

Rt Hon Nicky Morgan MP
Chair
Treasury Select Committee
House of Commons
London
SW1A 0AA

18th June 2019

Dear Ms Morgan,

Thank you for your letter of 11th June, and the questions you have raised in relation to the LF Woodford Equity Income fund (the fund, the Woodford fund, Woodford Equity Income).

I want to begin by expressing my regret for the distress, uncertainty and inconvenience caused to all those of our clients who have used Hargreaves Lansdown's platform to invest in the Woodford fund and who are currently unable to access their investments. Helping our clients through this process, learning the lessons and applying them in a timely manner is our top priority.

In addition to answering the Committee's specific questions, we have set out in this letter some more detailed background on Hargreaves Lansdown, its favourite funds list and its engagement with the Woodford fund. We have also set out the actions we have taken in response to the recent developments with Woodford and our initial view on what else needs to be done to protect the interests of savers and investors.

I hope that this information is useful to the Committee. If you have further questions or would like additional information, please do not hesitate to contact me.

Hargreaves Lansdown

Hargreaves Lansdown operates a platform which enables people to make investment decisions directly, without the services of a financial adviser. Our clients can choose from a range of approximately 3,000 funds, 8,000 UK, US, Canadian and European shares, and 2,000 exchange-traded funds (ETF), investment trusts, bonds and gilts. They hold these investments in an HL account, for example a Stocks and Shares ISA or self-invested personal pension (SIPP).

HL continues to be headquartered in Bristol, where it was founded in 1981, and our 1.2 million clients invest £97.8 billion through us (as at 30 April 2019), making us the UK's largest direct-to-investor service.

'Best buy' lists

One tool that people can use when making investment decisions is 'best buy' lists. Such lists provide an important function. Behavioural economics suggests that when people are presented with an extremely wide or unfamiliar choice, for example about financial planning, they can end up not making any decision at all. At a time when demographic changes require increased saving for retirement, this would clearly be sub-optimal for individuals and for society as a whole.

In their Investment Platforms Market Study, the FCA found that, on average, 17% of non-advised platform clients¹ use 'best buy' lists, and that for less-experienced consumers or those new to

¹ 3.22, 3.23 and 6.20 in the <https://www.fca.org.uk/publication/market-studies/ms17-1-2.pdf>

investing 'best buy' lists and/or model portfolios appear to provide a useful tool in making decisions when choosing from a full range of funds. The FCA also found that best buy lists do add value by identifying funds that perform better than funds not on the list.

In order for best buy lists to help savers make investment decisions, it is crucial that they are rigorously and fairly constructed, that this process is backed up by appropriate oversight and governance, and that there is no commercial conflict of interest between the 'best buy' list / model portfolio provider and their clients.

Rigorously and fairly constructed

At Hargreaves Lansdown, our 14 person investment research team devotes thousands of working hours every year to conducting quantitative and qualitative analysis of fund managers and the funds they manage.

The process begins with a bespoke quantitative system of fund manager performance records. This helps identify fund managers which have added value over the long-term through repeatable skill rather than market movements or thematic biases.

Once we have identified this ability our fund research team conducts face to face meetings, and applies a qualitative analysis of the manager's process, philosophy, team support, incentivisation and portfolio construction. Typically, we conduct more than 175 fund manager meetings a year through this process.

Our methodology for constructing and reviewing the constituents of our favourite funds list, the Wealth 50 is extremely rigorous and uses the outputs of the fund research team work above. The Wealth 50 selection follows the same robust research process as its predecessor the Wealth 150. The Wealth 50 was launched in January 2019 due to client demand for a shorter more focused list.

To challenge the quality of the existing list and identify potential new entrants, the team completes formal assessments of every major investment sector twice each year. This assessment includes a review of every Wealth 50 fund and Hargreaves Lansdown Multi-Manager portfolio holding in their respective sectors, and any other funds we believe have strong performance potential.

The process culminates in independent investment decisions being taken on the inclusion or removal of funds on the Wealth 50 list. These decisions can either be taken as part of the reviews or on an ad hoc basis and any change must be proposed, seconded, challenged and voted on by the investment team. On any day, any member of the team can propose a change to the Wealth 50 list. Any change to the Wealth 50 is immediately communicated to clients who hold the relevant fund.

