Report of The Task Force on Past Performance

September 2001

Contents

Executive summary

1. The Task Force on Past Performance – a group of industry and consumer representatives and other independent experts – was convened in September last year to consider issues relating to the use of past performance information in advertising.

2. The Task Force considered evidence suggesting that past performance information on its own is of little indicative value to consumers and should be used only in support of other factors when they make their investment decisions. As part of their work they commissioned research into consumer and practitioner views, the results of which informed their conclusions and recommendations. A report of the research findings is attached as Annex A.

3. The Task Force noted the FSA's analysis of the extent to which past performance information could be of value to consumers in making investment decisions, and agreed that the information is of little or no value in itself as an indicator of future performance. Consumers should understand this, and be encouraged to use it only in support of other factors they should take into account in making their investment decisions.

4. In the light of that conclusion, the Task Force believe strongly that the FSA needs to change its current approach to regulating the way that past performance information may be used in financial advertisements if it is to mitigate risks to both its public awareness and consumer protection objectives. The Task Force's research suggests that consumers consider advertisements containing past performance data to be neither clear nor fair. And despite specific rules prohibiting firms from making any implied or explicit connection between past performance and future prospects, the research suggests that consumers still make the leap from one to the other. The research also indicates that investment firms are concerned that the rules should be tightened up and many want the FSA to provide more objective, consistent and overt policing of advertising.

5. The majority of Task Force members consider that a full-scale ban on the publication of fund or investment manager-specific past performance information would not deliver benefits that would outweigh the likely difficulties arising from the ban. However, a minority does favour such a ban and consider that continuing to allow the use of fund or investment manager-specific past performance information in advertising is inconsistent with the FSA's public awareness and consumer protection objectives.

6. However, the Task Force does agree that it is useful for consumers to have information about the overall performance of equity-based investments relative to deposits and that it is important for consumers to have an appreciation of the fact that in the long-term, equities have consistently out-performed deposits.

7. The Task Force have made a number of detailed recommendations to the FSA about the way in which past performance information should be presented in advertisements:

   - Past performance should not be the main message of an advertisement.
   - A past performance warning should be presented prominently and legibly in the main body of the text.
   - The practice of re-constructing hypothetical past performance from information other than that based on the actual performance of the relevant fund should be banned.
   - The feasibility of standardising the content and presentation of statements of past performance in advertising should be considered. The FSA should review the pros and cons of devising a single, consistent measure for presentation of past performance. If adopted, the FSA could reconsider its decision not to include past performance information in the Comparative Information Scheme.
   - The FSA should also research and adopt a method by which the risk of a fund relative to others within the same or similar sectors, and relative to other forms of investment such as cash, could be measured and communicated clearly; it should also consider whether it is feasible and desirable to require the inclusion of a price indicator in advertisements.
   - The FSA should undertake further work on a model that can be used to indicate performance, price and risk and also consider how this information might be included in advertisements in a way that will enhance consumer understanding.

8. The Task Force have urged the FSA to implement their recommendations as rapidly as possible. However, they recognise that doing so will require a considerable amount of further work by the FSA and the recommendations need to be seen in the context of the FSA's wider review of the entire financial promotion regime. Consultation will be required before any proposed changes can be implemented. All this will take time. But the Task Force is keen that action should be taken to correct some of the most severe problems connected with past performance information as quickly as possible and believes that it will be of great benefit to consumers to take short-term measures to tighten up the FSA's supervision and enforcement of existing regulations. In that respect, they strongly recommend that as an interim measure, the FSA should review its new Conduct of Business Sourcebook with a view to establishing what changes in supervision practice will be appropriate from 1 December 2001 – the date on which the new Financial Services and Markets Act regime will be substantively implemented – to take account of the move to the new regime.

1 Introduction and background to the establishment of the Task Force

FSA's views on the reliability of past performance

1.1 The financial services regulatory regime has long sought to control the use of past performance information by firms in their advertising and other marketing literature. In the absence of regulation of the way in which past performance information is presented, there is a high risk of consumers being misled into believing that the past performance of an investment fund would persist into the future and that past performance data informed them about 'what they would get back'. Firms would also be able to quote data selectively in a way that showed their funds in a good light.

1.2 There is a large body of research evidence to show that past investment fund performance is not in itself a useful guide to the future performance of investment funds. Much of this is summarised in FSA Occasional Paper 9,[1] which concludes 'the weight of evidence is that information on past performance cannot be exploited usefully by retail investors', although these conclusions are not universally accepted.

1.3 In its work on comparative information, the FSA asked consulting actuaries Bacon & Woodrow to review research and any other evidence that showed a link between past and future performance. Bacon & Woodrow reported to the FSA that the future performance of an investment would depend on a number of factors including the fund's investment strategy, prevailing economic conditions, costs and charges, the fund manager's skills (and those of his/her team) and their persistence, and luck. They concluded that the selection of an investment product provider based solely on an analysis of past performance was fundamentally unsound, and that past performance data could be very misleading in the absence of detailed qualitative data.[2]

1.4 The FSA considered carefully whether to include past performance as an indicator in its Comparative Information Tables for financial services. The FSA was aware, from its own market research, that consumers sought information on past performance and would ideally like to see indicators of past and future (sic) performance in the Tables. Set against this was the knowledge that research evidence could not substantiate the use of past investment

1 *Past Imperfect? The Performance of UK equity managed funds.* August 2000.

2 *Comparative Tables Report prepared for the Financial Services Authority. Bacon & Woodrow actuaries and Consultants.* September 1999.

fund performance data as an indicator of future performance, and the advice from Bacon & Woodrow that inclusion of such an indicator could mislead consumers. In the light of this, the FSA decided that it would be inconsistent with its statutory objective to promote public understanding of the financial system for it to publish past performance data as a key indicator in FSA-branded Comparative Information Tables.

