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Custodians Team Up to Uncloak Benchmark Fees

By Jackie Noblett

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Fund firms and service providers shell out significant sums for index data used to measure fund performance, yet those charges are often embedded in a tangled web of operational costs.

But a group of custodians plan to shine a light on how benchmark fees impact custodian charges to funds. Providing detailed information about those costs could drive some firms to swap brand-name benchmarks with lower-cost options.

State Street, BNY Mellon and Northern Trust last week announced that they have agreed to the Custodian Guidelines for Transparency in Benchmark Costs, a series of best practices to help their asset management and asset owner clients understand the costs associated with using indexes for the purposes of performance measurement.

In agreeing to these standards, the custodians will work to give their asset management clients information on the "relative cost of benchmarks," with total costs that include index licensing fees as well as the costs the service provider incurs to process and manage the data in their performance measurement service. They have also agreed to conduct a free benchmark cost assessment for clients upon their request, showing clients the cost of alternative benchmark options.

Benchmark costs have spiraled in recent years with the rise of funds' being benchmarked to multi-asset or other "custom" indexes, custodians and operations experts say. Further, some index providers require custodians to pay fees above and beyond the core licensing fee every time they distribute performance reports with such information to clients.

"There's a lot of ignorance in the marketplace about what those costs are," says Dave Spaulding, CEO of performance measurement consultancy The Spaulding Group, who helped spearhead the standardization effort. "Custodians have known about it for years, [but] the cost base for the custodians has been increasing and they're being squeezed to the point that they can't continue to eat them."

Custodians have little say in which indexes a fund firm client chooses to benchmark performance against, and the decision is usually driven in part by how clients — from pension funds to distributor due diligence teams — use indexes in evaluating strategies. Often times the default is a well-known index, such as the S&P 500 for U.S. equities, MSCI for global equities and the Barclays Aggregate Bond Index for core fixed income.

Yet those choices have a big impact on the cost of running performance measurement by custodians and service providers. Acquiring the appropriate indexes to perform such services "has gotten more complicated and costly in the past few years," says Joe Nardulli, senior market data consultant at Northern Trust. The higher costs became particularly noticeable following the financial crisis, he adds.

Some asset managers have been aggressive in managing their own licensing costs for passive funds that track the performance of broad-based indexes. Most notably, Vanguard dumped MSCI as a benchmark on 22 index funds and ETFs in order to lock in long-term pricing.

"More indexes and tracked products are being launched all the time, and I think this is a proactive move by the custodians to show clients the cost of doing this," says Matt Bacon, principal of operations consultancy Alpha Financial Markets Consulting, in an e-mail response to questions.

But for other fund managers and investors, it is "inertia" and familiarity rather than a particular investment reason driving benchmark selection, says Sean Wasserman, a managing director atNasdaq. "All [investors] see is a management fee from a manager and a headline fee from a custodian. They don't see any of the downstream implications of their choices."

Nasdaq is offering to license its global markets indexes to custodians that agree to the principles, thereby positioning itself as a low-cost alternative to other benchmark data providers.

Yet some index providers say that their brand does have tangible value to clients using their benchmarks, and clients are willing to pay for it.

"Our clients are increasingly placing a heavy emphasis on the value of brand," says David Guarino, spokesman for S&P Dow Jones Indices, in an e-mail statement. "Clearly we should be compensated for the intellectual property, the strong customer service and brand reputation we provide."

In addition to index funds, the rise of go-anywhere and multi-asset strategies in funds increasingly requires a specialized benchmark for performance reporting and measurement, Northern Trust's Nardulli says. This could require a custom index, which tends to have higher fees, but what one index provider considers "custom" may differ from another provider and cause variations in pricing.

Generally, index providers charge custodians a fee for accessing the benchmark data to measure performance, and sometimes can charge extra fees based on how many funds will use that benchmark data in their performance reports. Each contract can be somewhat different in how the fees are structured, experts note.

While Guarino described S&P's index licensing agreements as "multifaceted" and declined to provide specific detail, he says the arrangements "align our interests with the success of our customers."

Generally custodians incorporate benchmark licensing and data fees into an overall performance reporting charge, but the standards will unbundle some of the pieces that affect the fee, such as index costs. Firms will be able to see how choosing a benchmark that is less expensive to license will impact their custodian fees, Nardulli says.

Customized benchmark cost analysis for clients will serve as an additional educational tool, he adds. The analysis will include both costs and correlation, tracking error and other data about the benchmark options.

While supporters of the transparency standards see them as a way to help asset manager and pension fund clients manage costs, it is unclear whether they will reduce the index costs.

"I don't see a lot of the incumbents reacting until some of the low-cost [index] providers take market share," Nasdaq's Wasserman says.

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