

**EFAMA's Report on ESMA's  
supervisory work on potential closet index tracking  
6 July 2016**

**Executive Summary**

- ESMA's work on closet indexing raises legitimate questions about the quality of information given by funds that are not actively managed but claim to be actively managed. The difficulty in addressing this problem relates to the identification of this type of funds. Indeed, **a wide range of factors must be taken into account to assess whether a fund is being actively managed**, including the fund's objectives and the extent to which the stated investment policy allows to take risks, the research efforts to build the fund portfolio, the reference investment universe, the investment's strategy and style, and the degree of freedom available in relation to a benchmark when a reference to a benchmark is made. All these considerations should be looked at in the context of the portfolio being assessed as well as its evolution over time. Consequently, it is too simplistic to rely on a few quantitative criteria to identify closet index funds.
- Regarding the use of active share, which is typically used for measuring how much the holdings of equity funds differ from their comparative benchmark at a particular point in time, numerous research papers have highlighted the limitations of this criterion as a stand-alone concept to measure the activeness of a fund.
  - **The level of active share is highly dependent on the benchmark selected.** The literature shows that the level of active share varies very much with the number of constituents of the benchmark, its concentration level and capitalization size. These characteristics impose various constraints on the ability of a fund manager to achieve a high active share.
  - **Active share can only be measured in relation to a specific benchmark.** Hence, if the fund does not follow a specific benchmark, the use of active share requires the choice of an index among a set of possible indices. Obviously, this leaves ample room for interpretation.
  - **The concept of active share has other limitations.** Active share measures the similarity of a portfolio to a benchmark at a single point in time. Hence, active share may change considerably depending on when it is measured. This is especially true because market conditions play an important role in the evolution of active share over time.
- **Investors are not necessarily better off selecting high active share managers**, for the following reasons:
  - Active share reflects the similarities of the holdings of a fund to those of an index, and not outcomes.
  - Active share does not predict fund performance and is not sufficient to find managers who outperform their benchmarks.
  - Active share neglects considerations of the risk involved, and can result in outperformance but also significant under-performance.

- Placing great importance to a given level of active share could create an environment where fund managers are under pressure to adjust their investment strategy with the aim of exceeding a certain threshold.
  - A too high active share can indicate a problem about the appropriateness of the selected index as benchmark.
- **The use of a pre-defined threshold for active share as a tool to identify potential closet index funds raises serious questions.** It is indeed widely accepted that small-cap funds, funds with small AuM, and funds with a diversified benchmark are all more likely to have higher active share. It is therefore much easier for these funds to achieve a high active share than for large funds, large-cap funds or funds benchmarked for example to single-country markets in which a few companies represent a sizeable part of the index. Retaining a single threshold would therefore end up favouring some investment styles over others.
  - **The use of active share with tracking error also poses problems.** Indeed, whilst low active share and low tracking error may point out that a fund is not actively managed, it is also true that there are funds that combine a low active share and a low tracking error and are truly actively managed. Research has also shown that funds with high active share and high tracking error are not necessarily performing better than funds with lower active shares and tracking errors. Finally, if a threshold is set for the tracking error, fund managers may be tempted to take more risk with the aim of exceeding the threshold.
  - If national competent authorities wish nevertheless to use active share and tracking error, EFAMA strongly agrees with ESMA that **a fund-by-fund analysis based on a wide range of quantitative indicators and qualitative considerations is required** before the authorities can decide that a fund with a low active share and low tracking error that identifies itself as being actively managed, should be considered as a closet index fund given the information provided in the fund KIID.
  - Despite the difficulty in identifying closet index funds, **EFAMA agrees that a potential gap between the information provided by fund managers about the fund management service they provide and the service they in fact offer, does deserve due consideration.** Indeed, fund managers should not give the impression that they are providing a more active fund management than they do in practice.
  - In EFAMA's view, **the current UCITS regulatory framework already provides a good basis to ensure that investors will receive appropriate information** to achieve this objective. In this context, we would recommend that fund managers take particular care in making sure that they are fully compliant with those regulatory requirements and are ready to respond to enquiries from national supervisors in this respect.
  - EFAMA also recognizes **that there may be a need to clarify the practical interpretation of some of the already existing legal requirements** to foster legal clarity and avoid diverging interpretations, as rightly pointed out by ESMA in its Statement. We are currently looking into this matter and will be happy to share its conclusions with ESMA in due course and to support ESMA's work in this respect.

## 1. Introduction

EFAMA has carefully reviewed ESMA’s statement “Supervisory work on potential index tracking”, which sets out research to determine whether any indication of closet indexing could be found at EU level.<sup>1</sup> We welcome the overarching rationale of this work – to ensure the effectiveness of investor disclosure and the legitimate expectations of investors in respect of the service provided by asset managers. Investor protection is beyond question at the heart of the asset management industry’s priorities, and it is in this spirit that EFAMA hopes to positively contribute to the debate on potential closet index tracking.

Following a brief introduction on the methodology used by ESMA, section 3 highlights the limits of identifying closet index funds through a statistical analysis, drawing on recently published research papers.

Section 4 takes this analysis one step further by discussing how national competent authorities can identify closet index funds and whether there is a need to respond to closet indexing by clarifying and/or improving the current regulatory rules on fund disclosure.

## 2. ESMA’s analysis of closet indexing

ESMA used three different sets of metrics to identify potential closet indexing funds:

- **Active share**, which shows the percentage of the portfolio of a fund that does not coincide with the underlying benchmark.
- **Tracking error**, which shows the volatility of the difference between the return of the fund and the return of its benchmark.
- **R<sup>2</sup> ratio**, which shows the correlation between the fund performance and the performance of the fund’s benchmark.

ESMA noted that “*low active share and low tracking error indicate that the portfolio of a fund is close to that of the respective index, which could be a sign for passive fund management*”.