1.5 Discussion and consultation on this issue, however, gave rise to some interest and debate on the role of past performance data in advertisements and other marketing material for investment products, and on the FSA's approach to setting advertising standards in this area. Some commentators felt that the FSA should consider banning the use of past performance data in advertisements; others felt that current standards needed tightening up. While the FSA responded that it did not consider that banning the use of objective information was the right response, it decided to look into the issues in more depth before determining its regulatory response.

1.6 To this end, the FSA decided last Autumn to set up a Task Force comprising members from consumer bodies, the industry, and relevant experts to advise the FSA on its regulatory stance to the use of past performance data in advertising.

1.7 The Terms of Reference of the Past Performance Task Force (see Annex 2) were, broadly:

- to help the FSA in its review of the use of past performance data;
- to review current promotions and advise the FSA on which issues/areas the FSA should focus;
- to advise on consumer research and review the research findings; and
- to consider whether a standard approach to the use of past performance data would be desirable and feasible.

(See Appendix A for full terms of reference and membership of the Task Force.)

1.8 The Task Force met six times between November 2000 and July 2001, and was supported in its work by a team of FSA staff. Their approach has been to collate and analyse systematically the issues connected with the presentation and usage of past performance data in adverts for investment products, focusing particularly on investment funds. The analysis has been supported by specially commissioned market research.

1.9 The Task Force have decided that they wish to make several recommendations for change to the FSA. This document reports the Task Force's work, their conclusions and recommendations.

2 The current approach to regulation

2.1 The current regulatory regime (and that being carried forward into the FSMA-based rules) stems from the overarching principle that advertising should be clear, fair and not misleading. The regime elaborates the interpretation of 'not misleading' in its requirements on past performance. The rules and guidance concentrate on ensuring that past investment fund performance is not presented in a way which suggests it is indicative of the future, and that past performance data drawn from an unreasonable or unrepresentative period should not be shown.

2.2 The current rules require that

- the information and presentation should not be misleading;
- the past performance information should be relevant;
- the source of the information and the time period covered should be stated; and
- a warning that past performance will not necessarily be repeated must be given (although no specific text is mandated).

2.3 The new regime carries forward the existing requirement for a 'benchmark' performance period of five years to be shown, although other periods can be shown as well. The rules allow performance to be quoted either on an 'offer to bid' or 'offer to offer' basis, providing this is relevant to the context of the advertisement and that the basis is stated.

2.4 In addition, the regulators have over the years provided extensive guidance on the use of past performance information. This covers, for example, the need to avoid past performance being seen as an indicator of future growth, and the inappropriate use of selected or short-term time periods. These have been codified in the new regime in rules and guidance which provide that unfair comparisons with other types of investment, use of unreasonably short time periods, or inconsistent periods for a range of funds, may mean that the advertisement fails to meet the 'not misleading' standard. If performance-based comparisons are made with deposits, there must be a clear, and equally prominent, signal that the investment does not provide the same security of capital.

3 Consumer research

3.1 In undertaking the task of advising the FSA, the Task Force thought it important to learn more about consumers' use and interpretation of past performance information in promotional material.

Previous research touching on past performance

3.2 Before the establishment of the Task Force, research specifically related to consumers and past performance had not been undertaken by the FSA. However, past performance has been touched on during other FSA commissioned research, and these findings were reviewed and presented to the Task Force. The main points were that:

- Past performance is considered by consumers when choosing a financial product.
- In the FSA's research on comparative information, and on the effectiveness of disclosure, consumers voiced strong interest in past performance information.
- Consumers do have some confidence in the figures (partly because they assume regulatory control).

But although there are some signs that past performance figures are believed, it may be that they are taken as indicative rather than absolute. It is interesting to note that despite consumers' interest in past performance information, they are aware of the message that past performance is no guarantee of the future. The extent to which they see that as being a real risk at a personal level is, however, questionable.

The Task Force's research

3.3 The Task Force commissioned The Research Business International to conduct research on its behalf. The main objectives of the research were:

- to explore how elements of advertising influence consumer behaviour;
- to find out what consumers understand by 'clear, fair and not misleading'; and
- to explore the extent to which advertisements are considered to meet the letter of the regulations but fail in the spirit.

3.4 The research adopted a qualitative approach, exploring the views and opinions of consumers, industry practitioners and their advertising agencies. It was conducted during March and April 2001.

3.5 The research focused on consumers' attitudes to the information presented in the press and other published media. Although conscious that financial products are promoted in a much wider range of media, the Task Force felt press advertisements were a key medium for the promotion of past performance data.

Consumer attitudes to financial advertising

3.6 The object was to capture the views of those who would have been exposed to financial advertising. The sample selected for this research were therefore regular readers of the financial pages of the press, active decision-makers and currently in the market for investment products. The researchers found that these individuals fell broadly into two groups: the 'investment confident' and 'brand reliant', although these groupings were based on behaviour and did not correlate precisely with the consumers' level of financial sophistication.

3.7 Financial editorial in the press was found to be a key source of information for the consumers interviewed, who believed that it offered independent, unbiased and accurate commentary on the market. Press advertising also provided information, albeit in a secondary role, alerting respondents to investment products and opportunities. It is worth noting that respondents' claims that advertising did not affect their purchase appeared to be contradicted by other clues, such as awareness and recognition of the advertising, knowledge of advertisers' 'techniques', response to advertisements in the past, and anecdotal stories about friends and relatives buying direct from the advertisement.

3.8 The research confirmed that investment decisions are influenced by many factors – the consumer's experience as well as the current information available to them. But brand reputation and 'returns' (performance) both played a key role for all consumers.

3.9 Less sophisticated consumers tended to seek reassurance in a well-known brand and looked for a good 'interest rate'. The brand was indicative of the company's track record, the nature of the investment, the risk associated with the investment and the relative level of expected returns. The more sophisticated evaluated performance relative to risk, and the track record of the company or fund in question. Performance was benchmarked against perceived interest rates on building society accounts, although many admitted ignorance of current rates on offer. All respondents felt the balance of risk: return within the advertising was disproportionately in favour of 'return', with the risk warnings not overt enough and meaningful information on the risk of losing money virtually non-existent.

