

MEMO TO THE BOARD OF DIRECTORS: CLOSET INDEXING

DATE: SEPTEMBER 2019

On 18th July 2019, the Central Bank of Ireland (“CBI”) published the results of a thematic review it conducted on Irish regulated UCITS to identify cases where a UCITS described to investors as “actively managed”, and which charged fees for such a service, was actually performing close to the performance of an index, without proper disclosure as such.

There were 57 cases of insufficient disclosure to investors identified by the CBI during the review.

In the first half of this memo, highlighted are the key points from the results of the CBI’s published review for Directors to be most aware.

In the second half of this memo, there is an analysis template which can be used to demonstrate whether the fund is actively managed or if it is passively tracking a benchmark, including actions which must be taken if the fund is determined to be passively managed.

CBI Thematic Review	
High Level Findings	Key Points for Board Directors
1. Investors given insufficient or inaccurate information in the Prospectus and KIID to enable investors to make an informed decision on their investment in the UCITS	<ul style="list-style-type: none"> a. Prospectus and KIID disclosures must accurately describe the true nature of the investment strategy ie: Is it active or passive b. Information in Prospectus and KIID must be consistent with other fund documents, specifically marketing material c. If index tracking, Prospectus and KIID should disclose that they are operating in a risk-managed, constrained manner with risk limits in place, limiting the UCITS’s ability to deviate from the benchmark

High Level Findings (continued)	Key Points for Board Directors (continued)
2. Poor governance and controls by Boards of UCITS	<ul style="list-style-type: none"> a. Ensure sufficient review and oversight of offering documents b. Board minutes must contain sufficient evidence of challenges by the Board of a chosen investment strategy c. Prior to approval, complete thorough review of proposals of management fees in excess of the UCITS's outperformance of benchmark d. Ensure sufficient oversight of the distribution and investment strategy e. Regular assessment of (i) is performance in line with the service that investors are paying for; and (ii) are fees in line with the actual level of active management?
3. Multi-manager UCITS – performance very similar to index	Board to consider if use of multi-manager approach results in strong correlation to an index, and if so, are active management fees appropriate in such case?
4. The fee charged in certain share classes is greater than the outperformance against the benchmark, thus cancelling out any outperformance achieved	Ensure investors in all share classes realise a positive return against the benchmark
5. KIID does not include relevant benchmark disclosure	Ensure full disclosure to allow investors to determine from the KIID if investment in the UCITS is good value relative to the benchmark
6. Fund Management Companies Guidance requires annual investment manager presentation to the Board of the UCITS	<ul style="list-style-type: none"> a. Board to consider if the UCITS delivered on its investment objective and does it remain a viable and suitable investment for investors? b. Consider the performance, fee structure and investor base c. The review of the presentation should be documented