ESMA classified as potentially being closet indexers three categories of funds:

- Funds with an active share of less than 60% and a tracking error of less than 4%. According to ESMA, this approach is based on academic research and is used by consumer organisations such as Finance Watch.
- Funds with an active share of less than 50% and a tracking error of less than 3%. According to ESMA, this set of metrics could be more indicative in Member States with relatively small equity markets.

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<sup>1</sup> See [https://www.esma.europa.eu/sites/default/files/library/2016-165\\_public\\_statement\\_-\\_supervisory\\_work\\_on\\_potential\\_closet\\_index\\_tracking.pdf](https://www.esma.europa.eu/sites/default/files/library/2016-165_public_statement_-_supervisory_work_on_potential_closet_index_tracking.pdf)

- Funds with an active share of less than 50% and a tracking error of less than 3% and a R<sup>2</sup> of more than 95%. According to ESMA, R<sup>2</sup> was used as a third criterion to further sharpen the analytical focus.

### 3. Demystifying active share

This section analyses the role that active share has taken in identifying potential closet indexing, and highlights the limitations of an active share figure considered in isolation. Having reviewed academic literature and thoroughly analysed and discussed the issue with our members, EFAMA hopes to constructively build on, in ESMA's own words, the "*limitations of the quantitative analysis*".

#### 3.1. The concept of active share

Active share is typically used for measuring how much the holdings of equity funds differ from their comparative benchmark at a particular point in time. It is generally agreed that the use of active share cannot be generalized to other types of funds.

Active share is calculated as the sum of absolute differences between the weights of securities in a given fund and the weights of securities in the benchmark, divided by 2, i.e.

$$\text{Active share} = \frac{1}{2} \sum_{i,N} |w_{fund,i} - w_{benchmark,i}|,$$

where  $w_{fund,i}$  and  $w_{benchmark,i}$  are the weights of asset  $i$  in the fund and the benchmark, respectively, and  $N$  is the number of assets held in either the fund or the benchmark.

A fund with an active share of 100% has no common holdings with the index at the time the active share is calculated, whereas a fund with an active share of 0% is identical to the benchmark.

A core requirement of calculating active share is data on the assets weights of the benchmarks. In general, all positions, including cash, bonds and underlying assets in other funds, which may be part of the portfolio or part of the index, should be taken into account. Derivatives should also be incorporated even if the calculation is more complex.

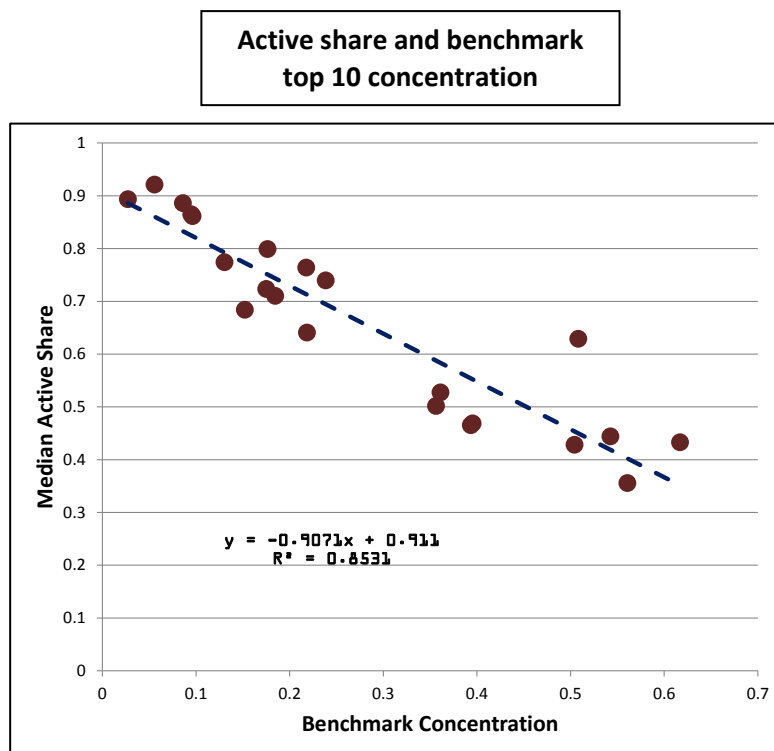
##### 3.1.1. Active share depends on the benchmark used

Our members' experience, which is backed up by research, is that the level of active share is very much dependent on the benchmark used. This is so because benchmarks do not stand as equals. They can differ from each other on many characteristics, in particular the number of constituents, the concentration level and the capitalization size. These characteristics impose various constraints on the ability of a fund manager to achieve a high active share, as explained below.

- **Number of constituents:** Khusainova and Mier (2014) explains that a manager benchmarked to an index with a large number of constituents will have a greater opportunity set to overweight promising stocks and underweight less attractive stocks than a manager benchmarked to an index with a small number of constituents.

- Benchmark concentration:** Axioma (2015) argues that it is more difficult to achieve a high active share with a concentrated benchmark, which is generally dominated by a relatively small number of large market stocks. The UCITS 5/10/40 rule, which limits the managers to a maximum position size of 10% (and only a maximum of 40% of a fund’s assets may be in positions of between 5% and 10%), also reduces the possibility of overweighting the stocks that are weighted close to 10%. The only way they can increase the active share is by underweighting them. However, it may be difficult for liquidity reasons to take large positions in the smaller stocks in the index.