3.10 Consumers held a deep-seated belief in the performance of the stock market over the long-term, and that any 'hiccups' would be temporary and short-term. Although risk was accepted on a rational level, many consumers did not 'personalise' that risk. Nevertheless, any risk to capital was unacceptable for most, with only a minority prepared to expose themselves to a potential risk to their investment returns (and then only for highly volatile funds). But for many, particularly the less sophisticated, the brand brought added reassurance and may have 'masked' the actual exposure to risk.

3.11 Past performance was important to attract attention. Consumers believed the claims were technically 'true', but queried whether they were 'real' – did anyone actually reap these rewards? It was the way in which the figures were presented, and the terminology used to describe and justify the claim, that raised questions. Many consumers were unable to interpret or compare the claims in any meaningful way.

Clear, fair and not misleading?

3.12 The research concluded that consumers felt the basis of claims, the terminology used and the small print specifically contributed to an overall sense that financial advertisements were not clear; they were also not fair in that advertisers expected too much of them as readers of advertisements. However, consumers do not consider advertisers to be making advertisements deliberately misleading, although some advertisements were open to misinterpretation and misunderstanding. Consumers were uncertain about their responsibilities as to the extent to which 'caveat emptor' applied when reading financial advertisements.

3.13 Small print was universally disliked, being overwhelming and unintelligible, although it was recognised as important, containing the detail and warnings surrounding the claim. Most respondents admitted that they find the small print impossible to interpret, which calls into question its efficacy as a risk-warning device.

3.14 Much of the terminology used in the advertising was found to be obscure and not well understood except by a minority of the more knowledgeable respondents. However, its very inaccessibility acted as a filter in terms of the target market attracted to the advertisement.

Industry views on past performance information

3.15 The researchers also interviewed industry practitioners. On the firm side, an even mix of marketing and compliance managers was selected. The companies included both mainstream life and pensions providers, specialist investment houses and two major IFAs. In addition, there were some interviews with staff from advertising agencies – a mix of creatives and planners. The agencies included both mainstream companies and specialist financial services companies, and all respondents were closely involved in developing advertising for investment clients

3.16 Those firms and agencies consulted generally agreed that the role of past performance advertising is to invite enquiry into (rather than immediately sell) a product. They believed that consumers and advisers seek out performance data to assess the providers' track record and they were reluctant to accept that past performance does not repeat in the future.

3.17 Both firms and agencies believed that consumers use past performance and brand to select funds, with independent endorsement (via press editorial) also playing a key role. This perceived demand for past performance, and firms' experience that response rates decline if performance was omitted from the advertising, encouraged the current wide use of the information.

3.18 There was general feeling that the regulations contain too many 'grey' areas and that the FSA's policing of the advertising was not perceived to be visible enough. The concerns raised by firms include the basis of figures used, the context surrounding their use and the presentation of the information. All asked that the rules be implemented in an objective, consistent and transparent manner to improve adherence to the spirit of 'fair, clear and not misleading'. Many wanted the FSA to provide more objective, consistent and overt policing of advertising, and possibly move towards a common platform for presenting performance information to improve transparency of the figures.

3.19 Both firms and agencies believe small print to be unread and ineffectual. There were also comments that the sheer amount of small print contributes to consumers' (possible) use of advertising as a 'brochure', rather than treating the advertisement as an invitation for further information. All asked that small print be pared down to the absolute minimum.

Researchers' conclusions

3.20 All respondents agreed that past performance and brand was key to the choice of investment product. The less sophisticated investors placed great faith in the brand, although it also remained important for the more knowledgeable consumer. Past performance was seen as fundamental, and if not present would be sought elsewhere by many. Consumers were using performance figures as a reasonable indicator of future performance and benchmarking their (minimum) expectations against perceived savings account rates.

4 Problems arising from the current approach to past performance in advertising

Past performance being used to suggest future prospects

4.1 Despite specific rules banning firms from making any implied or explicit connection between past performance and future prospects, the research demonstrates that consumers still make the leap from one to the other, even where great care is taken to avoid any overt or even implied connection between the two. Arguably, any presentation of past performance information could inspire speculation about expected returns.

4.2 This tendency to draw conclusions from past performance information is a symptom of consumers' strong desire to understand what the prospects for their investment might be. But firms wishing to make statements about the future growth of an investment are bound by detailed rules that standardise the rates and presentational aspects of projections. The FSA fixes from time to time the three growth rates that must be used to show projections over standard time periods. The projections must also show the effect of charges and deductions.

4.3 The intention behind this approach is only in part to give consumers an idea of 'what you might get back' – the principal aim is to show the impact of charges on growth. But the net effect of the requirements is that information about projections is rendered too detailed and unwieldy to use in non-direct offer advertisements. Experience bears this out: advertisements for investment products, particularly non-life products, very rarely give projections. Therefore, the only 'performance' numbers which appear in most advertisements are past performance figures, and consumers draw their own conclusions from the information.

Warning messages and the use of small print

4.4 When firms show past performance information in their advertising, they are required to make clear in the advertisement that past performance is not necessarily a guide to future performance. Often the statement appears in a 'small print' footnote, or in the case of non-published media, a supplementary statement following the main promotional content.

4.5 The research has supported the widely held view that small print is less effective as a warning than one in the main copy. And given that there are other rules requiring regulatory statements to be suitably prominent (for example, the rules concerning the nature and scope of guarantees), the past performance warning should arguably be more prominently positioned than in the footnote.

4.6 But the rules and guidance currently require advertisements to contain a potentially large number of other warnings, clarifications and information, and further requirements may be imposed by other legislation, such as the Data Protection Act. Since advertisers find it impractical to include all the required statements in the body copy, the practice has developed of including the statements in footnote, unless there is an explicit requirement to present them in the body copy. Financial advertisements have thus become notorious for the amount of 'small print' which they contain.

