

What to watch for when selecting Equity Index Funds

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Important information

- The value of investments and the income from them can go down as well as up and investors may not get back the amount invested. Any investment views expressed may no longer be current.
- These funds do not offer any guarantee or protection with respect to return, capital preservation, stable net asset value or volatility. Funds are subject to charges and expenses. Charges and expenses reduce the potential growth of your investment. This means you could get back less than you paid in. The costs may decrease or increase as a result of currency and exchange fluctuations.
- The investment policy of these funds is to track the performance of an index as closely as possible, regardless of whether the index level rises or falls, while seeking to minimise as far as possible the tracking difference/error between the fund's performance and that of the index.
- The Investment Manager does not integrate Sustainability Risks into its security selection process as the securities held by each index tracking fund are determined by the constituents of the index and the Investment Manager is constrained by this.
- There is no guarantee that the investment objective of any index tracking fund will be achieved. The performance of a fund may not match the performance of the index it tracks due to factors including, but not limited to, the investment strategy used, fees and expenses and taxes. Fidelity International's partial swing pricing policy can cause differences in the fund's performance versus the index.
- For funds that invest in overseas markets, changes in currency exchange rates may affect the value of an investment. In some cases, currency hedging may minimise the effect of this but may not always be successful. Hedging also has the effect of limiting the potential for currency gains to be made.
- Funds that invest within a limited geographical area may carry more risk than funds that are more diversified.
- Funds that invest more heavily than others in small and mid-capitalisation companies can carry a higher risk because such share prices may be more volatile than those of larger companies and the securities are often less liquid.
- Investments in emerging markets can be more volatile than other more developed markets.
- The use of financial derivative instruments may result in increased gains or losses within these funds.
- These funds may have high volatility owing to their portfolio composition.
- Past performance does not predict future returns.
- The promoted investment concerns the acquisition of units or shares in a fund and not in a given underlying asset owned by the fund.
- Please refer to the Prospectus and KIID of the funds before making any final investment decisions.



Jason Humphrey

Director, Index Distribution, UK

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Introduction

There's more to selecting equity index funds than low fees

For every complex problem there is an answer that is simple, clear and often wrong. So it is with equity index funds and fees. Investors may be drawn to the cheapest KIID Ongoing Charges (OCF) as they believe their interests are best served by having the lowest fees possible. After all, for funds that track the same index, how much impact can other factors have?

The answer, it turns out, can be quite a lot.

Logically, good client outcomes for equity index tracking funds should be judged less by OCF than by tracking difference - a measure of how closely a fund tracks its index - as this gives a truer reflection of the 'cost' of ownership.

However, comparing tracking difference between funds is complicated; there is no simple way for investors to be sure of the true cost of owning an index fund. It is therefore understandable that investors gravitate towards a lower OCF, but this does not give a full picture of the total cost of ownership.

As with active funds, we outline why extensive due diligence is key when selecting equity index funds. Asking the right questions can lead to better investment outcomes.



Learning outcomes

The UK market for equity index funds tends to be cost led, perhaps overly so, because the simple truth is that there are other aspects to the way equity index funds operate that can have far more significance on client outcomes than the difference of a basis point or two in annual ongoing charges.

This paper explores why these aspects are important due diligence considerations. You might find it surprising as to how unlevel the playing field actually is, but by raising awareness of these issues we hope to help our professional clients improve their equity index fund due diligence on behalf of their own consumers.

We would welcome the opportunity to discuss with you our research that identifies key differences between Fidelity and the other four largest managers that offer a similarly broad range of equity index funds to UK investors. Through this, we can help you uncover some of the pitfalls that can distort the comparability of tracking difference across different fund providers.

Active decisions for passive investing

When it comes to due diligence, professional investors cover what's going on inside a fund's portfolio well.

But in our experience, it's what goes on around an equity index fund's portfolio that can have just as much, if not more, significance on the client outcome.

The focus of this paper will predominantly be on how different equity index funds can be structured, but first we will explore the index selection.

Factors affecting equity index funds

Index selection

Ensuring the intended exposure is as expected

- Market exposure
- Composition

Examples:

- MSCI World is a developed market index, but FTSE World includes several 'primary' emerging markets as well
- MSCI Pacific ex Japan includes 4 developed markets; FTSE World Asia Pacific ex Japan additionally includes S.Korea, Malaysia, Taiwan and Thailand
- MSCI Emerging Markets has c.23.7% exposure to S.Korea; FTSE Emerging has 0%

Structure of product

Funds have different characteristics

- KIID Ongoing Charges figure (OCF)
- Portfolio Transaction Cost (PTC)
- EMT Ongoing Cost / "Synthetic" Cost
- Dilution policy
- Domicile & taxation & index variants
- Valuation points
- Liquidity
- Fair value policy
- Securities lending
- Client reporting
- Accuracy & comparability of performance measurement

Manager method & skill

Understanding approach and outcomes

- Performance & tracking difference / tracking error
- Index tracking method:
 - Synthetic
 - Physical – full replication
 - Physical – partial replication

Source: Fidelity, index providers, 30 June 2026.

Index selection: What's in a name?

Fund and index names may look the same but their exposures can be very different.

For example, on the left-hand side of the table below are the indices tracked by the main equity index funds in the IA Asia Pacific ex Japan peer group. MSCI Pacific ex Japan is a developed market index covering Australia, Hong Kong, New Zealand and Singapore. FTSE World Asia Pacific ex Japan includes four additional markets: Korea, which FTSE differently classifies as a developed market, but additionally three advanced emerging markets, with the result that there is more than 50% difference in index weighting – a very different exposure.

It's a similar story on the right-hand side of the table in the IA Global peer group. For example, MSCI World and FTSE World sound the same, but MSCI's index includes 23 developed markets. Whereas FTSE's index differently classifies Korea and Poland as developed, as well as including 10 advanced emerging markets.

There's more to it than names appearing the same. This can present further challenges in client portfolios and investors need to be aware that they aren't

unintentionally doubling up on certain exposures, or missing others entirely.