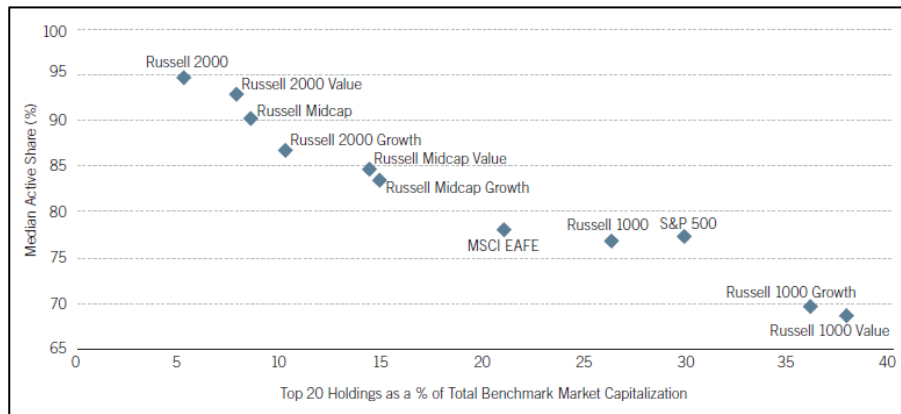
Brandes Institute (2015) confirms the importance of the benchmark concentration level by showing that the range of active share for funds benchmarked to any index is significantly correlated to the concentration of that index. More explicitly, the authors classify 22 investment fund peer groups, measured against 22 different indices. The table below confirms that there is a strong relationship between the median active share of each portfolio universe (measured using the peer group benchmarked to each specific index), and the top 10 concentration of that index.



Source: Brandes Institute (2015)

Cohen et al. (2014) supports this finding by showing that funds which are benchmarked against more “top-heavy” indices (more steeply cap-weighted) tend to have lower active share than funds benchmarked against “flatter” benchmarks in which holdings are more equally dispersed.

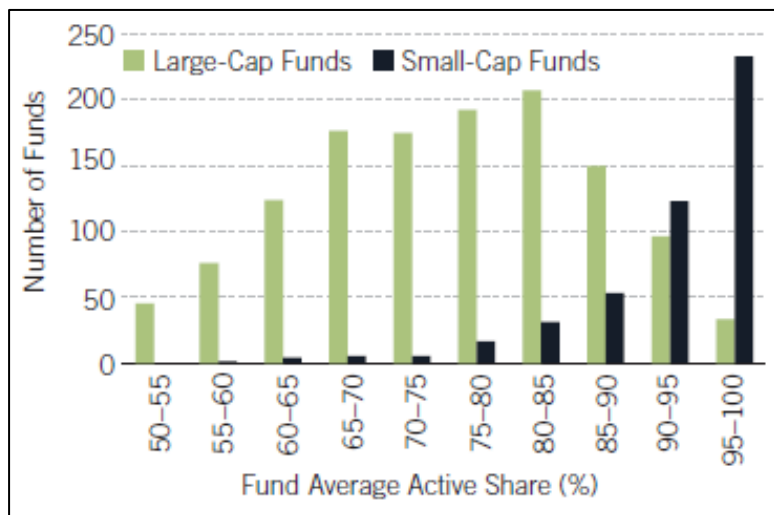
**Active share and benchmark top 20 concentration**



Source: Cohen et al. (2014)

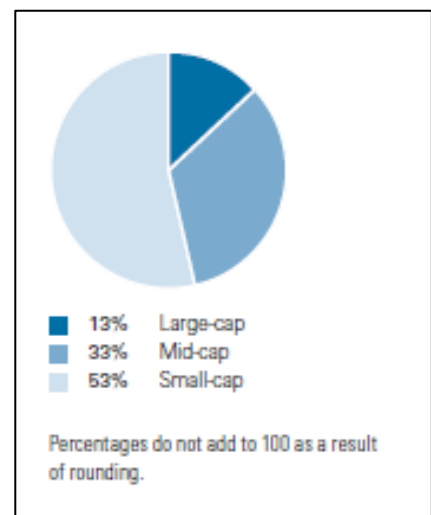
- Cap size:** Cohen et al. (2014) also shows that in a sample of more than 2,000 U.S. funds, small-cap funds disproportionately have active shares in the 95%-100% range, while large-caps funds showed a more normal distribution. In a study based on a sample of 903 long-only active, domestic equity mutual funds, Schlanger et al. (2012) shows that the top active share decile tended to be concentrated in small- and mid-capitalization equities. Cremers (2015) explains this result by noting that active share is basically a measure of the amount of stock picking; hence *“small cap managers have generally more stock picking opportunities, e.g. because they have many more stocks to choose from, generally have few assets under management and face less concentrated benchmarks or better diversification opportunities within their style universe.”*

**Active share by capitalization size**



Source: Cohen et al. (2014)

**Capitalization of top-decile active-share funds**



Source: Schlanger et al. (2012)

### 3.1.2. The concept of active share has other limitations

- **Active share can only be measured in relation to a specific benchmark:** The calculation of the fund's active share is facilitated when the description of the fund's investment policy includes a reference to a benchmark. On the other hand, when a fund does not follow a specific benchmark, the use of active share requires the choice of a benchmark among a set of possible benchmarks. Obviously, this leaves an ample room for interpretation.
- **Active share measures the similarity of a portfolio to a benchmark at a single point in time:** Cremers and Curtis (2015) explain that the active share of a fund can change very much over time, in particular because the active share of a fund is dependent on the portfolio manager. Caquineau et al. (2016) also confirms that the level of active share can vary dramatically for an individual fund over the long term but also over the short term. Consequently, a fund's active share is highly dependent on the point(s) of time chosen for measurement.
- **Active share tends to fall in times of uncertainty:** Market conditions play an important role in the evolution of active share over time. Petajisto (2013)'s long-term study of U.S. mutual funds shows that *"closet indexing peaked in 1999-2002, declined until 2006, and then increased again from late 2007 to 2009 toward its prior peak"*. One reason explaining this finding is that fund managers tend to reduce the size of their active bets during periods of high market volatility. Caquineau et al. (2016) explains that underperforming the benchmark in a down market may be more painful than losing to the competition in a bull market. This is something that has also been raised by the Financial Conduct Authority in the United Kingdom in its thematic review on meeting investors' expectations that acknowledges that *"there may be good reasons for a fund to perform in a similar way to an index. For example, an active decision to invest closely to an index for a short period to limit the fund's risk compared to the index"*.<sup>2</sup>
- **Active share tends to decrease with increasing fund size:** Cremers and Curtis (2015) also recognize that small funds benefit far more from an investment opportunity of a given size than large funds, which may face a challenge in identifying sufficiently large investment opportunities and therefore decide to hold a larger percentage of their assets in the benchmark. Using data on funds available for sale in Europe, Caquineau et al. (2016) confirms that the most active funds typically are smaller than the average. This is especially true for the smallest asset managers in the sample (below EUR 200 million AuM) among which Caquineau et al. did not find any funds with active share below 60%.