Selective time periods

4.7 The rules require that past performance data be given for a period of five years (or since the launch of the fund, if the fund is less than five years old). But managers can also show performance over other time periods, provided this is based on some objective criterion. This is currently within the rules, providing the five-year 'benchmark' performance is also given. However, at present, there is no specification about how prominently the 5-year performance should be shown.

4.8 Sometimes the prescribed information is shown in the small print and the firm might make a more prominent feature of the performance over a different period. This might be an extended period such as ten years, or since the launch date where this is over five years ago, or over a shorter period to reflect a change of manager or fund objective.

4.9 Allowing performance over periods other than five years does raise the possibility that managers can select the time period so as to show their products in the best light. These may be their 'specialist' funds investing in particular geographic or industry sectors. By actively promoting those specialist funds, there is a risk that managers might tempt investors into a fund, which is inappropriate for the consumer's attitude and appetite for risk. But in any case, most funds can find a period in their history when they performed particularly well in comparison with their peers, but allowing advertisements to present such selective information can lead to a misleading impression of the overall performance of the fund.

Fostering unrealistic expectations

4.10 Advertisements showing exceptionally high returns risk raising consumer expectations to an unreasonable level (particularly in the context of a low-inflation environment). This in turn can result in either dissatisfaction with perfectly reasonable performance from a conservative, but low-risk, fund, or ill-considered and inappropriate investment in higher-risk funds.

5 The case for change

5.1 The Task Force recognise that in any policy analysis, the 'no change from the status quo' option should be considered on its merits. The FSA could decide that its regulation of advertising is sufficiently clear and comprehensive and that no further action is needed.

5.2 But the Task Force strongly believes that it would be unacceptable for the FSA to keep its current approach without further restrictions on the use of past performance data. It would mean acceptance that products could continue to be promoted with heavy emphasis on information that consumers should use, only in support of other factors that they should take into account in their investment decisions. It would also mean accepting that the presentation of past performance data could continue to lead consumers to doubt whether advertisements are either fair or clear. **The Task Force therefore believes that major changes to the current regime are necessary if the FSA is to mitigate risks to both its public awareness and consumer protection objectives.**

5.3 In addition, the Task Force wishes to draw the FSA's attention to comments from practitioners reflected in the research findings that indicate they seek more transparency in the way in which the FSA polices and enforces its controls on advertising. While recognising that there are legal constraints on the extent to which the FSA can publicise its supervisory and enforcement actions, the FSA should consider whether an acceptable mechanism could be devised that would allow them to publish examples of advertising practice that falls short of its standards.

6 Should the publication of past performance information in promotional material be banned?

6.1 One approach to the problem of misuse of past performance information would be to restrict access to that information. Further analysis shows, however, that there are arguments against the approach which must be considered.

Arguments in favour of a ban

6.2 Given the view that past investment fund performance information is, on its own, of little value to customers in choosing a fund, and given that it is difficult to prevent consumers from making such use of the information when it is presented to them, particularly in a marketing context, then one remedy to the problem would be to prohibit the use of such information in advertising.

6.3 By permitting the use of past investment fund performance information in a marketing context, there must be some implicit acceptance that it has a role – to some extent – in the buying process. This argument can be expanded to suggest that by permitting past performance to be used in advertising, the FSA is endorsing or legitimising the use of the information and agreeing that past performance is a useful criterion on which consumers should base their choices. The FSA has already decided not to include past performance in its own FSA Comparative Information tables for the reasons noted in paragraph 1.4 above. It could, using similar arguments, choose to ban the use of fund or investment manager-specific past performance information in financial promotions.

6.4 A positive benefit of a ban could be that firms would be led to focus more on other factors that can be important for investors, such as charges and product flexibility (such as ease of switching between funds). This in turn could lead to improved consumer choice.

Arguments against a ban

6.5 Managed funds can provide easy and (relative to the alternatives) cheap access to equity markets. Findings that the relative performance of funds does not repeat significantly does not imply an absence of skill or added value in the fund management process (just that there is no significant difference between funds that can be exploited). A reason for lack of persistence might be that fund managers are all trying equally hard. A consequence of banning the publication of past performance information might therefore risk removing an important incentive for mangers to conduct research/exercise skill in making investment decisions. The result could be an increase in the volume of trading by active funds, or managers taking less care simply because the importance of their performance to the firm is much reduced.

6.6 In addition, since charges are reflected in the past performance of products, a ban could to some extent restrict consumers' access to information about the past effect of charges.

6.7 There are other potential consumer detriments which might arise in consequence of a ban. For example, there is no guarantee that other, more consumer-friendly, information about features of funds such as price or flexibility would be advertised instead of past performance. Another possible effect is that the amount of advertising as a whole could be reduced. Whether this would be valuable for firms or consumers is unknown.

6.8 Arguably past performance is factual information which, if presented in a context that emphasised the fact that it is not a reliable guide to future performance and should not be the main or sole factor taken into account in investment decisions, need not result in consumer detriment when advertised. It was also felt that encouraging the provision of a broader set of information alongside past performance could promote a more active and critical approach by consumers in their evaluation of competing products.

The Task Force's view on banning

6.9 The Task Force are not in unanimous agreement on this point. **Most members consider that a full-scale ban on the use of past performance information in advertising would not deliver benefits that would outweigh the likely difficulties arising from the ban**. They favour alternative approaches (described below) to control the presentation of the information.

6.10 **A significant minority favour a ban. This minority consider that continuing to allow the use of past performance information in promotional material is inconsistent with the FSA's public awareness and consumer protection objectives.**

7 Alternative options for the FSA in the absence of a ban

7.1 The Task Force agree that further measures are needed to reduce the risk that past performance information is used by investors to form an unrealistic expectation of the future growth of their investment. They have identified a range of measures which they wish to recommend to the FSA, assuming that the FSA decides to continue to permit the use of past performance information in advertising.