This research has resulted in the selection of funds onto the Wealth 150/50 which have on average outperformed both their relevant benchmark index and their sector average after charges, by 5.8% and 11.8% respectively over the period they have been on the Wealth 150/50 list.²

Oversight and governance

² The Wealth 150 was only replaced by the Wealth 50 list in early 2019 in response to client demand for a more succinct list. It is still too early to produce performance data for the newer list.

Independent challenge and oversight to HL's investment business and decision making process is provided by the Investment Committee (a Committee of the HL plc Board). The Committee's remit includes overseeing investment research decision making, policies and outcomes inter alia relating to Multi Manager funds, and the Wealth 50, and the marketing of third party funds.

Decisions around the client proposition surrounding 'best buy' lists are reviewed by the Product Governance Committee and Executive Committee to ensure alignment of the product proposition with the organisation's values, e.g. delivering client education linked to their objectives and ensuring the delivery of appropriate client service and outcomes.

No commercial conflicts of interest

In terms of fee income, Hargreaves Lansdown is paid directly by our clients, not by the fund managers. Our fee income is calculated as a percentage of the clients' assets held on our platform, and we earn the same fee regardless of the funds our clients hold. If they select a good fund manager and their assets grow more quickly, we end up earning more; this means our interests are aligned with our clients.

Furthermore, and entirely separate from the question of investment performance is the negotiation that Hargreaves Lansdown conducts with fund managers on behalf of our clients to reduce their investment costs. Hargreaves Lansdown uses the combined buying power of our 1 million plus clients to get the lowest cost we can for each fund.

All other things being equal, a lower price for our selected managers delivers better investment returns for our clients. The average reduction to the standard annual management charge negotiated by Hargreaves Lansdown for actively managed funds on the Wealth 50 list is 30%. In 2018, our clients saved over £61 million on their fund management costs as a result of the terms negotiated on their behalf.

The Committee's questions

- 1. How many Hargreaves Lansdown customers are exposed to the LF Woodford Equity Income Fund, whether directly or indirectly? What is the average size of their direct investment? What is the total exposure of Hargreaves Lansdown's customers?**

There are 133,769 Hargreaves Lansdown clients with direct exposure to LF Woodford Equity Income. They own units worth £1,091m, which represents 1.1% of Hargreaves Lansdown's total Assets Under Administration. The average direct investor holding in Woodford is £8,152, with 50% of our clients holding less than £4,000 and 20% holding less than £1,000.

The total number of directly and indirectly exposed Hargreaves Lansdown's clients are 291,520. Indirectly exposed clients are those who own units in funds that have an underlying exposure to Woodford Equity Income fund, including the Hargreaves Lansdown Multi Manager range. This means 76% of our clients have no direct or indirect exposure to the Woodford Equity Income fund. Collectively, the total exposure of Hargreaves Lansdown's clients is £1,619m. This represents under 1.7% of Hargreaves Lansdown's total Assets Under Administration.

- 2. Lee Gardhouse your Chief Investment Officer, noted in a recent statement that "We've been speaking to Woodford for some time about the number of unquoted and hard-to-trade companies in his portfolio." Can you provide the Committee with a timeline as to your engagement with Woodford, including when you raised your concerns, both before and after the suspension?**

The nature of active fund management portfolios is that there will be periods of outperformance and underperformance by all managers. There are a limited number of individuals who do deliver outperformance over their peers and indices over the long term, and that investors who own these managers' portfolios benefit from these outcomes.

The Wealth 150 list of our favourite funds was launched in October 2003 as a way of helping investors to identify these managers in a universe of more than 3,000 funds available to UK investors.

Neil Woodford worked at Invesco Perpetual at the time of the Wealth 150 launch and, as detailed in question three, two of his funds were featured on the list during his tenure at the firm.

During his career, Woodford has had a track record of underperforming for periods but then recovering strongly, as he often takes investment positions against prevailing sentiment.

As with all fund managers on our Wealth 50, we carried out significant due diligence before admitting the Woodford Equity Income fund to the list. This included sending our own internal auditor to Woodford Investment Management before the fund launched and obtaining details on how they would be valuing their unquoted stocks.