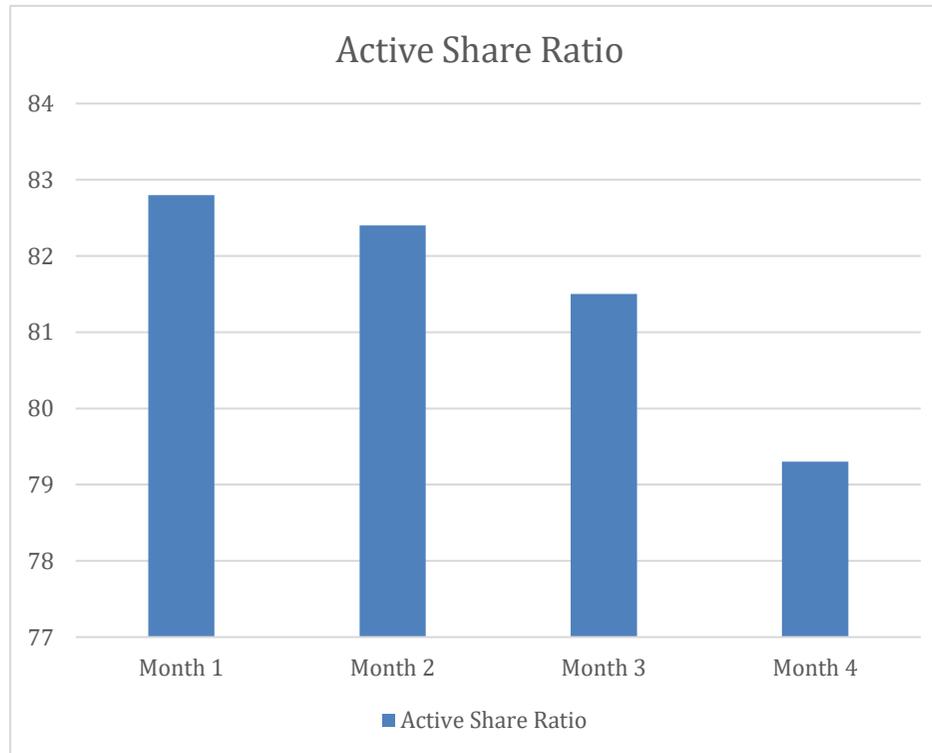
Below is a two-part template which can be used (i) by the investment manager to assess if a Fund is a closet tracker or is actively managed; and (ii) by the Directors to consider what actions need to be taken thereafter.

1. Active Management Analysis																
1. (a) Investment Strategy	<p>Q: <i>What is the Fund's investment strategy?</i></p> <p>Q: <i>Is it documented in the prospectus or KIID that the Fund will track or benchmark an index?</i></p> <p>Q: <i>Will the Investment Manager's investment decisions be influenced by a benchmark or index?</i></p>															
<p>1. (b) Perform an active management analysis to ascertain/demonstrate if the metrics indicate that the Fund is actively managed. The analysis should consider 4 key metrics:</p> <p>(i) Performance tracking to benchmark(s)</p> <p>(ii) Monthly Active Share Ratio</p> <p>(iii) 3 year Rolling Tracking Error</p> <p>(iv) 3 year Rolling Beta</p>	<p>1. (b) (i) <u>Performance tracking to benchmark(s):</u></p> <p>A passive strategy would tend to track an index and therefore the historical performance line of the Fund and the benchmark(s) would be the same.</p> <p>Q: <i>Conduct a review of the Fund's 3 year Rolling Performance versus the benchmark(s) demonstrating on a line chart.</i></p> <div style="text-align: center;"> <table border="1" style="margin: 10px auto;"> <caption>Fund vs Benchmark Data</caption> <thead> <tr> <th>Month</th> <th>Fund</th> <th>Benchmark</th> </tr> </thead> <tbody> <tr> <td>Month 1</td> <td>4.5</td> <td>2.5</td> </tr> <tr> <td>Month 2</td> <td>2.5</td> <td>4.5</td> </tr> <tr> <td>Month 3</td> <td>3.5</td> <td>1.8</td> </tr> <tr> <td>Month 4</td> <td>4.5</td> <td>2.8</td> </tr> </tbody> </table> </div>	Month	Fund	Benchmark	Month 1	4.5	2.5	Month 2	2.5	4.5	Month 3	3.5	1.8	Month 4	4.5	2.8
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1. (b) (ii) Monthly Active Share Ratio

The active share ratio is one of the most common metrics used to measure active management. The ratio can range from 0 (identical to the benchmark), to 100 (completely different to the benchmark). A passive strategy would typically have a ratio of between 0 and 25.