7.2 The Task Force wish to emphasise that the following recommendations represent measures to control any potential consumer detriment arising from continued publication of past performance information of specific funds. However, they do consider that **it is useful for consumers to have information about the overall performance of equity-based investments relative to deposits** and that an appreciation of the fact that, in the long-term, equities have consistently out-performed deposits is important information which consumers should be made aware of.

Raising the current standards

7.3 The Task Force have identified several points where the regulatory regime could deliver further consumer protection if it were made more restrictive.

Past performance data should not be the main message of an advertisement

7.4 The Task Force are concerned by advertisements where the past performance of a fund provided the main sales message and have concluded that past performance should not be allowed to be presented as the main message of the advertisement.

7.5 The Task Force recognise that it would be difficult to devise rules and guidance to implement this point, as it would call for subjective assessments of the impact of statements and presentations. However, there is precedent for such an approach in controls over advertising of some non-financial products. They therefore recommend that **the FSA should devise requirements that past investment fund performance should not be the main message of an advertisement.**

Risk warnings and small print

7.6 To address the possibility of consumers misusing past performance information, the current regime relies on the inclusion of warning statements reminding customers that past performance is not necessarily a guide to the future. The Task Force recognise generally that 'warning' statements are, in many ways, an unsatisfactory tool. The reader is likely to be more strongly influenced by the positive message about past performance and they will instinctively link that information to speculation about the future. It is better to avoid a misleading impression being planted in the reader's mind than to use warnings as a way to mitigate the damage after the event.

7.7 The Task Force also note that there is a risk that if warnings become increasingly familiar and stereotyped their impact becomes cumulatively less. The FSA's recent research for the new mortgage information regime confirmed that the risk warning ('your home is at risk') tends to quickly become a cliché as far as customers are concerned.

7.8 These are points that the Task Force believes the FSA should give careful consideration to in its general review of the financial promotion regulatory regime, which it is currently undertaking.

7.9 In the case of past performance, however, the Task Force believes that the FSA should still take measures to warn consumers about the dangers of using past performance information alone to guide their investment decisions. The Task Force therefore recommend that, as a minimum, **the FSA should require that a past performance warning be presented prominently and legibly in the main body of the text. A minority of Task Force members thought that the FSA should take an even more restrictive approach and require that the warning be given equal prominence to any statement about past performance.**

'Hypothetical' past performance

7.10 The Task Force note the current practice to permit hypothetical performance in some circumstances, such as where the performance of an existing underlying fund has been adjusted to take account of a new tax regime or replacement charging structure. They accept this approach, which has become standard practice in the industry, providing that advertisements explain clearly the approach that has been taken.

7.11 However the Task Force find some methods of re-constructing hypothetical past performance unacceptable. They are concerned particularly where a new product is launched with a 'virtual' performance record created specifically for that product based on the terms of the product and historical information about equity performance, interest rates, option prices and other information. The danger here is that the structures of these products can make the simulated past returns a misleading indicator of risk.

7.12 They consider the construction of such past performance records to be unacceptable, and request the FSA **to prohibit the practice of re-constructing hypothetical past performance from information other than that based on the actual performance of the relevant fund.** A minority of the Task Force members thought that, in addition to this, the FSA should ban any form of hypothetical past performance.

Standardising the presentation of past performance information

7.13 The Task Force have noted the supervisory concern that firms are allowed to select the period of past performance in order to show their products in the best light (the problems arising from this practice is explained in section 4 above). They recommend that **the FSA should take the necessary action to standardise the content and presentation of statements of past performance in advertising.**

7.14 The objective underlying a more standardised approach would be to prevent the selective and misleading presentation of information, and to introduce some element of uniformity to the way past performance statistics are used by different firms. The underlying premise would be that, although the FSA cannot stop consumers wanting to know about past performance, it can take measures to ensure that firms present it in an accurate and consistent way. Prescribed standards would reduce the scope for misleading practices by providing clearer guidelines for firms about what is and is not acceptable.

7.15 The Task Force recognise that any measures taken by the FSA to standardise presentation of past performance are likely to affect the market. There is no perfect measure of the performance of a fund. There will always be some funds able to report a particularly good performance against one measure or other – and occasionally this will appear to be consistent, even if the outcome is no different from that which would occur by chance alone.

Discrete or cumulative measure for past performance?

7.16 Typically, funds advertise their cumulative performance, over at least 5 years if they have been in existence for that long. However such figures can be significantly affected by a particularly good or bad return over a short period. The addition of a discrete measure of performance – that is, one which covers one or more individual years' performance – would therefore be beneficial. Consumers might then see whether a fund has consistently ranked in the top quartile of performers each year or whether a high cumulative – that is, measured over a number of years – return is because of an exceptional year only.

7.17 The Task Force has already noted the importance that risk should play in the choice of a person's investments and that insufficient attention is currently given to risk. Adding a discrete measure of performance could help provide an indication of risk. Within any sector, there will be some funds that offer a potentially higher return due to a higher appetite for risk. A measure that looked at performance over discrete time periods could disguise the higher returns that are to be expected from a riskier fund and which are apparent when cumulative performance is shown, but be a more obvious indicator of risk because the short-term volatility is more likely to be demonstrated. This is because more volatile funds have a greater chance of producing an exceptional return in one year (and so report a very good cumulative performance over a longer period that included that exceptional year), but the returns are also less likely to be consistently high in other discrete years' performance.

7.18 Funds which have had a less consistent performance in the past (more risky) will therefore have a lower measure of discrete performance than those which have performed consistently well. The Task Force has noted evidence prepared by the FSA that demonstrated that funds with high cumulative performance are generally more risky by a discrete performance measure.

7.19 However, the Task Force recognises that there is probably consumer demand for cumulative performance information; indeed, it is the cumulative information that shows over the longer term that equities outperform deposits. The Task Force recommend that **the FSA consider in more detail the best way to standardise past performance information in terms of cumulative and discrete performances.** This consideration should include further analysis of the merits of discrete measures of performance and how such measures can be presented in a useful and consumer-friendly way. It should also cover the question of whether additional cumulative (that is from various points in the past to the present) performance information should be permitted.