Our research and investment team met with the fund manager both in Bristol and Oxford. We also met with their head of dealing, head of compliance, chief operating officer, head of legal and CEO.

Since taking the decision to include the Woodford Equity Income fund on the list in 2014, we have met with, or conducted teleconferences, with Neil Woodford and his team 31 times to discuss the portfolio and his investment process.

The team had also met with the manager at his previous employer Invesco, where his previous funds Invesco Perpetual Income and Invesco Perpetual High Income were held in our Multi Manager funds since 2002, and were listed on the Wealth 150.

For the first two and a half years from launch the Woodford Equity Income fund was among the top performers in the sector, but by the end of 2016 the fund started to underperform. We had seen the fund manager display similar underperformance in 1999, but then bouncing back strongly to 2003 and again underperforming in 2009, rallying strongly to 2016. We believed there was a reasonable expectation that he would do the same again.

The fund manager has a history of successfully investing in small and/or unquoted stocks through his time at Woodford Investment Management, and previously at Invesco Perpetual, dating back to at least 2001. We have been gathering full portfolio data on a monthly basis on Woodford's investments since this time. We communicated to clients that the Woodford Equity Income fund would buy into these small and unquoted businesses from launch.

In November 2017, as part of our regular analysis, we identified an increase in the proportion of these small and unquoted assets in the Woodford Equity Income fund. We met with the fund manager that month and urged him to address the issue. The manager committed to us that he would make no new investments into unquoted businesses from that point.

We also recommended the fund manager reduce the early warning thresholds for his investments in unquoted companies, which they agreed to do.

We insisted that they abide by the UCITS guidelines not to breach the 10% level and to inform us immediately if they did, to which they also agreed. We have subsequently, on 18th June 2019 in FCA Chair Andrew Bailey's response to the Treasury Select Committee, found out that Woodford twice breached this limit in February and March 2018. They did not inform us of this on either occasion.

At this point we insisted on more regular meetings to track how Woodford would be managing the portfolio shift. Our judgement was that our discussions would result in actions that would lead to him restructuring the portfolio and better relative returns over the longer term.

We communicated an increase in the proportion of small and unquoted stocks to our clients in December 2017.

In January 2018 we initiated monthly communications with Woodford Investment Management specifically addressing the unquoted stocks in the portfolio, either via a call or email.

Through 2018 we continued to meet with the manager. At each of these meetings, and in our monthly communications, we questioned the manager on the levels of unquoted stocks in the portfolio. We also asked for details on how he planned to reduce these positions.

In April 2018 the fund was re-categorised by the Investment Association as an UK All Companies fund rather than an UK Equity Income fund to reflect the lower income being paid by the fund. We communicated this change to clients.

In November 2018 we emailed the authorised corporate director Link Asset Services to request information on the valuation of the unquoted part of the portfolio, and their fair value pricing process. We followed up with Link in March this year.

We met Woodford in April this year to further discuss the detailed plan to remove the unquoted and illiquid element of the portfolio. He promised to remove the unquoted and illiquid element entirely, and to announce this publicly.

Woodford Investment Management confirmed these plans in more detail to clients in early May 2019 and announced their intention to sell all unquoted holdings.

On the same day we communicated to clients that we had been encouraging him to adjust the portfolio and were pleased he was taking action to do this. We believed this would return the fund to a more stable state and the public announcement would reduce pressure on Woodford, therefore reducing outflows.

On careful analysis of the situation, and taking a balanced view in the interests of clients, our investment team decided to maintain the fund in the Wealth 50.

During the course of 2018, redemptions from the fund began to increase. This meant the manager sold stocks where he had the least conviction to meet demands for investor cash. This in turn meant the unquoted portion of the portfolio was not reduced as quickly as possible.

Unfortunately, pressure continued to build and, after Kent County Council requested the redemption of £260 million, Link decided to suspend dealing in the fund.

Since our analysis identified the rise in the proportion of unquoted companies in the portfolio, we have consistently communicated our wish to see this reduced to Woodford Investment Management, who listened to our concerns and were taking action.

However, the rate of outflows from the fund meant that they were not able to fulfil their commitments to reduce and eliminate unquoted and illiquid investments before Link decided to suspend dealing in the fund.