### 3.1.3. Active share and the 60% threshold

Cremers and Petajisto (2009) and Petajisto (2013), undoubtedly the most publicised research papers in this area, suggested that funds with active share below 60% should be defined as "closet indexers".

EFAMA members are of the view that there is no threshold level that could be used universally to determine whether a fund is a closet indexer or not. The above discussion has indeed highlighted that small-cap funds, funds with small AuM, and funds with a diversified benchmark are all more likely to have higher active share. This means that it is much easier for these funds to achieve an active share higher than 60% than for large-cap funds, funds

<sup>2</sup> FCA, Thematic Review TR16/2, Meeting investors' expectations, April 2016, paragraph 3.6.

with big AuM or funds benchmarked for example to single-country markets in Europe in which a few companies represent a sizeable part of the index.

Retaining a 60% threshold would therefore end up favouring some investment styles over others. There would be no objective reason to discriminate in this way between different fund types. As noted by Caqueneau et al. (2016), *“low active share is not inherently wrong”*. By the same token, Frazzini et al. (2015) notes that active share’s key insight to manager selection seems to be *“sell large-cap funds, buy small-cap funds”*.

EFAMA does not believe that a regulatory initiative should favour some investment strategies over others. For this reason, we warn against the risk that the emergence of a 60% threshold active share as a new regulatory tool would lead to an implicit advice to disregard certain categories of funds.

By recognizing that the use of a 50% threshold could be more appropriate in countries with relatively small equity markets, ESMA also recognized the limitation of the 60% threshold. Still, EFAMA recommends that ESMA and national competent authorities refrain from identifying closet index funds by using a methodology based on an active share threshold, be it 60% or another lower threshold. If it were possible to measure the extent to which funds try to make very active decisions, the reality would be such that within peer groups corresponding to the same level of active management, some funds would have a high active share, whereas other funds would have a low active share.

If national competent authorities wish nevertheless to use a methodology based on active share, EFAMA strongly supports the view – as suggested by ESMA – that a fund-by-fund analysis including other quantitative and qualitative dimensions is required before the authorities can be confident that a low active share fund is a closet index fund.

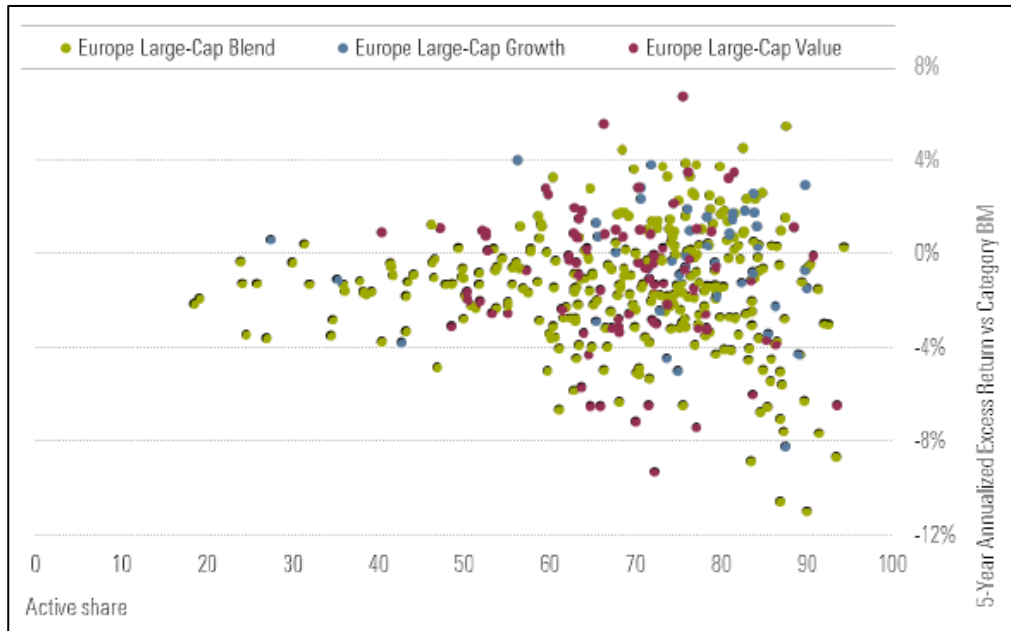
#### **3.1.4. Active share and fund performance**

Cremers and Petajisto (2009) and Petajisto (2013) claim that the investment universe can be divided between high active share funds which tend to outperform their benchmarks and low active share funds which tend to underperform their benchmarks. This does not mean however that investors are necessarily better off selecting high active share funds. This warning is backed by a number of research papers, which have highlighted different findings.

- **High active share may result in strong outperformance but also significant underperformance:** Using a sample of funds available for sale in Europe, Caqueneau et al. (2016) shows that the dispersion of the five-year annualized excess returns against each fund’s style benchmark over the June 2010 to June 2015 period tended to increase as active share increases. Whilst the dispersion for funds with a five-year active share below 60% ranged from 4.0% to negative 5.0% annualized excess returns versus their respective category benchmarks, excess returns ranged from 6.7% to negative 11.0% for funds with a five-year average active share above 60%. The authors also show that the highest active share bucket suffered the largest maximum losses. In other words, high active share funds may result in the strongest outperformance, but also the worst underperformance.