7.20 Should cumulative performance be permitted, the FSA should consider whether to mandate only one specified period. For example, as now, firms could be obliged to quote performance over the previous, say, five-year period, but (unlike the current position) no other period could be used. Exceptionally, for funds that have been in existence less than five years, they would be entitled to show performance since launch. However, careful consideration would have to be given to the impact of such an approach on long-term products such as pensions and some life policies.

7.21 In relation to the methods of quoting past performance, the Task Force have noted the research finding that consumers preferred the use of monetary amounts rather than percentage returns or annualised percentage returns. However, they also note the comment from advertising agencies that monetary amounts were regarded as a device to deal with indifferent performance. The Task Force also note from the research that consumers are likely to equate any figures shown in advertisements with the actual returns that investors would have received. They therefore consider that, although alternative presentations might be allowed in specialist or trade publications, consumer advertising should be allowed to feature only actual investment returns, net of charges, and that any comparisons, etc should be devised accordingly.

7.22 The Task Force recommend that **the FSA should review the options and devise a single consistent measure for presentation of past performance. Any figures should be quoted on a basis which shows the actual effect of investing in the fund.**

7.23 In reviewing the issue of standardising past performance information, the Task Force noted the FSA's decision not to include past performance information as part of its comparative information scheme. They concluded that, should it be possible to arrive at a single standardised and objective measure of past performance, there would be some attraction in presenting the information in the comparative tables. This would give consumers access to information for all product providers and allow them to test and compare their claims.

7.24 However, the Task Force has noted the FSA's arguments against this approach, set out in section 1 of this paper. There is the further concern that publication of past performance information by the FSA could have the effect of 'legitimising' and promoting the use of information that the FSA considers risks misleading consumers by leading them to believe that the information has significant predictive value in itself.

7.25 The Task Force have noted the FSA's evaluation of the option, but are not in unanimous agreement with it. On balance, they suggest that should an acceptable standardised measure of past performance be developed, then the FSA should reconsider its decision not to include past performance information in the Comparative Information Scheme.

Putting past performance in context

7.26 In considering options for controlling the presentation of past performance information, the Task Force suggest that it would be helpful for any statement of performance to be put in context. The first question is whether there should be some independent benchmark against which to rank performance, or should ranking be relative to similar products. A further question is whether other information is necessary to provide a context in which past performance can be viewed in its proper perspective; for example, the riskiness of a product, or its relative price.

Benchmarking or ranking

7.27 The Task Force have noted that research showed that consumers find it very difficult to compare between funds in different sectors, particularly sectors with different risk profiles, etc. They have also observed that the past performance of many funds reflected the sector in which the fund was invested, rather than the inherent skill of any manager.

7.28 One solution which the FSA might wish to consider would be to prohibit the use of absolute performance figures for investment funds, but rather to require funds to show their respective performance against other funds in that sector. For example, a fund would be entitled to claim 'Third out of 63 funds in the North America sector'. The Task Force have considered the use of quartiles or quintiles in this context. For example a fund could quote '1st quartile performance over five years in the North American sector'. However, the Task Force acknowledge that consumer understanding could form a barrier to such an approach.

Risk

7.29 The Task Force note that research found consumers typically do not consider risk when making a choice of investment fund. Neither the risk of a particular fund relative to funds in the same sector nor the risk of the sector as a whole are given prominence in decision making. But the Task Force believes consumers would benefit if information were readily available on the risk of the sector in which a fund falls.

7.30 They have also noted from the research that consumers intuitively appear to benchmark expected returns against the performance of deposits. The Task Force found this to be a reasonable practice on the part of consumers, but concluded that it is also very important to be able to communicate to potential consumers that when investing in equities there is a risk that they may not get their money back.

7.31 Measuring risk is a challenge and the Task Force acknowledge that the risk to which a fund's clients were exposed in the past would not necessarily provide a guide to the future. This is both because market conditions may change and because the incentives for a fund to manage risk in the future are clouded by the difficulty of obtaining a reliable measure. However the Task Force believe that, for a consumer who chooses to consider the past performance of a fund when picking an investment, the past risk of the fund provides a necessary context in addition to any general risk associated with equity investment. They therefore recommend that **the FSA research and adopt a method by which the risk of a fund relative to others within the same or similar sectors, and relative to other forms of investment, such as cash can be measured and communicated clearly to consumers in an advertisement.** Were such a method to be developed, the Task Force would like to see inclusion of a relative risk indicator in the FSA Comparative Tables.

<u>Price</u>

7.32 A number of funds levy initial and management charges, and further costs may be charged to the investor. The price which a consumer pays for investment funds may therefore change with the amount invested and the period of time for which the fund is held. The Task Force are also aware that personalised price information may be available from financial advisors and that product literature will provide a number of indicators of price. Although there are difficulties associated with finding a representative measure of price the Task Force recommend that the FSA considers whether it is feasible and desirable to require the inclusion of a price indicator in advertisements. Price and the return that the customer might expect to receive are directly related and therefore relevant to the investment choices made.

A holistic approach

7.33 The Task Force considered in some detail whether the information needed to give context to the figures typically provided on past performance might be standardised in a combined format to give consumers an easy to recognise and understand package of information within an advertisement for a given product. A model consisting of up to three indicators: past performance, risk and possibly price – the 'matrix' approach – was devised as an illustrative approach.

7.34 The matrix approach was not further developed by the FSA during the time available to the Task Force. But, in principle, the Task Force see advantages in requiring advertisements that quoted past performance information to include other information, presented in a standard, comparable, way in the form of a matrix with symbolic representations of past performance, relative risk and cost. However, the reaction of both firms and consumers to this approach would need to be carefully evaluated. In particular, the FSA will need to establish whether consumers would find the information helpful and what impact if any publication of matrix data might have on market dynamics.