We have tried to discuss this decision with Link, their approach to valuing the fund's individual private and illiquid investments whilst dealing is suspended and how and when they might approach reopening the fund. To date, they have not answered these questions or our concerns.

On the afternoon of Tuesday 4th June, soon after the decision to suspend the fund was made, we decided to waive our platform administration fees for clients who have holdings in the Woodford Equity Income Fund and to urge Woodford to do the same in respect of his fund management fees.

We continue to believe Woodford should suspend collecting its fees whilst their clients cannot access their investments. This is the right thing for them to do.

3. How long has LF Woodford Equity Income Fund (and Woodford Income Focus) appeared on the Wealth 50 (or any similar) fund list?

The LF Woodford Equity Income Fund was added to the Wealth 150 list when the fund launched in June 2014. It was also added to the Wealth 50 list when that list was launched in January 2019. The LF Woodford Income Focus Fund was added to the Wealth 150 list when the fund launched in March 2017. It was added to the Wealth 50 list in January 2019.

Neil Woodford previously worked at Invesco Perpetual from 1988 to 2013. A number of his Invesco Perpetual funds were also on the Wealth 150, as follows:

- Invesco Perpetual Income – added October 2003 (launch of Wealth 150)

- Invesco Perpetual Monthly Income Plus (co-managed with Paul Read and Paul Causer) – added October 2003 (launch of Wealth 150)
- Invesco Perpetual Distribution (co-managed with Paul Read and Paul Causer) – added February 2004
- Invesco Perpetual UK Equity Pension – added May 2005
- Invesco Perpetual High Income – added March 2008

The funds were removed when he left Invesco Perpetual in October 2013.

4. How often is the continued inclusion of a fund on the Wealth 50 list considered?

This is an ongoing process. We carry out a formal review of every sector and fund on the Wealth 50 twice a year. These reviews are spread out across the year during our monthly sector review meetings. We regularly meet and have teleconferences with fund managers of both Wealth 50 and non-Wealth 50 funds. Funds are both added and removed as part of the sector review process and are open to challenge and review on an ad hoc basis.

Wealth 50 process

- Quantitative analysis: our bespoke system identifies fund managers that have outperformed the market over the long term as a result of skill rather than luck
- Qualitative analysis: our research team conducts more than 175 fund manager meetings a year
- Cutting costs: our negotiation team is tasked to get the best possible charges they can for our clients on the funds we have identified as best in class
- Voted and reviewed: any addition has to be proposed, seconded and voted. The list is open to constant challenge and formal reviews
- Communication with clients: any change to the Wealth 50 is immediately communicated to clients who hold the relevant fund

Examples of changes to the Wealth 50:

- As part of our six monthly sector review process we added Majedie UK Equity to the Wealth 50 and removed TM Sanditon UK
- Outside of our sector review process, we added AXA WF Framlington UK (new fund launch) to the Wealth 50 and removed Schroder Tokyo (change of manager)

5. Have you modelled whether the inclusion of a fund on the Wealth 50 list increases the flow of funds towards a fund, and if so, by how much?

Yes, and we have identified a correlation between a fund being included in the Wealth 50 list and investment flows to the fund increasing.

However, the distribution of the observed change in flows is broad, and the external factors that influence funds flows are varied, so it is not possible to quantify the impact with confidence.

The increase in flows allows us to negotiate with the fund groups, passing the benefit on to our clients through lower charges. However, to be clear, the Wealth 50 is research led. Only once our

investment team has selected a fund on the basis of its future performance potential do we enter negotiations with the fund group.

On this basis, clients benefit from what we believe are the best funds at the best prices. Fund groups benefit from increased flows. We benefit from being able to offer guidance and discounts to our clients.

6. Your “The Wealth 50” website notes that “Using the collective size and power of one million clients, we negotiate hard to get you some of the lowest fund charges across the industry.” Was a discount obtained from Woodford Investment Managers, and if so, what was the size of that discount?

When the Woodford Equity Income and Woodford Income Focus funds were launched (in 2014 and 2017 respectively), we were able to negotiate a discount on the funds charge. The standard charge was 0.75% per annum for both funds, and we were able to offer clients of HL a discounted charge of 0.6% per annum for both funds.