For example, if you buy a fund tracking MSCI Pacific ex Japan and FTSE Emerging Markets, you will have no exposure to Korea. Moreover, if you buy a fund tracking FTSE World Asia Pacific ex Japan and any Emerging Markets tracker, you will be doubling up on certain country exposures.

At Fidelity we've constructed our equity index range to avoid this problem and so there is clear separation of developed vs emerging market exposures. It is important to consider which managers are tracking what index, with careful thought needed to be given to client portfolios that blend index funds from different fund managers.

This becomes even more nuanced when it comes to 'ESG' indices – a clear understanding of varying index methodologies is needed to ensure this aligns with desired sustainability objectives, bearing in mind that just as MSCI and FTSE differ on e.g. their classification of 'developed' vs 'emerging' they also differ in their methodologies and frameworks for assessing 'ESG'.

Asia Pacific ex Japan and Global index funds exposure

Peer Group	Morningstar IA Asia Pacific Ex Japan		Morningstar IA Global				
Fund	Fidelity Index Pacific ex Japan Vanguard Pacific ex Japan Stock Index	iShares Pacific ex Japan Equity Index HSBC Pacific Index L&G Pacific Index	Fidelity Index World Vanguard Global Stock Index	Vanguard FTSE Developed World ex-UK Equity Index	L&G Global Equity Index L&G International Index	HSBC FTSE All-World Index	Vanguard FTSE Global All Cap Index
Index	MSCI Pacific ex Japan	FTSE World Asia Pacific Ex Japan	MSCI World	FTSE Developed ex UK	FTSE World FTSE World (ex UK)	FTSE All World	FTSE Global All Cap
Cap	Large & Mid	Large & Mid	Large & Mid	Large & Mid	Large & Mid	Large & Mid	Large & Mid & Small
Developed Markets	Australia Hong Kong New Zealand Singapore	Australia Hong Kong Korea New Zealand Singapore	23	24 (+Korea, Poland, -UK)	25 (+Korea, Poland) 24 (+Korea, Poland, -UK)	25 (+Korea, Poland)	25 (+Korea, Poland)
Emerging Markets	-	Advanced: Malaysia Taiwan Thailand	-	-	10 (Advanced)	23	23
Constituents	93	588	1,283	1,882	2,485 2,392	4,264	10,139

Source: Fidelity, Morningstar Direct, index providers, 30 June 2026. Fidelity compared with the four largest managers offering a broad range of index funds, mapped to onshore IA sectors.

Cost

Cost is still an important factor, but there are a number of ways to consider this beyond the headline rate of ongoing charges.

- Are KIID Ongoing Charges (OCF) fixed or variable?
- What are the implications of synthetic cost?
- Do KIID OCFs equal the sum of their parts?
- What impact does portfolio transaction cost (PTC) reporting have on the cost outcome?
- And what are the cost implications of the various anti-dilution mechanisms that exist?

Are KIID Ongoing Charges (OCF) fixed or variable?

Some managers have a fixed all-in annual management charge so in these instances the AMC and OCF are one and the same. Others have a variable OCF, where they take a fixed AMC, but the other annual costs that make up OCF such as custody, administration, audit and legal fees can vary.

Against a market backdrop of seemingly ever downward OCF pressure, investors understandably might not expect equity index OCF to go up, yet this occurs regularly - and very likely without them realising.

For all the importance placed by regulators on OCF, and where AMC cuts are often announced with media fanfare, there is no mechanism to inform investors when OCF increases due to factors other than an AMC increase. Regulations require disclosure that OCF may vary from year to year where this is the case, which is not particularly helpful to an investor who has been (mis)guided towards thinking their interests are best served by having the lowest OCF at the point of investment.

Given that equity index OCFs are as low as they are, a variation of even one or two basis points is material as a percentage of OCF. Through our research, we have seen variations of up to five basis points and one manager's FTSE All Share tracker OCF more than doubled. We will return to this later on in this paper.

Even on third party data vendors, the latest OCF is captured, but often times there is no history of how this important figure has changed over time.

It is therefore important to understand which managers use a fixed versus variable OCF approach. Given the research and analysis that we have undertaken over several years, we can share with you the history of OCF changes for those with a variable approach.

What are the implications of synthetic cost?

Synthetic cost refers to the ongoing charges of any underlying funds than an equity index fund invests in.

While most indices include underlying funds such as REITS, regulation peculiarly excludes these, which means that synthetic cost considerations mainly apply in the case of UK closed-ended investment trusts.

Lack of regulatory alignment across UCITS, MiFID and PRIIPs has led to different manager interpretations and consequently inconsistent disclosure of fund charges. This can be misleading and confusing to investors.

It is logical that there should be no difference between KIID OCF and EMT Ongoing Cost (OC) and this has been true for most equity index funds, but not all. Notably, some funds have excluded synthetic cost from OCF but included it in OC. The result is that investors are faced with two different ongoing charges/cost figures for the same fund, which is naturally confusing.

Other funds have included synthetic cost in OCF, with the result that they more than doubled - and in some cases more than trebled - their OCF overnight. These funds didn't suddenly cost more; these costs have always been in place and reflected in past performance, but optically these funds subsequently looked materially more expensive. While professional investors understand this, this will be off-putting in a consumer market that thinks interests are best served by having the lowest OCF. It is understandable that financial intermediaries would want to avoid the complexity of explaining this to their underlying clients.

Our research and analysis has also identified instances where some funds have changed their approach to include synthetic costs, before reversing that decision. This has implications depending on timing and frequency of ongoing due diligence.

Furthermore, while you'd expect that only equity index funds investing in UK, or global including UK, indices would be impacted, we've seen differences occurring in other non-UK exposed funds too, including differences in synthetic costs between one share class and another of the same fund. Logically, this shouldn't be the case and highlights challenges too for data disclosure processes and data vendors on which so many investors rely.

We can help you navigate this challenging cost disclosure environment by pointing out how different funds have approached this issue, including any historical changes we have seen over time.

Do KIID OCFs equal the sum of their parts?

An outcome of the annual Value Assessment Reports, the first of which were published in 2020, was the conclusion from some managers that some of their equity index funds offered better value than others.