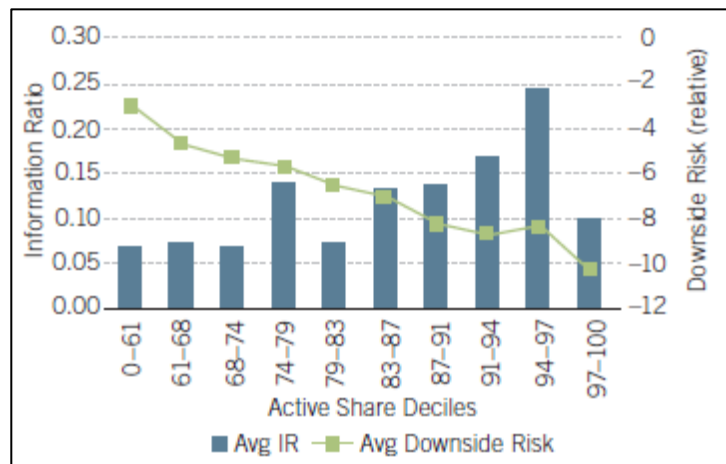
**Active share versus Annualized Excess Return  
(June 2010-June 2015)**



Source: Cohen et al. (2014)

- Active share neglects considerations of the risks involved:** Cohen et al. (2014) shows that exposure to volatility and tail risk tends to increase with active share. There is therefore a trade-off between excess return and increased risk. The authors illustrate this trade-off by showing that the information ratio, which measures excess return per unit of active risk, and active share do not have a clear relationship. At the same time, they find a discernible positive correlation between active share and a portfolio's worst case scenario.

**Information ratio (IR) and  
downside risk**



Source: Cohen et al. (2014)

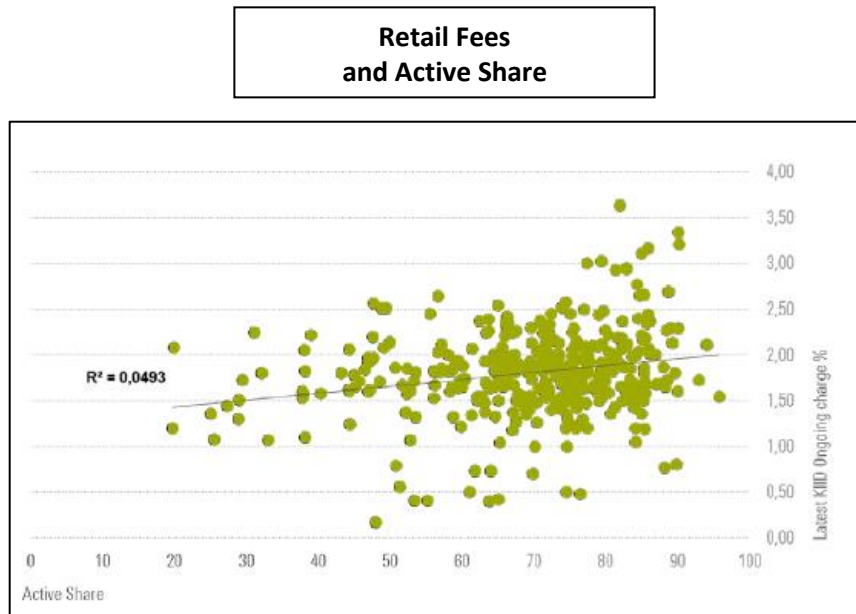
- **High active share alone is generally not sufficient to find managers who outperform their benchmarks:** Fulkerson and Riley (2015) explain that *“there is no reason to expect a fund will outperform its benchmark just because it deviated from it.”* The authors find that two-third of the outperformance of funds with high active share compared to their benchmark can be attributed to out-of-benchmark stock selection ability. The remaining one-third can be attributed to in-benchmark stock selection ability. The authors also show that funds with high active share that invest the least outside their benchmark have the most out-of-benchmark stock selection ability. These results confirm that having high active share is not a skill unto itself: *“it must be correlated with some form of manager skill for it to predict performance.”*

Cremers and Pareek (2015) agree that high active share alone is generally not sufficient to find managers who outperform their benchmarks. More specifically, they find that among high active share portfolios only those patient investment strategies are able to outperform their benchmarks on average. Funds which trade frequently generally underperform their benchmarks, regardless of active share. For example, the authors find that the equally-weighted portfolio of funds with high active share (top quintile) and short fund duration (bottom quintile) underperformed with a five-factor alpha of -3.56%. The authors conclude that the outperformance shown by the most active and patient funds can be explained by their managers' investment in high quality stocks.

- **Active share does not predict fund performance:** Frazzini et al. (2015) argues that the key result highlighted by Cremers and Petajisto (2009), i.e. the “stock pickers” (funds which are in the highest quintile of active share) outperform “closet indexers” (funds which are in the lowest quintile of active share) is driven by the benchmark return. The authors show that whilst the “stock pickers” have higher raw fund returns, the difference with the returns achieved by “closet indexers” is not statistically significant. When comparing “stock pickers” and “closet indexers” that share the same benchmark universe, they show that the performance difference between the two groups of funds falls and is also not statistically different from zero. According to Cremers (2015) and Petajisto (2015), the difference in the results reflects among other things the fact that they have classified the funds according to the absolute level of active share, whereas Frazzini et al. ranked funds separately by benchmark and then combined funds across benchmarks.

### 3.1.5. Active share and fund fee

Caquineau et al. (2016) has analysed the relationship between active share and fee. This study found that there is a wide dispersion in fee. It is therefore possible to find both cheap funds and very expensive ones with similar levels of active share. It also found some evidence that retail investors pay less for low active share funds.