When we relaunched our Wealth 150 as the Wealth 50 in January 2019, we were able to negotiate a further discount to the funds charges so that our clients paid a fund charge of 0.5% per annum for both funds.

7. Have you modelled whether a “Wealth 50” discount provided on fund management fees increases the flow of funds towards a particular fund, and if so, by how much?

The Wealth 50 combines two elements: what we believe are the best funds (our beliefs about the performance potential), at the best prices (the discount).

It is therefore not possible to determine which part of the flow is driven by the price, which part by the performance potential, and which part by the combination of these two elements.

Nevertheless, in 2018 our clients benefited by £61 million in discounted fees as a result of the terms we have negotiated with fund groups. Average reduction in fund management costs on actively managed funds is 30% below the standard annual management charge for actively managed funds on our Wealth 50 list.

8. How much did Hargreaves Lansdown receive in fees for money its customers invested in LF Woodford Equity Income Fund, by year, since 2014 until today?

The table below summarises the fee income Hargreaves Lansdown has received in respect of the Woodford Equity Income Fund.

Calendar Year	HL income received in respect of Woodford Equity Income¹ £m	Total Group Revenue £m	% of Group Revenue
2014	2.4	293.7	0.8%
2015	8.0	308.9	2.6%
2016	10.6	352.6	3.0%
2017	10.8	420.2	2.6%
2018	7.4	498.7	1.6%
To end of April 2019	1.9	159.5	1.2%

¹ Platform fee income charged directly to clients on the value of Woodford Equity Income fund investments. This fee is levied as a proportion of clients' overall fund holdings within their Fund & Share, ISA and SIPP accounts. The platform fee is charged at the same rate regardless of underlying fund held. No payments are retained by Hargreaves Lansdown from Woodford Investment Management, where received, they are rebated to clients in full.

9. Hargreaves Lansdown states on its website that “It’s important to make clear we never take payment or commission for funds to appear on the Wealth 50. We only look at performance potential.” However, your dealing charges page notes that “Hargreaves Lansdown receives commission from some fund groups for arranging and administering your investments”.

Has Hargreaves Lansdown received any commission (or any other reward) from arranging and administering investments, or for any other activities, related to LF Woodford Equity Income Fund, or funds managed by Woodford Investment Management? If yes, please provide the relevant amount by year.

We can confirm that we do not retain any of the commission we receive from Woodford Equity Income and Woodford Income Focus in compliance with the FCA’s RDR platform charge rules. Any payment received from Woodford Investment Management is passed to the client in the form of a loyalty bonus. There are no other financial payments or rewards. There is no commission received from Patient Capital Trust.

The statement on our website refers to a number of off-platform, IPO commission and pre-RDR regulation arrangements.

Next steps

The most important issue in this situation is that the Woodford Equity Income Fund reopens as soon as is practicable, whilst protecting the interests of ongoing investors and those who wish to redeem their holdings at this point. Link, the ACD, also have a vital role in this decision and process. We are therefore engaging actively with the regulator, Woodford and Link to ensure that all clients, not just those represented by Hargreaves Lansdown, receive this outcome.

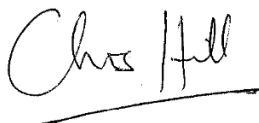
Since the suspension of the fund, HL has taken a number of steps to protect the interests of savers and investors – and we believe that more must be done.

First, when Link made the decision to suspend dealing in the Woodford fund was made, we decided to waive our platform administration fees for clients who have holdings in the Woodford Equity Income Fund. We urge Woodford to do the same in respect of his fund management fees.

Second, we have removed the fund from the Wealth 50. We immediately communicated the suspension of the fund and this decision to clients, and have dealt with all calls and emails we have received since in a timely and orderly manner. We will continue to communicate any updates on the situation to ensure are fully informed and appraised of any choices that may become available for their holdings in the future.

Third, we have been ensuring our regulators are kept up to date and we have commenced a review of our actions in relation to the fund. We are determined to learn any lessons and to apply them, in the interests of our clients, in a timely manner.

I hope that this information is useful to the Committee. If you have further questions or would like additional information, please do not hesitate to contact me.

A handwritten signature in black ink that reads "Chris Hill". The signature is written in a cursive style and is underlined with a single horizontal stroke.

Chris Hill

CEO, Hargreaves Lansdown