For example, we have seen notable OCF differences between global (including UK) equity index funds and global (excluding UK) equity index funds from the same managers. In our view, the inclusion or exclusion of the UK cannot amount to such wide differences in ongoing charges given the UK accounts for a very small proportion of global equity indices.

Against this backdrop, it is important to identify which managers have sought to address such pricing disparities versus those who have not.

What impact does PTC reporting have on the cost outcome?

The simple answer is 'a lot' and the evidence is that the lowest KIID OCF does not mean the lowest cost option for investors. In fact, in some cases, the lowest KIID OCF turns into the most expensive option once PTC is added.

PTC, contrary to regulatory expectation of enabling comparison across different products, has been a highly unlevel playing field. There have been significant variations in PTC over time, with differing approaches and potentially calculation credibility questions.

Our research into PTC evolution over time can help identify the lowest cost outcome when combining KIID OCF (or EMT OC) and PTC across different equity index funds. You might be surprised by the results - it is not always the funds with the lowest KIID OCF.

And what are the cost implications of the various anti-dilution mechanisms that exist?

Finally on the topic of cost, there are the implications of dilution policy to consider.

Fortunately, from an investor perspective, in recent years there's been coalescence with several managers changing their methodology to a partial swing pricing approach. Partial swing pricing means that ordinarily funds are mid-priced. As a result, only in the case of very large client cashflows will the price swing to offer or bid.

We have long since argued the merits of partial swing pricing, even going so far as to highlight that other approaches such as dual pricing are unfair. So, we take a degree of vindication that other managers have aligned.

However, from a performance measurement perspective, comparison across different equity index funds can be complicated by this. Were partial swing pricing funds bid, mid or offer priced at the start and end of a performance measurement period? You're not going to get an accurate comparison if one fund was priced offer to bid, whereas another was priced bid to offer.

Even though most index managers are now aligned on partial swing pricing, historical changes to dilution policy should be considered when analysing longer-term track records. Our research has highlighted that a number of managers have been on something of a journey, with one fund in particular undergoing five different approaches in a little over five years.

For those funds that have changed their methodology from dual pricing, there's an important implication for accurate performance and tracking measurement given that industry standard performance measurement is bid-to-bid, so doesn't reflect that bid-offer spread. That's problematic when you consider that for certain exposures like UK equity, the more sizeable cost of investing isn't ongoing charges, but the dilution policy implications.

Selecting equity index funds on the basis of a difference of one basis point in KIID OCF really pales into insignificance when you consider that we can cite an example where a FTSE All Share tracker fund's bid-offer spread topped out at around 130 basis points. This was an extreme example at the height of Covid volatility, but it illustrates that understanding a manager's dilution policy, and quantifying their dilution cost, is another important step in understanding performance measurement and how this can inform fund selection.

After all, dilution costs can be many times the size of annual ongoing charges.

Swing factor analysis

It's also important to be mindful that there can be sizeable differences in dilution costs across different funds tracking the same or similar index. Because of this, we attempted to compare swing factors across different managers - this wasn't an in-depth analysis, just a very simple request, yet worryingly turned out to be anything but straightforward.

We contacted managers to request swing factor disclosure at a specific date for comparison – our request was not asking whether funds had swung or not, simply what factors would have been applied if they had.

You might be surprised by the responses we received,

which didn't leave us any closer to being able to compare swing factors. We have, however, been able to fill in gaps with indicative disclosures in prospectus or KIID, albeit not date aligned. Even so, our analysis would seem to confirm that there are cases of material differences for the same exposure across different managers - would you reasonably expect to see a five-fold difference in swing factors between two funds tracking the same index?

This analysis - which we are happy to share with you - illustrates that dilution policy implications can dwarf the difference of a basis point or two in annual OCF that the market overly fixates upon.



Taxation

Fund domicile & taxation

Next, we consider how a fund's domicile, the taxes it pays, as well as the index variant used for performance measurement, can all significantly impact on the client outcome.

Funds can be subject to different withholding tax treatments depending on their domicile and legal structure. Relative to Irish and Luxembourg retail equity index funds, a UK-domiciled equity index fund generally has more favourable double tax treaty benefits for a UK investor.

US equity dividends are a prime example, with tax normally withheld at a rate of 30%. However, for UK-domiciled funds this is reduced to 15%, but Irish-domiciled index funds (excluding ETFs) and Luxembourg-domiciled index funds (and physically replicated ETFs) still incur the full rate of 30%. When you consider that the S&P 500's historic gross dividend yield has been around 2%, that's worth approximately 30 basis points in absolute terms per annum. This dwarfs the difference of a basis point or two in annual ongoing charges.

Japan is another example where a UK fund pays 10% withholding tax vs an Irish or Luxembourg fund paying 15%. If MSCI Japan's gross dividend yield is 2.5%, that's worth 12.5 basis points per annum. Elsewhere, in a global developed market fund that, for example, tracks MSCI World, the combined effect works out as a UK-domiciled fund having up to around a 20 basis points annualised performance advantage.

Even in emerging markets there are advantages, mainly Taiwan, although this is not as notable at less than five basis points per annum. But additionally, while a UK fund has to pay Capital Gains Tax on India, an Irish fund has to pay on India and Brazil. For example, Brazil had a really strong Q1 in 2022, and the Brazilian capital gains tax accrual in Fidelity's equivalent cross-border Irish fund was nine basis points.

UK investors have a plethora of choice - they can purchase UK-domiciled funds, as well as Irish or Luxembourg domiciled funds distributed into the UK on a cross-border basis. In the case of the latter, domicile and withholding tax treatment have a very important bearing.

Fund domicile taxation implications per region

	UK	IE	Standard NTR index	Approx UK vs IE benefit
USA WHT (S&P 500)	15%	30%	30%	0.20 - 0.30%
Japan WHT (MSCI Japan)	10%	15%	15%	0.10 - 0.15%
Dev. World WHT (MSCI World)	Blend (mainly USA & Japan)			0.15 - 0.20%
EM WHT (MSCI EM)	Blend (mainly Taiwan & India)			0.05 - 0.10%
EM CGT (MSCI EM)	India (c.14%)	India (c.14%) Brazil (c.25%)	nil	varies

Source: Fidelity. WHT = Withholding tax; CGT = Capital Gains tax.