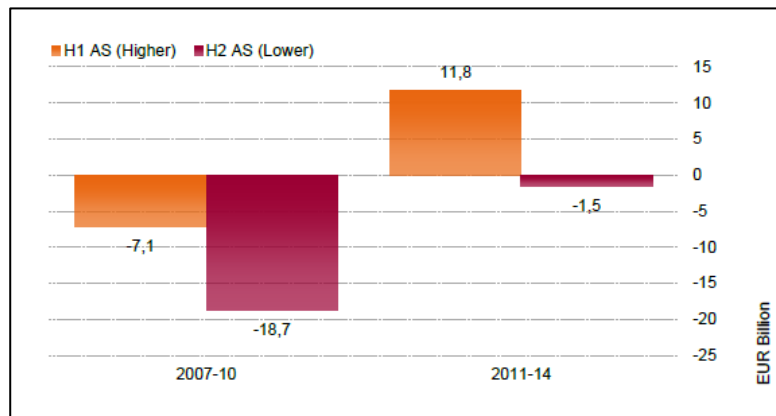
Source: Caquineau et al. (2016) (AS based on 3-year average April 2012 – March 2015)

Cremers and Curtis (2015) confirm this finding in a study where they analysed 1,255 different U.S. equity funds, in which they identified 12% of the assets being low active share funds at the end of 2014. They show that these funds had an average expense ratio 0.21% lower than the average expense ratio for the full sample (0.84% per year compared to 1.05%). They also calculate an indicator which adjusts the fund's expense ratio for the extent the fund holdings overlap with the holdings of the fund's benchmark index. They call this the "Active Fee". They find that the average Active Fee for the low active share fund sample equals 1.54%, compared to an average Active Fee of 1.36% in the full sample. They find however that the distribution across the mean was wide. As an illustration, the Active Fee in the low active share fund sample ranged from 0.20% to 6.80% (compared to the mean Active Fee of 1.36%). The results confirm that investors may find funds with a low "Active Fee" among low and high active share funds.

Caquineau et al. (2016) has also found that funds with above-average active shares saw much higher net flows during the two periods considered (2007-2010 and 2011-2014). One possible explanation for this result is that the proportion of low active share funds has fallen in recent years. This development, combined with research results that show that new funds are more likely to beat the market than those that have been around for a decade or more, may explain the stronger demand for high active share funds.<sup>3</sup>

<sup>3</sup> Pastor et al. (2014) show that younger funds tend to outperform the oldest funds.

### Cumulative Net Flows into Funds by Active Share



Source: Caqueneau et al. (2016) (AS H1 is comprised of the 50% most active funds, AS H2 of the funds in the lower half)

### 3.2. Combining active share with tracking error

Tracking error represents the volatility of a portfolio's excess returns relative to the benchmark.

$$\text{Tracking error} = \text{Stdev} ( R_{fund,t} - R_{benchmark,t} )$$

where *Stdev* is the standard deviation,  $R_{fund,t}$  is the fund return at time  $t$ , and  $R_{benchmark,t}$  is the benchmark index return at time  $t$ .

A typical active manager aims for an expected return higher than the benchmark index, but s/he also wants to have a low tracking error to minimize the risk of significantly underperforming the index.

Tracking error is based on a historical return series whereas active share compares the portfolio holdings of the fund and the benchmark at a given point in time. However, for tracking error as well as for active share, the results are highly dependent on when you are measuring.

In order to compute active share, you need data on the portfolio composition of the fund and of its benchmark. In our members' view, this information is not necessarily easily available, and may be costly to obtain. In order to compute tracking error, you need data on historical returns for the fund and its benchmark. As noted earlier, determining an appropriate benchmark index for funds that are not telling investors that they are following a benchmark is not a trivial task.

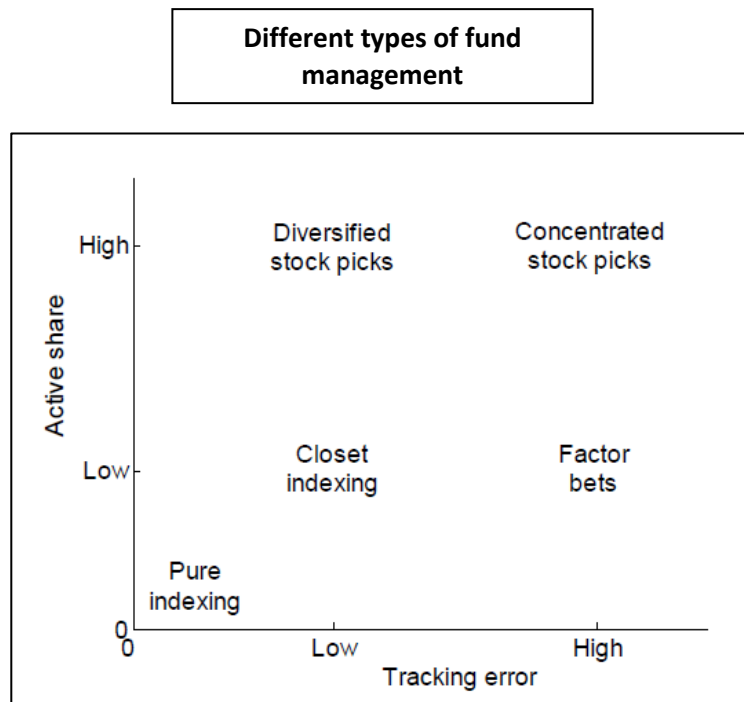
Comparing active share and tracking error, Khusainova and Mier (2014) highlights the following points:

- Tracking error has the potential to be a better indicator of factor bets, i.e. time-varying bets on systematic risks factors such as entire industries or sectors of the economy, and does not necessarily fully account for the degree of deviation of the portfolio's individual holdings relative to the benchmark. This point is

illustrated below. As a result, Khusainova and Mier (2014) notes that “*looking solely at this statistic can be misleading since low tracking error is not always indicative of a passive management style*”.