7.35 The Task Force recommend that **the FSA undertake further work on a model which can be used to indicate performance, price and risk and also to consider how this**

information might be included in advertisements in a way that will enhance consumer understanding. Too much information in an advertisement will prove counter productive, perhaps dissuading customers from making an investment which is in their interests and also confusing them as to the important features of the product. Therefore a simple approach is preferable, possibly using symbolic representations of the measures.

8 Conclusion

Adapting the supervisory approach to existing rules

8.1 The Task Force recognise that many of their recommendations will lead to further analysis, consumer testing and consultation by the FSA before firm proposals can be established. Any new approach must be simple and accessible for consumers. They also acknowledge that their work should be seen in the context of the FSA's wider review of the entire financial promotion regime.

8.2 In many cases, any action on the part of the FSA to change its rules and guidance on those rules will incur a requirement to consult on the proposed changes. However, the Task Force are keen that action should be taken to correct some of the most severe problems connected with past performance information as quickly as possible.

8.3 The Task Force believe that the FSA could achieve some benefits without radical change to the regime, by tightening up its supervision and enforcement of existing regulations without necessarily being prescriptive or issuing formal guidance about exactly how past performance should be represented.

8.4 In that respect, they strongly recommend that, **as an interim measure to address the problems associated with past performance information, the FSA should review its new Conduct of Business Sourcebook with the view to establishing what changes in supervision practice will be appropriate at N2 (the date on which the new Financial Services and Markets Act regime will be substantively implemented – 1 December 2001) to take account of the move to the new regime.**

Market research on past performance

THE RESEARCH BUSINESS

Background and Objectives

In January 2001, the Financial Services Authority commissioned The Research Business *International* to conduct research to explore how consumers use and interpret past performance information in advertisements when choosing an investment.

The main objectives of the research were:

- To explore how elements of advertising influence consumer behaviour
- To explore what consumers understand by 'fair, clear and not misleading' with regard to past performance advertising in the press
- To find out the extent to which advertisements are considered to meet the letter of the regulations but fail in the spirit

Methodology

The material under review was press advertising for managed investment products, primarily ISAs and bonds. The research adopted a multi-stage qualitative approach, exploring the views and opinions of consumers, industry practitioners and their advertising agencies.

- **Consumers:** 24 x 1 hour depth interviews reconvened into extended mini group discussions with consumers. The sample was in the target market for this type of advertising: regular readers of the financial pages of the press, active decision makers and currently in the market for investment products. The sample also included a mixture of "bulls" (aggressive investors) and "bears" (more cautious investors), and static (non-switchers of investment) and mobile (switchers) investors and those investing for growth and income
- **Firms:** 12 x 1 hour depth interviews with product providers, with an even mix of marketing and compliance managers. The companies interviewed included mainstream life and pensions providers, specialist investment houses and two major IFA firms.

- **Agencies:** 6 x 1 hour depth interviews with a mix of creatives and planners from advertising agencies. The agencies included both mainstream companies and specialist financial services companies, and all respondents were closely involved in developing advertising for investment clients

The research was carried out during March and April 2001.

Consumer Research

1 Profile

The majority of respondents interviewed were found to be conservative investors, preferring well-known brand names and selecting products perceived as low risk. Relatively uninformed about financial products, they appeared to lack full understanding of the investment products (and associated terminology) which are on offer and in which they may have invested. On the other hand, a minority of confident investors demonstrated a good awareness of the market and products, and were careful to regularly monitor their investment portfolio.

2 The Consumer Context

Investment decisions emerged as multifaceted and influenced by the consumer's past experience as well as the current information available to them. Brand reputation and 'returns' (performance) were found to play a key role for all consumers.

Less sophisticated investors tended to seek reassurance in a well-known brand and also required a good 'interest rate'. Those with more knowledge, the minority, considered risk, as well as the track record of the company or fund in question, before making their decision. Generally, performance was benchmarked against (perceived) interest rates on building society accounts.

There was a deep-seated belief in the long-term performance of the stock market. The evidence suggested that, although risk is accepted on a rational level, many consumers did not accept the true risk emotionally. Risk to capital was unacceptable for most, with only a minority prepared to expose themselves to a potential risk to their investment returns (and then only for highly volatile funds as part of an overall portfolio). For many, particularly the less sophisticated, the brand brought added reassurance and may have 'masked' the actual exposure to risk.

3 Information Sources

The sources of information used to find out about financial products were broadly similar across the sample, although the way in which they were used differed according to sample group. Those who were less familiar with, and interested in, financial services used the sources at a relatively superficial level, seeking generic information. The more confident individuals were more interested in the detail and used a wider variety of sources.

Financial editorial in the press was a key source for all respondents, who believed that it offered independent, unbiased and accurate commentary on the market. Advertising within these publications also provided information, albeit in a secondary role, alerting respondents to investment products and opportunities. Some respondents' insistence that advertising does not affect purchase appear to be contradicted by other clues (such as awareness and recognition of the advertising, knowledge of advertisers' 'techniques', response to ads in the past, anecdotal stories re friends and relatives purchasing directly from the ad), indicating that it has a greater contribution than would appear on the surface.

4 Consumption of Advertising

Advertising influences the purchase at several stages in the decision process:

Alert
- To the product or investment opportunity

↓

Small Print
- Search for 'the catch' or used to extract pertinent information

↓

Verification of information
- Use of independent sources, either by default (less sophisticated do not search out information but stumble across it), or actively sourced (more sophisticated who searched for independent reports)

↓

Product Brochure
- Tangible evidence of the product and source of the application form

5 Elements of Advertising

Consumers identified four key elements to the ads

Brand: The brand is indicative of the company's track record, the nature of the investment, the risk associated with the investment and the relative level of expected returns. Confident investors have a large brand repertoire, whilst the less sophisticated were drawn to the recognised household names.