Withholding taxation and index variants

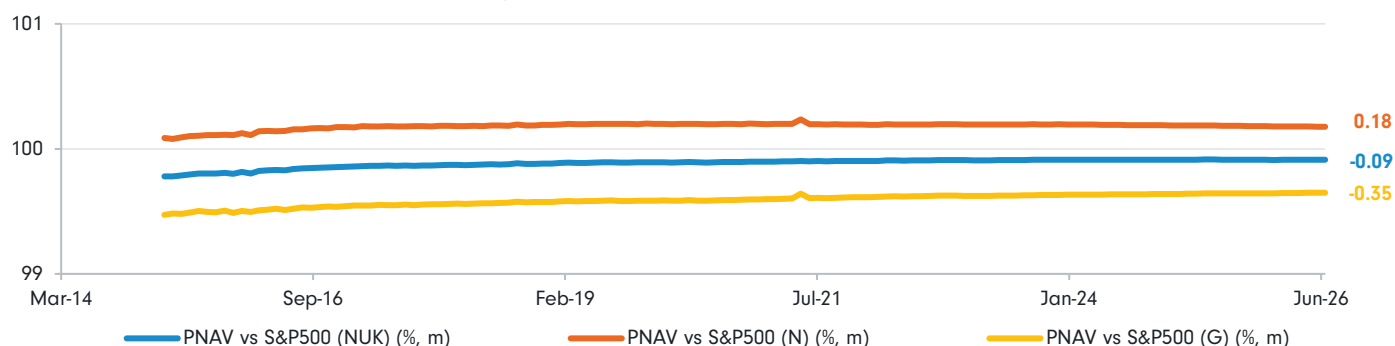
Another factor to be aware of when measuring and comparing tracking outcomes is the impact that withholding tax treatment can have depending on which index variant is used. Some funds gain an apparent tracking difference advantage by measuring against a net total return index. Conversely, others will appear to have a wider tracking difference if using a gross total return index.

This is highlighted by the chart below which shows the impact on the annualised tracking difference for the Fidelity Index US Fund since launch. We measure our Index US fund against a customised variant of the S&P 500 index that is designed and maintained by S&P to be net of 15% withholding tax to align more closely with our UK domiciled fund.

In summary:

- The blue line shows the tracking difference with the fund and index valuation time aligned vs the custom NUK index as being negative nine basis points annualised.
- If we used the standard net total return index, the orange line shows our annualised tracking difference would have been a positive 18 basis points annualised.
- Conversely, using the standard gross total return index would have had the opposite effect, with the amber line showing a negative 35 basis points annualised tracking difference.

Fidelity Index US P-Acc annualised tracking difference since launch



Source: Fidelity, 30 June 2026, nav-nav, income reinvested, in GBP, net of fees. Fidelity Index US P-ACC launch date: 03 March 2014. Annualised tracking difference chart shows geometric relative return, from first full month of performance. PNAV shows how a fund would have performed if its valuation point had been aligned with the index, without any fair value market or partial swing pricing adjustments. NUK is a customised net total return index variant of the S&P 500 index, designed and maintained by S&P, which is net of 15% withholding tax to align more closely with this fund's withholding tax treatment.

In terms of our other equity index funds, for Europe ex UK we use a gross total return index, because the fund's withholding tax treatment aligns more closely to this than it does to 'net', at least for now – that could change over time due to the impact of Brexit. But the fund still pays withholding taxes not reflected in a gross total return index, so its tracking difference will appear widest out of all our funds.

Conversely, we use standard net total return for MSCI World with the result that we end up with positive tracking difference. Where these indices are multi-territory and double tax treaties may not be as stable, we have not gone down the road of seeking a customised index.

However, others have and it's problematic where index providers, managers using those indices, and data vendors don't then clearly label them as being customised. And there are several culprits of this out there. We've seen above how impactful this can be for US exposures. The table below shows the annualised GBP performance difference between gross and standard net total return indices for the three years ending June 2026 for other exposures. In tracking terms, the differences are stark, indeed in Europe ex UK's case prior to COVID the difference was over 1% at times.

It is interesting to note the practices of different managers in this area. We have a specific case study example where we level the playing field. Here, we take two funds, one that 'appears' to be tracking tightly, and one that doesn't, but that's because the former is being measured against a custom withholding tax index (but not labelled as customised), while the latter is being measured against a

Indices performance difference between gross and standard net total return

Index	Annualised arithmetic performance difference between gross and standard net total return index, 3yrs ending Jun-26, in GBP
MSCI Europe ex UK	0.90%
MSCI Emerging Markets*	0.58%
MSCI World	0.51%
S&P 500	0.48%
MSCI Japan	0.41%
MSCI Pacific ex Japan	0.09%

Source: Fidelity, 30 June 2026; market index data sourced from RIMES.
 *The Net index was historically additionally impacted by one-off CGT events re Indian dividends that paid stock not cash; MSCI since announced (Aug-25) that Net, Gross and Price index variants will be treated similarly eliminating any inclusion of CGT on Indian stock dividends.

gross total return index. Replacing the unspecified custom withholding tax index with a gross total return index is transformational and reveals just how much 'appearances' can be deceiving: the fund that 'appears' to have tighter tracking difference actually has the wider tracking difference once the playing field is levelled.

In summary, it is important to be aware of the tax treatment of a fund, particularly where this can have significantly more impact on the client outcome than annual ongoing charges. It is also important to be aware of the tax treatment of the specific index for tracking measurement and how this compares to a fund, as this is yet another factor in assessing how accurate the reported tracking difference in fact is, and therefore how this informs fund selection. Pragmatically, the only way to level the playing field from a tax perspective is to ignore manager index returns and just compare all funds to gross total return indices.