- Active share addresses the limitations of tracking error by looking at the positions relative to individual holdings. In this way, active share has a better ability to capture effects of stock-picking actions.

Cremers and Petajisto (2009) add that tracking error puts significantly more weight on correlated active bets, whereas active share puts equal weight on all active bets regardless of diversification. Following this approach, they identify five different types of active and passive management, as shown in the chart below.



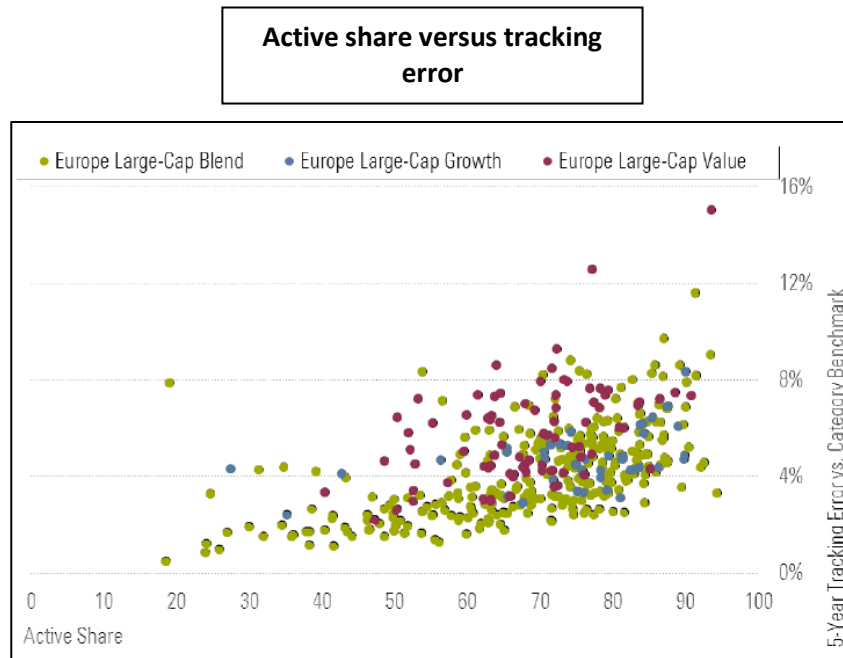
Source: Cremers and Petajisto (2009)

Several recent research papers have highlighted how active share and tracking errors are related.

- Sapra and Hunjan (2013) shows that the tracking error level is positively related to the level of active share. The authors also show that the relationship between active share and tracking error is conditional upon the level of market volatility. By way of illustration, for a given level of active share, the tracking error at the height of the global financial crisis in 2008 would be much higher than a few years before.

Sapra and Hunjan (2013) also analyses the general relationship between active share and tracking error for distinct types of investment managers. They show in particular that Pure Style Managers (PSMs), which only invest in broad systematic factors such as value stocks or economic sectors, have the highest ex-ante tracking errors per unit of active share. This is due to the fact that PSMs tend to take large active bets on systematic risk factors, thus increasing tracking errors at all levels of active share. As explained above, due to this fact, tracking error is often considered to be a good indicator of factor bets, whereas active share is a better metric to capture effects of stock-picking actions.

- Caquineau et al. (2016) also finds that as active share rises, tracking error tends to rise in a moderately exponential fashion (see chart below).



Source: Caquineau et al. (2016)

- Caquineau et al. (2016) also shows that “stock pickers” with an average excess return of negative 0.93%, were not able to distinguish themselves from “closet indexers”. One possible explanation for the difference in results between Petajisto (2013) and Caquineau et al. (2016) is that the period analysed by Caquineau et al. (July 2010 – June 2015) was shorter than the period covered by Petajisto (January 1990 – December 2009). **This confirms that the choice of the time period for measurement is critical.**

Incidentally, Caquineau et al. (2016) also shows that the fund groups with the highest tracking error (“factor bets” and “concentrated” funds) posted the strongest underperformance, despite active share higher than 60% and tracking error higher than 4%. This finding indicates that funds with an active share of more than 60% and a tracking error of more than 4%, i.e. **funds that would not be classified as potentially being closet indexers under the methodology used by ESMA, are not necessarily performing better than funds that would be deemed “unsuspicious”.**

#### **4. Responses to closet indexing**

The above analysis highlights the limitations of a quantitative analysis based on active share and tracking error to identify closet index funds. In a nutshell, there are funds that combine a low active share and a low tracking error and that are truly actively managed.

This does not mean however that ESMA's supervisory work on potential closet index tracking does not deserve due consideration.

In the view of EFAMA members, closet indexing raises two main questions:

- How can national competent authorities identify closet index funds?
- Is there a need to take action to better protect investors?

##### **4.1. Identification of closet index funds**

In our view, closet index funds should be defined as funds that are not actively managed but claim in the information provided to investors to be actively managed. In this context, we consider that the concept of "potential" closet index funds is not helpful. What is really important is to identify the funds that are not actively managed but claim to be, because it is important to avoid that fund managers create false expectations about the fund management service they provide.

For the reasons explained in section 3, EFAMA disagrees with the position taken in the academic literature, whereby a fund with an active share below 60% (or 50%) is called a closet index fund. The problem with this approach is that it neglects a whole range of factors that must be taken into account to assess whether a fund is being actively managed, including the fund's objectives and the extent to which the stated investment policy allows to take risks, the research efforts to build the fund portfolio, and the investment's strategy and style. In the specific cases where a fund's investment policy includes a reference to a benchmark with a limited degree of freedom available in relation to this benchmark, the analysis should also specifically include measures of risk and return to assess how the fund manager aims at achieving the optimal level of risk-adjusted return while tracking the benchmark.

