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The Danish FSA

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Active/passive management in Danish UCITS

Background

In September 2014, the Danish FSA published an analysis of the management of equity sub-funds in Danish UCITS[1]. The analysis was based on reports of the financial measures, *active share* and *tracking error,* at the end of 2013, and it included 188 equity sub-funds.

According to their prospectuses, all 188 sub-funds were following an active management strategy in order to achieve a higher return than the underlying benchmark index.

The two financial measures, *active share* and *tracking error,* show how closely a portfolio coincide with the underlying benchmark index, and how the return of a portfolio fluctuates compared with the benchmark index, respectively.

The analysis showed that 56 of the 188 sub-funds had an active share of less than 60% combined with a tracking error of less than 4%. According to the wide internationally accepted measures, this indicated that the sub-funds were not necessarily following an active investment strategy. At the same time, on the basis of further analyses and interviews with the industry, the Danish FSA reported that a number of sub-funds would be asked to justify their choice of strategy, including whether the sub-funds, in the light of the two financial measures, were actually being actively managed.

Investigation by the Danish FSA of potentially passive sub-funds

Subsequently, from November to December 2014, the Danish FSA engaged in a dialogue with the investment associations, the Danish Investment Fund Association (IFB). On the basis of this dialogue, in connection with its call for evidence, the Danish FSA decided to lower the criterion for low active share from 60% to 50%. This decision was made considering that sub-funds which

[1]Market developments 2013 Danish UCITS etc.

use narrow benchmarks have more difficulty achieving a high active share, as their investment universe is smaller.

Following similar considerations, the criterion for low tracking error was changed from 4% to 3%. This decision was made because the low volatility on the stock markets in recent years had lowered the level of tracking error, and this is an indication of the difference in fluctuations in the return compared with the underlying benchmark index.

Furthermore, the Danish FSA chose to focus on the three-year gross additional return of the sub-funds, i.e. the return before costs, compared with the return on the underlying benchmark index. The Danish FSA set this threshold at +/- 3 percentage points. In the opinion of the Danish FSA, both a positive and a negative gross additional return of less than 3 percentage points can indicate insufficient active management or potential passive management.

The result was that the number of sub-funds in focus in the investigation was reduced from 56 to 22. Thus, all 22 sub-funds had an *active share* and *tracking error* of less than 50% and 3%, respectively, and the three-year gross return of the sub-funds was within the interval +/- 3 percentage points compared to the return on the underlying benchmark index.

In January 2015, the Danish FSA contacted the boards of the 22 sub-funds. Of these, nine sub-funds were investing in the Danish stock market. In this connection, if the portfolio composition and gross return of the sub-funds coincided largely with their underlying benchmark index, the boards were asked to justify their choice of active management by the end of March 2015. The basis for this was to assess whether there were grounds for further supervisory measures against the sub-funds identified.

All the UCITS reported back that, in their view, the financial measures should not stand alone. The general view of the boards was that the relevant sub-funds were actively managed because there is ongoing monitoring and follow-up on the return of the sub-funds. Particularly with regard to the Danish stock market, the boards emphasized that the market is concentrated on few large stocks. Combined with the diversification rules for UCITS, according to the reports, it is therefore difficult for a sub-fund investing in Danish stocks to achieve a portfolio that deviates significantly from the underlying benchmark index, i.e. achieve a high active share.

The boards also stressed that, if a sub-fund did not yield a sufficient return, the board of the sub-fund would reconsider their choice of portfolio manager and possibly contemplate replacing their portfolio manager.

The reports also stated that investors did not request passively managed products and that the boards therefore did not wish to shift from actively managed sub-funds to passive management.
On the basis of the reports received, with regard to the 22 sub-funds, the Danish FSA has made individual assessments as to whether there was a basis for supervisory actions, either as orders or reprimands. Generally, in each case, the Danish FSA has assessed that there was not sufficient basis for this.

Note that six of the 22 sub-funds no longer exist as independent sub-funds; they have either merged into other sub-funds or been liquidated.

International focus on active/passive management

Internationally, both the *European Securities and Markets Authority (ESMA)* and several national supervisory authorities in the EU are focusing on this issue. In February 2016, ESMA published a statement concerning active/passive management[2]. Furthermore, ESMA has stated that it wishes to engage actively in additional analyses in this area, and that, together with the national competent authorities, ESMA is ready to take the steps necessary to ensure that all market participants comply with the regulatory requirements.

In May 2015, ESMA set up a task force for the purpose of national knowledge-sharing about this issue as well as further development of the method for analysis of the management behavior of equity funds. The Danish FSA is represented in this task force.

Current focus of the Danish FSA

In November 2015, the Danish Investment Fund Association adopted a recommendation for its members concerning publication of active share and tracking error in the annual reports of the UCITS. The Danish Investment Fund Association recommends that funds with sub-funds with active share less than 50 percent and tracking error less than 3 percent, respectively, in their annual reports, describe how the scope of active management coincides with the return goals of the funds, their investment universe, level of risk and other relevant parameters.

The Danish FSA has reviewed the annual reports for 2015 for the 35 equity sub-funds which are considered in non-compliance with the criteria. Against this background, the Danish FSA will contact selected UCITS to obtain more information about board considerations about these sub-funds, including with regard to possibly switching to passive management.

[2] https://www.esma.europa.eu/sites/default/files/library/2016-165_public_statement_-_supervisory_work_on_potential_closet_index_tracking.pdf