The importance of valuation time

Next, we come to the importance of valuation time. The majority of equity index funds in the UK value at midday, but most standard total return index valuations are market closing. This is not therefore a like-for-like performance comparison and can be a source of perceived tracking difference that either works for or against different funds. This can have a pronounced illusory effect, particularly when market volatility increases, but it's important to understand that this does not reflect loss of money or poor manager skill because it is perceived and not real.

An example of this is in the chart below, which shows the annualised tracking difference for the Fidelity Index US Fund since launch. The orange line indicates the tracking difference based on the fund's midday valuation time versus the valuation time of the S&P 500 index at US market close, which is an entire US trading session later. As you can see, the line is quite volatile, giving the impression that the tracking difference of the fund fluctuates considerably.

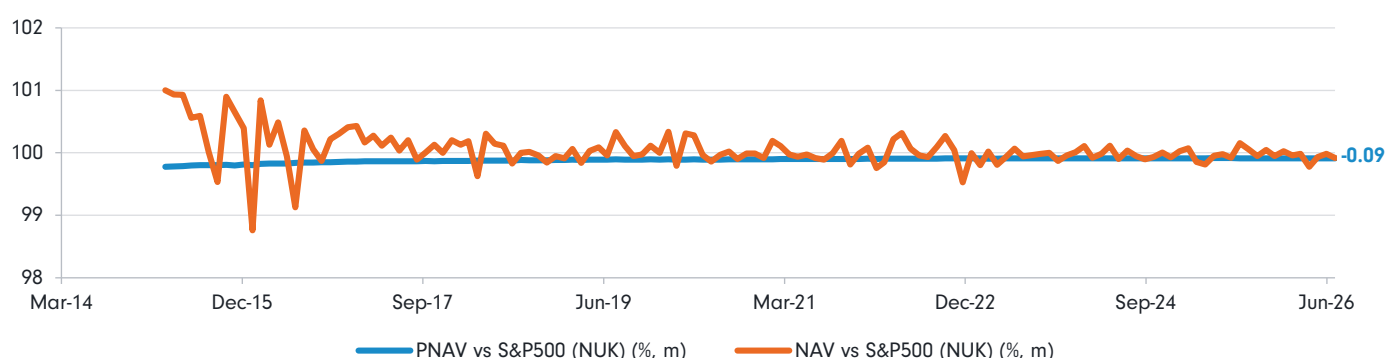
A truer comparison can be made by performing a revaluation of the fund using market close prices, which is

the same as the index. We call this a Performance NAV or PNAV for short. The blue PNAV line shows the annualised tracking difference with the fund and index valuation time aligned. This illustrates that the tracking difference has in fact been very smooth, averaging negative nine basis points per annum since launch, as the fund incurs costs which the index does not.

Over shorter time periods, the impact of valuation time mismatch can be pronounced. The left-hand table below incorrectly states 12-month (though at other times 12-month differences have exceeded +/- 4%) NAV tracking differences ranging from -1.31% to +1.11%. This results in a three-year annualised tracking error exceeding 6%, which clearly doesn't align with what you would expect from a tracker fund.

Conversely, the right-hand table shows the PNAV comparison, where the fund and index valuation time are aligned. This analysis highlights that the fund is meeting its tracking objective, with a three-year tracking error of only two basis points as at the end of June 2026.

Fidelity Index US P-Acc annualised tracking difference since launch



Fidelity Index US P-Acc

Five year NAV performance to 30.06.26

Net of Fees (%)	30.06.22	30.06.23	30.06.24	30.06.25	30.06.26
NAV	1.71	13.76	26.10	4.71	25.90
S&P 500 (NUK)	1.45	13.95	24.99	6.02	26.07
NAV excess returns*	+0.25	-0.19	+1.11	-1.31	-0.16
3yr ann. tracking error	5.08	5.84	6.13	5.44	4.32

Five year PNAV performance to 30.06.26

Net of Fees (%)	30.06.22	30.06.23	30.06.24	30.06.25	30.06.26
PNAV	1.40	13.88	24.91	5.94	25.93
S&P 500 (NUK)	1.45	13.95	24.99	6.02	26.07
PNAV excess returns	-0.05	-0.07	-0.08	-0.08	-0.14
3yr ann. tracking error	0.03	0.03	0.03	0.03	0.02

Source: Fidelity, 30 June 2026, nav-nav, income reinvested, in GBP, net of fees. Fidelity Index US P-ACC launch date: 03 March 2014. Annualised tracking difference chart shows geometric relative return, from first full month of performance. PNAV shows how a fund would have performed if its valuation point had been aligned with the index, without any fair value market or partial swing pricing adjustments. NUK is a customised net total return index variant of the S&P 500 index, designed and maintained by S&P, which is net of 15% withholding tax to align more closely with this fund's withholding tax treatment.

It can be difficult to gain an accurate picture of tracking difference. When you see performance reporting from third party data vendors you will only see NAV and not PNAV performance, irrespective of any index variant issues. You therefore need to be very cautious about any index dependent quantitative ratings offered by data vendors. In our view, ratings agencies that include a qualitative element in their rating assessment are more credible.

So where does this leave you in trying to understand whether an index fund is indeed doing what it says on the tin? The short answer is you can't in most cases without requesting manager PNAV equivalents.

To make this easier, Fidelity includes PNAV reporting in our monthly client pdf factsheets. However, this isn't done by any of the other four largest managers that offer a similarly broad range of equity index funds to UK investors.

Why not align fund valuation time to the index?

Now, we'll touch briefly on a popular question we get asked - why don't we simply align our valuation time to the index given this is what is typically done by cross-border funds. Granted, this would remove the valuation time mismatch, but it would throw up some different challenges.

Cross-border fund liquidity is typically not as good as funds will be closed for dealing not just on UK holidays, but on any other days where market closures result in more than 25% of index constituent shares not being tradable. Extended holidays such as Chinese New Year and Japan Golden Week can therefore be more impactful.

To close out the market timing window, cross-border funds typically have an advance dealing cut-off of, for example, of 4pm on T-1 for Asia Pacific and emerging markets. Switching between markets, for example from Asia to the US, is therefore impossible without time out of market, whereas this can be achieved with a single UK midday liquidity point. Moreover, a lack of same day NAV provision can also be an issue for some investors.