All these factors and considerations should be looked at in the context of the portfolio being assessed as well as its evolution over time. Consequently, it is too simplistic to rely on one or two criteria to identify closet index funds.

All this indicates that an analysis based on a few quantitative indicators can only be a first step in the investigation of closet indexing. EFAMA therefore agrees with ESMA that definite evidence requires a detailed, fund-by-fund follow-up analysis before the national competent authorities can decide that a low active share fund that identifies itself as being actively managed, is a closet index fund, and require the fund managers concerned to correct the information provided to investors.

##### **4.2. Investor protection**

In EFAMA's view, the real issue concerning investors is to ensure that they receive fair and clear information on the nature of active fund management service provided by the fund managers. Therefore, EFAMA also agrees with ESMA that *"the issues around closet indexing form part of a broader issue on the effectiveness of investor disclosure*

and the legitimate expectations of investors in respect to the service provided by some asset managers". Against this background, we believe it is important to consider whether there might be a way for fund managers to improve the quality of their disclosures about the level of active management of their funds.

For the reasons highlighted in section 3, EFAMA would caution against systematic mandatory disclosures of such metrics as the active share or tracking error of a fund, because of their inherent limitations as well as the very clear risk, for retail investors in particular, to misunderstand the informative value of those metrics and, therefore, to draw wrong conclusions when making investment decisions or comparing between different investment options.

It is also useful to bear in mind that the UCITS regulatory framework already contains a number of disclosure requirements that are of interest for this discussion. It includes general provisions requiring UCITS management companies to make appropriate disclosures in the fund's legal documentation (Prospectus and KIID) about the fund's investment objectives and essential characteristics in such a way that investors are "*reasonably able to understand the nature and the risks of the investment product that is being offered to them and, consequently, to take investment decisions on an informed basis*"<sup>4</sup>.

It also contains more specific provisions, such as Article 7.1 (d) of the UCITS KIID regulation 583/10 which is applicable to all UCITS<sup>5</sup> and reads as follows:

*"The description contained in the 'Objectives and investment policy' section of the key investor information document shall cover those essential features of the UCITS about which an investor should be informed, even if these features do not form part of the description of objectives and investment policy in the prospectus, including: (...)*

***(d) whether the UCITS allows for discretionary choices in regards to the particular investments that are to be made, and whether this approach includes or implies a reference to a benchmark and, if so, which one;***  
*(...)*

***For the purposes of point (d), where a reference to a benchmark is implied, the degree of freedom available in relation to this benchmark shall be indicated, and where the UCITS has an index tracking objective, this shall be stated."***

In EFAMA's view, the combination of those general and more specific disclosure requirements provides a sound legal basis for national supervisors to ensure that investors – whatever the type of UCITS they are intending to invest in – will receive in due time (i.e. prior to their investment) appropriate information about the fact that the portfolio management of a UCITS, although actively managed, may to a certain extent be "benchmark-constrained", hence potentially reducing the degree of freedom available to the portfolio manager in relation to this benchmark. The objective of those legal provisions is to give investors useful tools to assess the level of active management of a certain UCITS against its benchmark and, therefore, to make an informed judgement also about the relative performance of this UCITS and the costs and fees that are being charged.

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<sup>4</sup> Article 78.2 UCITS Directive 2009/65/EC. See also article 69.1, 79.1 and Annex 1, Schedule A., 1.15, of the same Directive, as well as specific disclosure requirements applicable to "Index-Tracking UCITS" and "Actively Managed UCITS ETFs" under ESMA's Guidelines on ETFs and other UCITS issues (ESMA/2014/937).

<sup>5</sup> Including those that are not invested exclusively in equities.



Consequently, EFAMA does not see the need to add new regulatory requirements and disclosure obligations. As we see it, the best way to address the problem of potential closet indexing is to make sure that the current rules on fund disclosures are properly complied with by UCITS asset managers and, as the case may be, enforced by relevant national supervisors.

In this context, we recognise that there may be a need to clarify the practical interpretation of some of the already existing legal requirements (in particular Article 7.1(d) of the UCITS KIID regulation), to foster legal clarity, avoid diverging interpretations and, more broadly, to ensure that these legal provisions achieve their objective of providing investors fair and clear information on the nature of active fund management service provided by the fund managers. EFAMA is currently looking into this matter and will be happy to share its conclusions with ESMA in due course and to support ESMA's work in this respect.

In the meantime, EFAMA has adopted two recommendations to further improve the quality of the disclosures to investors:

1. When preparing the funds legal documentation and related marketing materials, UCITS management companies should take particular care to disclose in a fair, complete and understandable manner the essential characteristics of the fund, including in particular when describing the degree of freedom available to the portfolio manager in relation to the fund's benchmark as requested under Article 7.1(d) of the UCITS KIID regulation 583/10.
2. For UCITS presenting themselves as being actively managed, it would also be good practice for UCITS management companies to keep internal records and evidence as appropriate to be able to explain (ex post) to their national competent authorities that the disclosures that have been made to investors truly reflect the level of active management provided by the fund (having regard to the specific circumstances of each individual UCITS).

## **5. Conclusion**

EFAMA fully corroborates ESMA's view that there are "*difficulties in coming up with a suitable identification criterion that could serve as a common basis for analysis of different fund markets*". Our analysis confirms indeed the limits of identifying closet index funds through a statistical analysis. Ultimately, metrics used for determining closet indexing are wholly dependent on a number of variables. This makes it difficult to rely on active share and tracking error alone to assess with certainty whether a fund is a closet indexer or not.

Ultimately, the real question for us in terms of investor protection is whether the information received by the investor is a true reflection of the service provided and gives investors the possibility to evaluate the advertised fund management service.

To address this issue, EFAMA recognises that there may be a need to clarify the practical interpretation of the current UCITS legal framework and will support the work undertaken by ESMA in assessing the need for further guidance and clarification in the area of fund disclosure to enhance the quality of the information provided to investors.

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