External perspective

Rebalancing the economics of the European mutual fund

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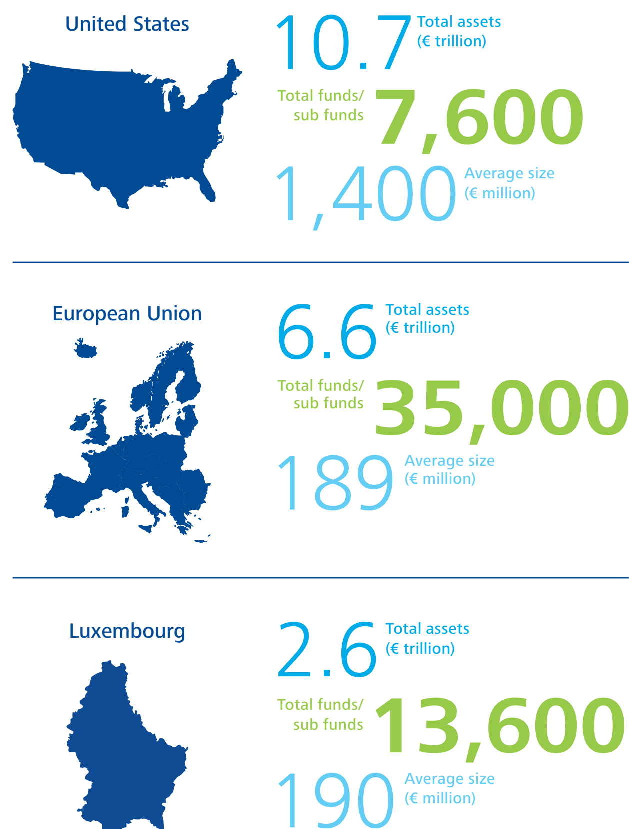
A proliferation of funds established across Europe over the years has left numerous legacy issues that pose a challenge to the profitability of European mutual funds.

These issues include bloated umbrella structures, a lack of concentration of strategic domicile, fragmented service provider arrangements and inefficient cost structures. This challenge has become more complex over the past few years, as European mutual funds have sought to comply with new regulations designed to improve transparency, enhance investor protection and curb the potential for systemic risk.

While there is no clear consensus on the precise cost of implementing the new regulations, there appears to be little doubt that such costs will be material. Added to this challenging backdrop is a period of relatively high inflation—further eroding investor returns—greater transparency on the costs investors pay for mutual funds, the explicit cost of advice, the high volatility of returns and households' focus on debt clearance rather than saving. The result is a dilution of the economic bargain of the investment fund to the point where investors may be perfectly protected from a product they can no longer afford.

Asset managers have to decide whether to try to pass on the additional costs or absorb them. In any event, they will be obliged to seek ways of rebalancing the economics of the European mutual fund.

The table below reflects the relative size of regulated funds in Europe versus the U.S.:



Sources: Investment Company Institute, 2013 Fact Book (www.icifactbook.org/fb_data.html) converted to approximate euro equivalent, European Fund and Asset Management Association (September 2012) and the Association of the Luxembourg Fund Industry (quarterly fact sheet, May 2013)

The Financial News CEO Snapshot survey of June this year—which included responses from over 30 European asset manager CEOs—revealed that 73% of respondents do not intend to pass on the additional costs to investors, while 50% say there is overcapacity (by number of funds) in Europe and 83% believe market consolidation is inevitable. A Cerulli survey[1] earlier this year pointed to a reduction of as much as 30% in the number of European funds in 2013 alone. There are nearly 1,000 European equity funds and 1,500 European bond funds—providing investors with an extensive choice, but a potentially bewildering and intimidating selection process, especially for those investors acting without advice.

So what are the options available to asset management companies in pursuit of this economic goal, beyond simple economic closing sub-scale funds? Here we consider four areas of focus: distribution costs, fund restructuring and 'super-sizing', a shift in product mix and design and the service provider contribution.

1. Distribution costs

As a rule of thumb, distribution costs account for around half the total cost of a fund and should contribute proportionately to the need to rebalance economics. While there is much debate on the structure of distributor remuneration (commission—often referred to by policymakers as 'inducements'—or fees) so far there has been little public debate on ways to transform the distribution channels and the quantum of the cost of distribution. Ten years ago we could not have imagined movie streaming, eBooks, iCloud, or the tablet and their impact on our personal and business lives. So why is it that fund distribution has barely changed in that period?

