the market.

IS THIS A CHANGE TO THE COSTS A CLIENT PAYS?

No, it's a regulatory change to how costs are calculated and displayed. There is no change to the costs a client pays.

WHAT ARE EX-ANTE COSTS?

These are the expected costs and associated charges of the fund.

WHAT ARE EX-POST COSTS?

These are the actual costs incurred in the fund. Ex-post costs will be provided from February 2019 for costs incurred in 2018.

WHAT ARE THE TRANSACTION COSTS?

Transaction costs are the costs associated with buying and selling the securities within the fund. There are two types of transaction costs: explicit costs and implicit costs.

WHAT IS AN EXPLICIT COST?

This is a cost charged to and paid directly by the fund to purchase and sell financial instruments. It includes broker commission, transaction taxes and exchange fees.

WHAT IS AN IMPLICIT COST?

Implicit costs are not easily observable making them hard to quantify. They include transaction costs embedded in the bid-offer spread and the response of the market to a trade or the timing of a trade (market impact, opportunity cost, delay costs).

In the methodology set out in the PRIIPs (Packaged Retail and Insurance-based Investment Products) regulations, implicit costs are the difference between the mid-market price of an asset at the time the order is placed in the market (the "arrival price"), and the price at which the deal is struck. The implicit cost can be either positive or negative, and can vary greatly depending on the liquidity of the financial instrument.

Firms are obliged to use the arrival price methodology from January 2018. For transactions prior to that the regulations allow different approaches to estimate the costs.

Legal & General INVESTMENT MANAGEMENT

WHAT IS INCLUDED IN THE TRANSACTION COSTS FIGURE?

- Brokerage commissions
- Transaction taxes and stamp duty
- Exchange fees
- Implicit costs
- Clearing charges
- Anti-dilution offset
- Indirect transaction costs (costs incurred by any funds held)

WHAT IS AN ANTI-DILUTION OFFSET?

Funds typically have a pricing mechanism that offsets the impact of transactions caused by cash flow into or out of the fund to the existing investors such as a fund spread. The amount of benefit to the on-going holders of the fund collected through such anti-dilution mechanisms is used to offset the transaction costs incurred.

WHAT ARE THE DIFFERENT METHODOLOGIES FOR CALCULATING TRANSACTION COSTS?

Different firms will use different methodologies for periods prior to the regulations coming into effect.

Fund managers have four options to calculate their costs and charges depending on which price point was available.

The **Arrival Price** is the mid-market price captured at the time the decision to trade is made. The difference between the arrival price and the price at which the trade was executed is the implicit cost.

The **Opening Price** is the price available at the opening of trading on the day the decision to trade is made. The opening price is used when the arrival price is not available.

The **Closing Price** is the final price calculated on the trading day before the decision to trade is made. The closing price is used if neither the arrival price nor the opening price are available.

The final methodology is to use a **Fixed Fee Table** where the transaction costs for each asset class are calculated by multiplying half of the estimated spread by the portfolio turnover.

WHAT METHODOLOGY ARE YOU USING TO CALCULATE TRANSACTION COSTS?

For funds with over one year of history we are using arrival prices for equities, bonds and FX. The closing price methodology is used for OTC derivatives while the fixed fee table is used for exchange traded derivatives. For funds with under one year of history we are using the fixed fee table.

WILL THE CLIENT PAY THE TRANSACTION COSTS?

Transaction costs are not paid directly by the client but have always been charged to the fund, and effectively reduce the returns achieved by the fund. Under the new rules we are disclosing these costs to improve the transparency of the funds, and ensure customers understand what they are paying for.

WILL THE REGULATIONS INTRODUCE ONE METHODOLOGY TO ALLOW INVESTORS TO COMPARE COSTS AND CHARGES?

Yes. For transactions executed from January 2018 all fund managers must use the Arrival Price methodology where possible.

WHY DO YOU SHOW A NEGATIVE TRANSACTION COST FIGURE?

The transaction cost figure includes an element of implicit cost (“slippage”) which is the difference between the **mid-market price at the time the trade** is sent to the market (“arrival price”) and the eventual execution price of the trade.

It is possible for the slippage cost to be negative; for example when buying an asset the arrival price might be higher than the actual price paid.

Another reason transaction costs might be negative is if the anti-dilution offset, the spread collected by the fund when people buy or sell so that the existing fund holders do not suffer their transaction costs, is higher than the actual costs incurred. This might happen, for example, if the fund manager is able to invest the inflow in new issues which do not incur any transaction costs or cross trades at mid.

It might be counter-intuitive to show negative transaction costs, but the rules and guidance are clear that this is the methodology that must be followed.

WHY ARE THE TRANSACTION COSTS FOR THE UK PROPERTY FUND SHOWING AS NEGATIVE?

The transaction costs for the UK Property Fund are showing as negative due to the fact that the fund has recently had an influx of new investments. The spread paid by these investors when buying units should offset the resulting transaction costs, however the fund has not yet incurred all the costs associated with placing that money in the market (i.e. when further properties are purchased) so currently the transaction costs are shown as negative.

WHY IS THE OCF FIGURE QUOTED IN THE EUROPEAN MIFID TEMPLATE (EMT) DIFFERENT TO THAT QUOTED ON FACTSHEETS AND THE WEBSITE?

We have to calculate the figures under different regulations, which are not exactly aligned. The OCF published on Fund documentation, such as a factsheet, is calculated under the methodology set out in guidance for the UCITS Directive.

The on-going charges figure in the EMT is different because under the MiFID/ PRIIPs methodology other charges are included such as financing costs (bank interest charges, repo interest paid) and property costs (maintenance and repair fees, property management fees, letting costs and legal fees related to running properties).

WHAT COSTS ARE INCLUDED IN THE EMT OCF WHICH ARE NOT INCLUDED IN THE OCF QUOTED IN FUND DOCUMENTATION?

- Bank overdraft interest
- Repo interest paid
- Income from security lending retained by the firm
- Ongoing charges from any funds, REITs, investment trusts held by the fund, or proxies where the actual charges are not available
- Costs in regard to the purchase and sale of real property and on-going maintenance costs.

WHERE CAN I FIND THE COSTS AND CHARGES FOR LGIM RETAIL FUNDS?

The costs and charges are included in our EMT which can be found on our Adviser Site along with some guidance on how to view your investment in light of these changes.

MiFID II: costs and charges – what to consider when assessing the value of your investment

While the inclusion of transaction costs will make some funds seem more expensive, they should not be read in isolation. These transaction costs have always been reflected in the fund performance which also needs to be considered. Certain investment strategies will incur higher transaction costs through higher fund turnover which may be generating better performance.

MiFID II: costs and charges – how to calculate the full cost of your investment

To calculate the overall cost applicable to each fund you will need to add the ongoing cost to the transaction cost.

Please note:

For funds less than a year, we will assess the most suitable methodology for each fund dependent on what is most consistent with the spread. In some cases we have chosen to use the worst case scenario so as to not overestimate performance.

Costs and charges will differ for index and active funds and higher costs can result in better performance so should not be looked at in isolation.

We will continually be updating the information as we speak to clients and receive your feedback