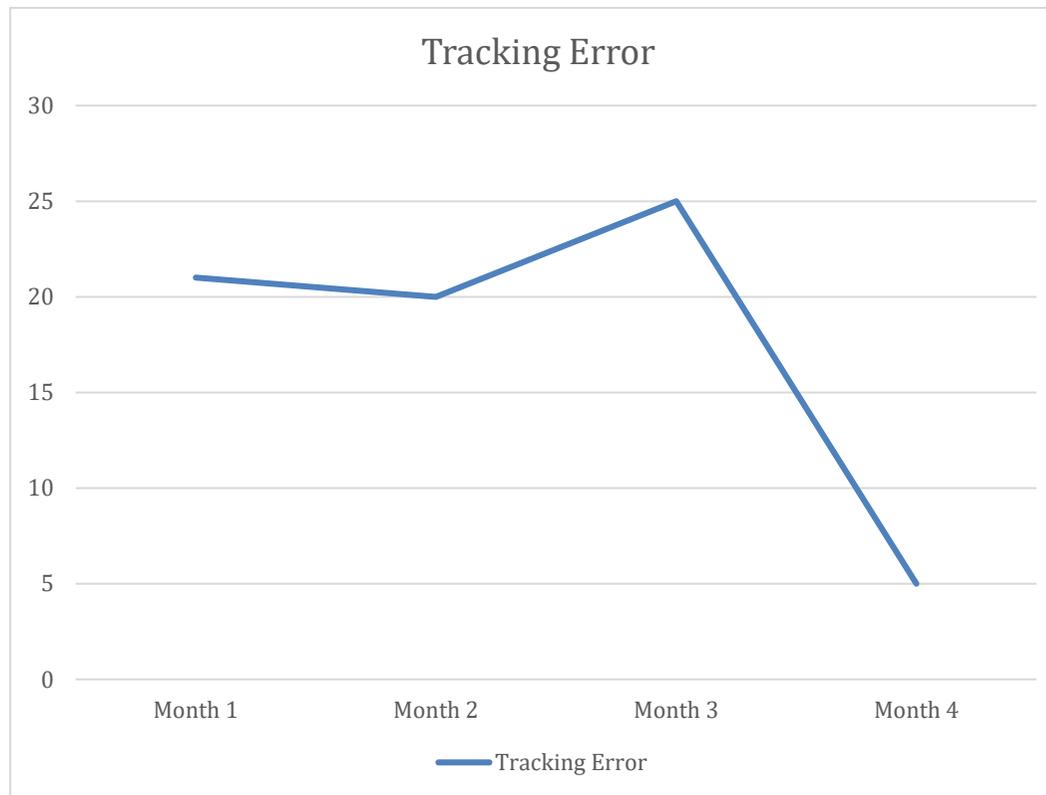
Q: What is the Fund's Active Share Ratio compared to the benchmark(s)? Demonstrate on a bar chart.

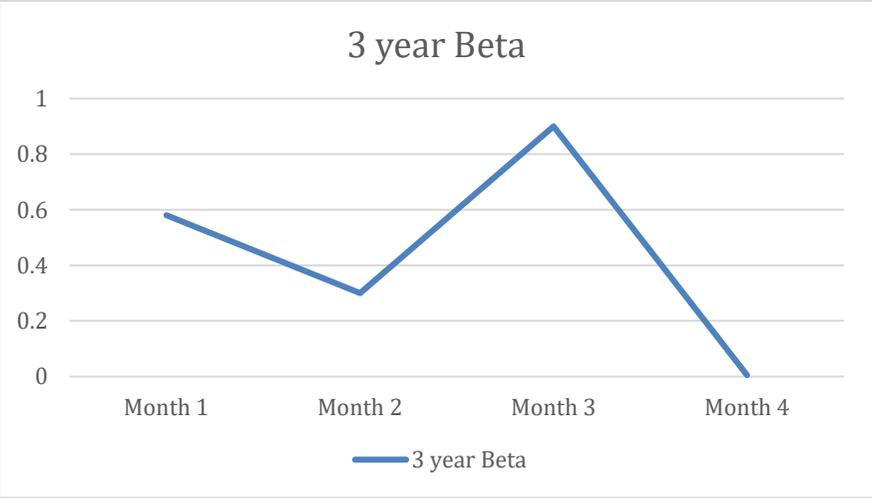


1. (b) (iii) 3 year Rolling Tracking Error

Tracking Error is a time series metric which measures the relative volatility between the portfolio and the benchmark. Passively managed funds would have a low tracking error. A high tracking error would indicate high relative volatility demonstrating low correlation to the benchmark(s).