So, on balance, the conventional UK midday fund valuation and liquidity point presents tangible benefits, so long as the issue of valuation time mismatch is adequately addressed.



Fair value policy

Fair value is all about the equitable treatment of shareholders. It ensures that when funds are priced at their valuation time, the prices used to value the underlying assets are fair, thereby protecting investors.

Fair value can take the form of individual security adjustments where a particular security might not have a regular exchange traded price, or perhaps more significantly, what is termed a fair value market adjustment. With the latter, events in one part of the world may affect stock prices even in a market which is closed due to time zone differences or a market holiday. When funds come to calculate the price at which their investors will deal, those market closing prices may no longer be an accurate reflection of the prices that would be quoted if that market was open. If prices are not adjusted, investors buying and selling fund units might not get a fair price.

Understanding a fund provider's fair value policy is another important step in understanding performance measurement and how this informs fund selection. Fidelity employs a policy of fair value market adjustment to seek to avoid such a situation. Through this policy, we adjust prices for changes that take place after a market has closed. The policy is controlled by a committee of senior Fidelity staff from across the firm. The policy is then consistently implemented by our fair value pricing team, who are supported by a number of models.

A straightforward example of fair valuing US equity at UK midday would include looking at price movement of S&P 500 index futures and ETFs tracking S&P500. The process is fully transparent to fund auditors and regulators.

In addition, studies have consistently shown that failure to fair value funds can cost long-term shareholders at the expense of market timers, who trade in and out of funds within a short period of time. Our policy seeks to prevent market timers from exploiting this arbitrage opportunity.

In terms of index fund performance measurement, fair value is another policy that you have to be mindful of when it comes to comparing funds. If you have two funds valued at the same time tracking the same index, you might think you can gauge the better tracking fund just based on each fund's total return.

But that's not the case. In fact, we have analysed the daily and cumulative performance difference between two funds tracking the same index, valued at the same time, with the same ongoing charges. How much would you reasonably expect their performance to differ in one day? We fully expect that you'll be surprised by the outcome.

How fund liquidity is traded is also just as important as how it's valued. In any of Fidelity's equity index funds when the underlying market is shut at UK midday, cashflow is equitised at UK midday using index futures in order to keep the portfolio fully invested at prices at or close to the valuation time.

This approach is not universally followed by other equity index fund providers, despite the fact that prices could be different if fund liquidity priced at UK midday is not traded until underlying markets open several hours later. In these instances, there is a risk that investors could gain or lose, not by choice but by chance.

Securities lending

We strongly believe that there is a place for lending in the market and that well run programmes can deliver clear and meaningful value to investors. However, we do take issue where programmes do not deliver on this concept, including where:

1. managers use it as a profit centre for themselves, and
2. the general lack of transparency clouds the value it adds for investors.

Where investors bear the risk of stock lending, they should receive 100% of the revenue less reasonable cost. ESMA says so, yet is it 'reasonable cost' that managers who are their own lending agent should pay themselves up to almost four times what other managers pay a third party lending agent on a commercial arms-length basis? Managers who use securities lending as a profit centre may well be able to offer lower ongoing charges due to this additional, less transparent revenue source.

Moreover, there is a lack of transparency around the uplift that lending provides. We've undertaken analysis to approximate what lending has added to fund performance in percentage terms. This has been done by accessing the lending net uplift from fund audited financial statements, then expressing this against average month-end assets over the reporting period - not as accurate as daily average. But it really shouldn't be this difficult for investors to ascertain what uplift lending is delivering.

Then there's the complexity it adds to the investor proposition. If an end investor were to lift up the lid on a FTSE 100 tracker fund, they might reasonably expect to see 100 UK blue-chip constituents and not unrelated collateral. And on the subject of collateral policy, looking at collateral at a point in time is arguably insufficient analysis. A more thorough analysis would be to look at how that collateral has evolved through time, particularly through heightened market volatility when you may be in need of that collateral the most.

Lending may also create a conflict of interest with proxy voting; securities need to be recalled in order to vote, therefore impacting lending revenue and, in turn, the profit participation of managers who are their own lending agent. A manager with a well-run, risk adverse lending programme will have lending and voting policies in place, with a clear approach as to when stock will be recalled to vote and when loans may be permitted to continue without recall or restriction.

Our analysis has highlighted the different funds that are engaged in lending programmes. In these instances, it is key to understand who are their lending agents, what are the fees and what overall value lending is adding for investors. We would be very happy to share this with you to help you judge the reward vs complexity that securities lending adds to the overall proposition.

Client reporting

Finally, some thoughts on client reporting. In most - but surprisingly not all - equity index fund manager factsheets, you will see fund performance compared to index performance. But, as we've seen, if there's a difference between fund and index valuation time, that's not an appropriate comparison.

Logically, you'd think it important that managers evidence to investors that index funds are meeting their tracking objective. You might therefore find it surprising how many don't adequately address this.

We've also demonstrated how impactful the index variant can be to the tracking outcome, yet some managers aren't clear about which index variant they are using.

Fidelity was the first equity index manager in the UK to start using FTSE's custom midday All Share index in our factsheets. We were comfortable doing this because the UK market is open at UK midday and our fund observes the same business day calendar.

Others have gone one step further and adopted custom midday indices across their wider ranges. This makes little sense to us; for example, what does FTSE USA midday represent? It's not US security prices at UK midday because the US market is shut at that time, so the prices that index uses are still market closing prices from the previous day. Where funds understandably apply fair value market adjustments, that moves their valuation away from those stale market closing prices, which misrepresents tracking difference and inflates tracking error.

We can explore with you the approaches used in other equity index fund factsheets, cite examples and discuss the relative pros and cons. We can also offer insight into instances where factsheet fund performance doesn't match with third party data vendors, as well as a case study example where different managers tracking the same index report materially different index returns. This is despite purporting to use index variants customised for UK midday valuation and customised for the withholding tax rates that apply to a UK-domiciled retail fund.