Past Performance Claims: Important to attract attention, consumers believed the claims were technically 'true', but queried whether they were 'real' (did someone actually benefit in this way?). It is not the presence of the figures that was questioned, but rather the way in which the figures were presented and the terminology used to describe and justify the claim. Many consumers were unable to interpret or compare the claims in any meaningful way, and this leaves the way open for misunderstandings and inappropriate usage of the figures. Percentages were felt to be potentially confusing because of averaging, compound growth and the way that, depending on the wording, it could be unclear exactly what the percentages quoted were referring to. Actual figures, in contrast, were seen as unambiguous.

The Small Print: The small print was universally disliked, being overwhelming and intelligible, although it is recognised as important, containing the detail and caveats surrounding the claim. Most respondents admitted that they find the small print impossible to interpret, which calls into question its efficacy as a risk-warning device.

Investment Jargon: Much of the terminology used in the advertising is obscure and not well understood except by a minority of the more knowledgeable respondents. However, its very inaccessibility acted as a filter in terms of the target market attracted to the ad.

6 Fair, Clear and Not Misleading

Consumers clearly felt that ads do not currently meet the FSA's objectives in this area. The use of jargon, complex percentages and small print, as well as a lack of signposting of the risk, were seen as unclear in themselves and unfair in that they demand too much knowledge on the part of the consumer. The ads were open to misinterpretation and misunderstanding, but were not thought to be deliberately misleading, because consumer protection bodies would not allow it, leading providers would not want their reputations damaged by such practice, and because in the end the buyer has a responsibility to find out something about the products they buy.

Advertisers and Agency Response

1 Overview

Advertisers and their agencies generally agreed that the role of past performance advertising is to invite enquiry into (rather than sell) a product. They believed that consumers and advisers seek out performance data to assess the providers' track record and they were reluctant to accept that past performance does not give any pointer to the future.

2 Target Audience

Other than analysis of response to advertising, little was known about the target audience for this type of advertising. Loosely defined as 'readers of the personal financial pages', advertisers and their agencies acknowledged that the audience was likely to be relatively unsophisticated in reality.

3 Use of Past Performance Information

Both advertisers and agencies believed that consumers use past performance and brand to select funds, with independent endorsement (via press editorial) also playing a key role. This perceived demand for past performance and the widespread view among these interviewees that response rates decline if performance is omitted from the advertising resulted in the current proliferation of this approach.

Advertising agencies in particular mentioned the power of the press, which was thought to set up consumer expectations and have considerable influence over choice of fund.

4 Approach to Performance Advertising

All advertisers claimed to operate within the spirit of the current regulation, but mentioned concerns over other companies' misdemeanours. There was general feeling that the regulations contain too many 'grey' areas and that the FSA's policing of the advertising is not thorough enough. The concerns raised by advertisers include basis of figures used, context surrounding their use and the presentation of the information. All requested that the rules be implemented in an objective, clear and consistent manner that will improve adherence to the spirit of the regulation overall. The responsibility for this would be placed on FSA with more objective, consistent and overt policing of the advertising requested.

Broadly speaking, agencies had the same concerns as the advertisers in terms of the presentation of performance information. Agencies also described a number of known techniques used to present the information in the best possible light. These included the selective basis of funds used for comparison, selective use and presentation of performance periods and per annum averaging, simulated rather than real performance, quartile information lacking in informative context, and general downplaying of risk.

5 The Issue of Small Print

Both advertisers and agencies shared similar concerns about the use of small print, believing it to be unread and ineffectual. There were also comments that the sheer amount of small print required contributes to consumers (possible) use of advertising as a 'brochure', rather than treating the ad as an invitation for further information. All requested that the small print be pared down to the absolute minimum.

Conclusions

Generally speaking, the audience for this type of advertising was relatively unsophisticated and was unable to interpret much of the information given in the ads. Whilst on the one hand this led to a degree of self-selection, it also left the advertising open to misinterpretation.

All respondents agreed that past performance and brand was key to the choice of investment product. Past performance was seen as fundamental, and if not present would be sought elsewhere by many. Consumers were using performance figures as a reasonable indicator of future performance and to benchmark their (minimum) expectations against the perceived saving account rates. The less sophisticated investors placed great faith in the brand, although it also remained important for the more knowledgeable consumer.

Risk is also a concern for investors, and all respondents felt that the balance of risk:return within the advertising was disproportionately in favour of 'return', with the risk warnings not overt enough.

The issue of small print was key, with evidence suggesting it is unread and ineffectual.

Past Performance in Advertising Task Force

Terms of Reference

1. To assist the FSA in its review of the use of past performance data in the promotion of financial products and services.
2. To review current promotions and advise the FSA on which issues/areas the FSA should focus on in respect of potential consumer detriment.
3. To advise on the scope and conduct of consumer research to test how advertisements influence consumer understanding of past performance and whether its use is considered to be 'clear, fair and not misleading'; and to review research findings.
4. To consider the desirability and feasibility of a standard approach to the use of past performance data that is fair to firms and not anti-competitive but which minimises the risk of misleading consumers, and if so what that approach should be.

Task Force membership:

Christine Farnish (Chair)	FSA
Clive Baldon (Secretary)	FSA
Roger Cornick	Perpetual
John Hylands	Standard Life
Peter Lunt	Department of Psychology, University College London
Mick McAteer	Consumers Association
Janet Walford	Money Management
Roger Wisbey	Advertising Standards Authority
David Watts	Consumer Panel Member

This Report expresses the views of the authour(s) and not necessarily those of the FSA.

If you require further copies of this report, please contact our print on demand service on 0845 608 2372, quoting reference 'Report on Past Performance'.

Alternatively, you can download this report from our website at: www.fsa.gov.uk/pubs/other/past_performance.pdf

Published by:

The Financial Services Authority
25 The North Colonnade Canary Wharf London E14 5HS
Telephone: +44 (0)20 7676 1000 Fax: +44 (0)20 7676 1099
Website: http://www.fsa.gov.uk

Registered as a Limited Company in England and Wales No. 1920623. Registered Office as above.