Q: What is the Fund's Tracking Error to the benchmark(s)? Demonstrate on a line chart



	<p>1. (b) (iv) 3 year Rolling Historical Rate</p> <p>Beta is a relative measure of dispersion. A passively managed fund would track closely to the benchmark and have a beta near 1. Lower than 1 would indicate low relativity to the benchmark.</p> <p><i>Q: What is the Beta of the Fund compared to the benchmark(s)? Demonstrate on a line chart</i></p>  <table border="1" data-bbox="678 501 1550 999"> <caption>3 year Beta Data</caption> <thead> <tr> <th>Month</th> <th>Beta</th> </tr> </thead> <tbody> <tr> <td>Month 1</td> <td>0.58</td> </tr> <tr> <td>Month 2</td> <td>0.30</td> </tr> <tr> <td>Month 3</td> <td>0.90</td> </tr> <tr> <td>Month 4</td> <td>0.00</td> </tr> </tbody> </table>	Month	Beta	Month 1	0.58	Month 2	0.30	Month 3	0.90	Month 4	0.00
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<p>1. (c) Conclusion from the Active Management Analysis</p>	<p><i>Q: Based on the results of the analysis, is the Fund actively managed or is it passively tracking the benchmark(s)?</i></p>										

2. CBI Letter Requirements – actions to take following Active Management Analysis	
Instruction as per the CBI Letter:	For consideration by Board of Directors following the conclusion of the Active Management Analysis:
2. (a) Information in Prospectus and KIID must be consistent with other fund documents, specifically marketing material	<i>Ensure KIIDs and prospectus are consistent with each other.</i>
2. (b) <ul style="list-style-type: none"> (i) Prospectus and KIID disclosures must accurately describe the true nature of the investment strategy ie: Is it active or passive? (ii) If index tracking, Prospectus and KIID should disclose that they are operating in a risk-managed, constrained manner with risk limits in place, limiting the UCITS's ability to deviate from the benchmark (iii) Ensure full disclosure to allow investors to determine from the KIID if investment in the UCITS is good value relative to the benchmark 	<i>If constrained to a benchmark or if there is a target performance above a benchmark, the necessary disclosures as per the CBI letter should be contained in the Fund's KIIDs and prospectus.</i>
2. (c) Ensure investors in all share classes realise a positive return against the benchmark	<i>Perform a review of the fees charged on share classes to assess if they are appropriate for a targeted level of performance above the benchmark(s).</i>
2. (d) Multi-manager passive UCITS	<i>Board to consider are active management fees appropriate in such case?</i>
2. (e) Deadline for updates to prospectus and KIIDs	<i>Necessary updates to KIIDs and prospectus to ensure compliance with ESMA Q&A and the CBI letter are to be submitted to the CBI by 31st March 2020.</i>

Further to the assessment above, below are actions for the Board of Directors to consider at fund set up and on an annual basis:

At Fund set-up:
<ul style="list-style-type: none">– Ensure sufficient review and oversight of offering documents– Board minutes must contain sufficient evidence of challenges by the Board of a chosen investment strategy– Prior to approval, complete thorough review of proposals of management fees in excess of the UCITS’s outperformance of benchmark– Ensure full disclosure in KIIDs to allow investors to determine from the KIID if investment in the UCITS is good value relative to the benchmark
On an annual basis:
<ul style="list-style-type: none">– Board minutes must contain sufficient evidence of challenges by the Board of a chosen investment strategy– Ensure sufficient oversight of the distribution and investment strategy– Regular assessment of (i) is performance in line with the service that investors are paying for; and (ii) are fees in line with the actual level of active management?– Ensure investors in all share classes realise a positive return against the benchmark– Board to consider if the UCITS delivered on its investment objective and does it remain a viable and suitable investment for investors?– Consider the performance, fee structure and investor base– The review of the presentation should be documented