Fidelity factsheets



Explanation that: "The Fund NAV performance below is based on security prices at noon, UK time. Midday index performance is only shown if there is a comparable noon price for the index, though Fidelity International's swing pricing policy can cause differences in NAV performance versus such a midday index. For all index funds therefore Market-close index performance is shown versus hypothetical Fund Performance Net Asset Value (Fund PNAV) performance based on market-close prices, also stripping out any adjustments resulting from Fidelity International's swing pricing policy. Fund PNAV is calculated at month-end only; it is for illustrative purposes only to allow a meaningful comparison as to how well the fund is tracking the index; no client dealing takes place using Fund PNAV. Any difference in Fund PNAV performance versus the market-close index takes into account the costs that the fund incurs, as well as any other tracking impacts." (PNAV definition is additionally provided in the factsheet glossary).

Clear labelling of index variant: the front page of the factsheet explains the index customisation i.e. what S&P 500 'NUK' represents.

Because PNAV and index valuation times are aligned, and no dilution adjustments are applied, this results in a more accurate 3yr annualised tracking error.

PNAV performance comparison displays show how well the fund is delivering on its tracking objective.

Source: <https://www.fidelityinternational.com/FILPS/Documents/en/current/mf.en.gb.GB00BJS8SH10.pdf>

Execution

Be careful about the potential costs of 'switching'

Much has been written by investment commentators that switching activity can have a negative impact when associated with a tendency to chase returns or in response to short-term market conditions; the same can also be argued of chasing lower fees.

While many investors may check that there are no switching fees, and be mindful of taxation implications, they may not consider that switching includes inherent execution risk when it comes to timing and cost in other ways. In this context, financial firms need to consider the FCA Consumer Duty to ensure that good outcomes are delivered for underlying retail investors.

Fund switches

Direct with fund managers

If both funds share the same valuation time, the 'sell' and 'buy' can theoretically occur simultaneously, meaning no time out of market; but this market risk is unavoidable with mismatched fund valuation times. Mismatched fund settlement times are also a factor.

Via platforms

Across many fund platforms switching funds does not involve a simultaneous 'sell' and 'buy' and therefore there is the risk from time out of market. The length of time out of market may vary across different platforms, and may vary depending on how the switch is placed.

For example, if a switch is for a monetary amount the buy and sell trades could be placed simultaneously, but percentage switches are more likely to vary depending on whether platforms pre-fund or not - albeit they may reserve the right not to pre-fund if a force majeure event occurs. So, the 'sell' may occur on the first business day and the 'buy' on the second business day, but if switching is not pre-funded, then the 'sell' has to settle before the 'buy' can take place. If the 'sell' settlement is T+3, then the 'buy' will therefore be on T+4.

Hypothetical case study

You switch Emerging Markets trackers to benefit from a 0.04% annual OCF reduction.

Because you switch a large amount, your dilution cost works out at 0.39%; that's an almost 10 years' investment horizon to work off that cost.

But worse still, your platform doesn't pre-fund, so you were four days out-of-market between your 'switch sell' and your 'switch buy'. In those four days, the market overall went up 1%, adding another 25 years' investment horizon before you benefit from your 0.04% OCF reduction.

In this example, we can all agree that 35 years is a 'false economy'.

This example uses assumed figures and is for illustrative purposes only.

In case of large amounts, triggering anti-dilution costs is also an important factor when you consider that for certain exposures like UK equity, the more sizeable cost of investing isn't ongoing charges, but the anti-dilution policy implications, as previously highlighted in this paper.

Fund conversions

Converting between share classes of the same fund (e.g. converting from Accumulation to Income, or to a share class with lower fees) should be simultaneous with no time out of market, and shouldn't trigger CGT, unless converting between hedged and unhedged share classes. However, it's important that a conversion isn't inappropriately handled as a 'switch' as this could cause time out of market and potentially trigger anti-dilution costs. Not all platforms are equally efficient, making it worthwhile verifying their processes.

Summary

Switching between funds, or inadvertently share classes of the same fund, may involve 'cost', whether that's opportunity cost, anti-dilution cost or taxation cost. These costs can dwarf the difference of a basis point or two in annual OCF.

To ensure good outcomes are delivered for underlying retail investors in accordance with the FCA Consumer Duty, rigorous due diligence should be performed to check the benefits outweigh the costs. It is advisable to discuss your intentions ahead of time with your fund manager, and your platform(s), particularly when switching involves larger amounts.

Summary

It's just as important, if not more important, to focus on what's going on around an equity index fund portfolio, not just in it. There are aspects of how equity index funds operate that can have far more impact on the performance outcome than the difference of a basis point of two in annual ongoing charges.

Key points:

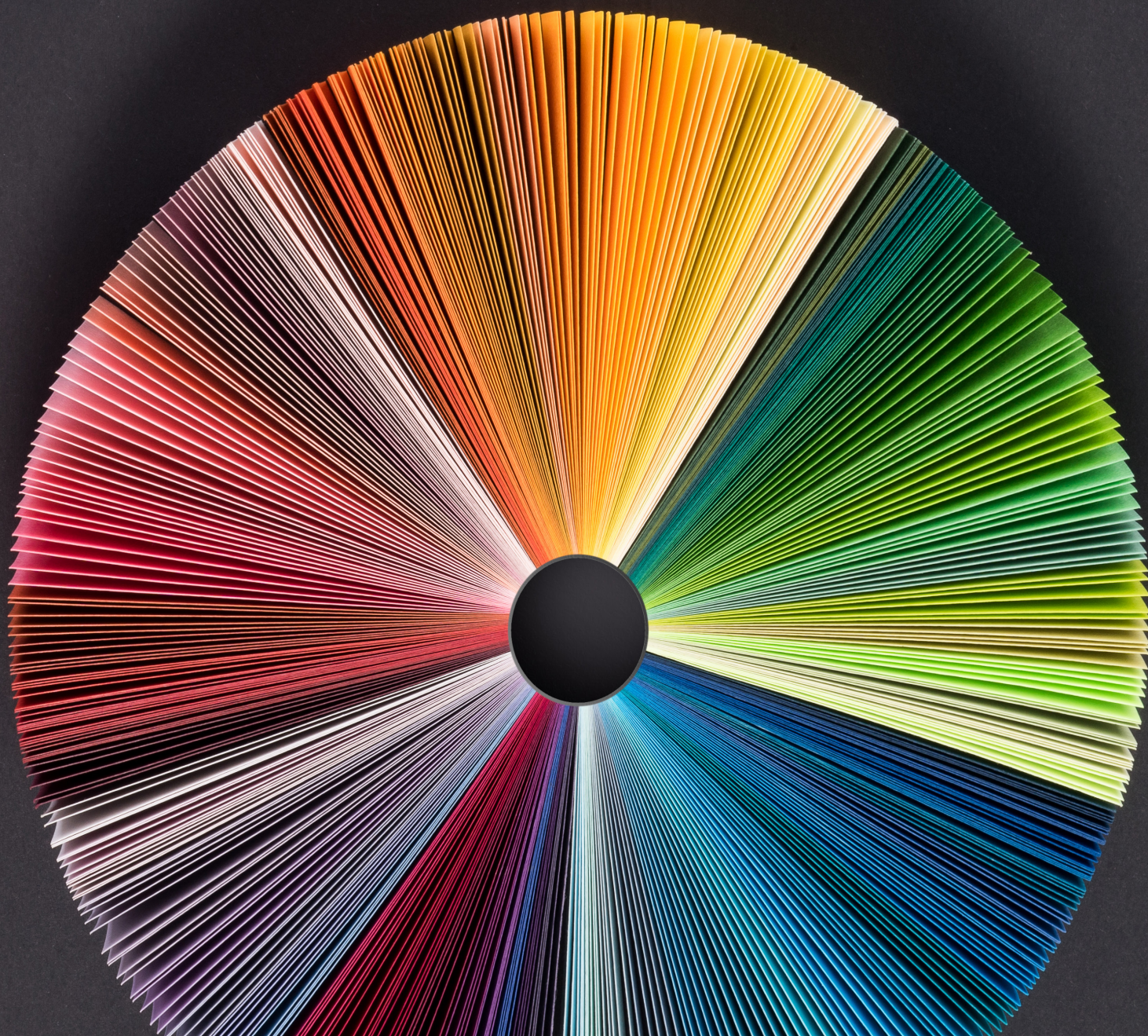
- **Index selection:** Be mindful of the differences in exposure between funds and indices that might be similar in name. Beware of doubling up or being under-exposed if mixing and matching different equity index funds.
- **Costs and charges:** You can screen on OCF, but don't make that your only criteria. Consider also whether an OCF is fixed or variable, and whether it represents value in terms of the sum of its parts. Also, look at the impact of synthetic costs, as well as the impact of portfolio transaction costs on the overall cost outcome. Understanding a manager's dilution policy, and quantifying their dilution cost, is another important step because dilution costs can be many times the size of annual ongoing charges.
- **Fund domicile and taxation:** UK-domiciled funds generally offer UK investors better withholding tax treatment than cross-border funds distributed into the UK. From a performance measurement perspective, be aware of the tax treatment of the specific index variant being used and how this compares to the fund. The index variant will not necessarily be apparent, so you might have to ask the question, but it's important in assessing how accurate the reported tracking difference in fact is, and therefore how this informs fund selection.
- **Valuation time:** Analyse any mismatch between the time the fund is valued and the time the index is valued. Is a custom midday index necessarily a midday index? If there's a mismatch, any tracking difference or tracking error measurement is going to be inaccurate. You cannot rely on third party vendor data that doesn't take into account valuation time mismatches and might be impacted by dilution adjustments. You also cannot rely on all manager factsheets. For accuracy and comparability, ask for manager mid-priced, or unswung, market closing equivalent fund prices, and compare those to standard gross total return indices to level the playing field.
- **Liquidity:** Bear in mind dealing holidays even on UK business days, as well as advance dealing cut-offs, and what this means for your ability to allocate from one regional equity index fund to another, without time out of market.
- **Fair value policy:** Just because a prospectus says a manager can do it, doesn't necessarily mean they do. You really need to ask for their policy. Managers have to be careful not to be so transparent that they enable any arbitration of this investor protection, but they should be able to articulate their policy to provide comfort that it is being employed responsibly.
- **Stock lending:** The key question here is whether you have sufficient ongoing transparency to be able to judge the reward versus the risk and complexity it adds to the investor proposition. We suggest you gain an understanding of the net uplift to the fund i.e. what's in it for the investor, and assess whether this is reasonable versus what the manager is taking.
- **Client reporting:** How does fund performance compare to index performance in client reporting? Manager factsheets should evidence to investors that index funds are meeting their tracking objective. However, there are several factors that can affect what's shown, and many managers fail to adequately address the difference in valuation time when comparing tracker fund performance with index performance in their client reporting.
- **Execution:** Switching between funds, or inadvertently share classes of the same fund, may involve 'cost', whether that's opportunity cost, anti-dilution cost or taxation cost. These costs can dwarf the difference of a basis point or two in annual OCF. To ensure good outcomes are delivered for underlying retail investors in accordance with the FCA Consumer Duty, rigorous due diligence should be performed to check the benefits outweigh the costs. It is advisable to discuss your intentions ahead of time with your fund manager, and your platform(s), particularly when switching involves larger amounts.

Now, if with all this we've been able to convince you that tracking difference can provide a more accurate measure of the cost of owning a fund than OCF alone, then you really need managers to provide you with appropriate data because of all the challenges you otherwise face with accurate tracking measurement.

You cannot rely on third party vendor data that doesn't take into account valuation time mismatches and might be impacted by dilution adjustments. You also cannot rely on

all manager factsheets. For accuracy and comparability, ask for manager mid-priced, or unswung, market closing equivalent fund prices, and compare those to standard gross total return indices to level the playing field.

We hope you have found this informative, and we would be very happy to discuss any of these issues with you in more detail. Please get in touch with your usual Fidelity representative for further information.



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