The debate around the shift from commission-based to fee-based remuneration models focuses on the impact this may have on the dominant bank distribution model in much of Europe but isn't that model in need of some serious transformation? Why shouldn't we imagine buying simple savings and investment products tomorrow in the same way we now buy books or movies online, with navigation and prompt tools with which we are all familiar: pre-packaged products that meet our lifestyle needs or are outcome-oriented for convenience and simplicity? Will tomorrow's fund distribution channels be the likes of Amazon and iTunes?

1 The Cerulli Report – European Distribution Dynamics 2013 – Navigating a Fragmented Market

The vast majority of retail investors with a portfolio of €50,000 shouldn't have to pay for advice—they need to be offered options in simple terms in order to make their choice. Execution-only outlets, that are backed by a trusted brand (either the outlet itself or the packaged products on offer), would provide a one-stop solution for investors. It could be argued that such a scenario might lead to the emergence of a true open architecture and revolutionise the cost/yield equation for the vast majority of retail investors. Generally, it is difficult to argue that a tied sales model is good for the consumer. There is a requirement for creativity and vision to transform the way that products with an inherent degree of protection (UCITS) at the point of creation can be provided through new emerging channels offering trust, independence, convenience and an attractive price at the point of sale, with competition being based on the quality of the buying experience.

2. Fund restructuring and super-sizing

It is clear that rationalisation of legacy fund structures is no longer an option, but a necessity. The traditional distribution model will be reluctant to concede revenue; investors will not pay more even if they are persuaded that they are better protected; service providers are absorbing a massive transfer of risk from the investor and, in any event, represent a fraction of the overall cost. That leaves the fund manager, for whom simply absorbing additional costs is not an option, as the remaining margin will not justify the risk.

Super-sizing funds through consolidation, restructuring and reducing the number of domiciles and management companies is required to transform legacy structures into a fund range designed for efficient cross-border distribution that is well positioned for the future.

The options most likely to be popular are master/feeder structures and centralised management companies operating under the passport regime. Both options were explicitly encouraged in UCITS IV and presented the industry with precisely what it asked for, but progress to date has been slow and sporadic. However, we have recently seen signs of increased activity, as early innovators act as pioneers for the rest of the industry.

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Some early examples of how master/feeder structures have been used to generate savings or create new distribution opportunities include:

- The first and most obvious example is the conversion of existing domestic funds into 'feeders', which in turn invest in a 'master' designed for cross-border distribution. The scale economies of the master are shared with the feeders and in many cases create the scale the master needs to attract larger investments from institutional investors it may not otherwise have attracted
- Establishing a feeder to 'brand' with a significant local distributor, for local/domestic asset gathering, as a more local look and feel alternative to a share class or generic sub-fund option
- Establishing a feeder in the same domicile as the master to deliberately create a slightly different product to the master by utilising the 15% of assets in the feeder that may be invested outside the master. This effectively creates a new product without the need for the substance and governance of a directly invested investment vehicle
- Establishing a corporate vehicle (e.g. a SICAV in Luxembourg) as a feeder in the same domicile as a long-established FCP, where the FCPlacks the appeal for genuine cross-border distribution. The SICAV is used to group cross-border assets and transforms the existing fund into a cross-border vehicle

The master/feeder structure has a number of features which, to varying degrees, can contribute to the economic goal discussed earlier. Clearly, such a structure is easier to implement when the feeder is a new vehicle and not the conversion of an existing vehicle, but even the latter example will often involve less complexity than a [cross-border] merger. Share class functionality should always be exhausted before embarking on a master/feeder structure, but this will still leave significant scope to achieve restructuring savings. J.P. Morgan and Deloitte have joined forces to develop some very detailed thinking behind these structures—the content of which is too detailed for this paper—but part of that research identifies where savings should result, which is mainly where an existing vehicle is converted into a feeder.

The areas in which savings can be made include the following:

- The consolidated asset pool (one asset pool rather than two) means portfolio management, trading and custody costs are reduced
- Fund administration costs are lower as valuation of a feeder is significantly less complex than for its previous form
- Marketing and audit costs are reduced
- A larger pool of assets is better positioned to lend securities and more attractive to institutional investors that may otherwise be prevented from considering a fund because of self-imposed limits on target investment fund size

Our estimates indicate target net savings of around 10-20bps (before the potential contribution from securities lending and new institutional investors) in a typical conversion of a fund into a feeder, but this will vary depending on the size and complexity of the project. We anticipate increased interest in such restructuring projects over the next 12-18 months, and have developed a core competency accordingly.

Management company passport projects will also increase in popularity as some early pioneers demonstrate their feasibility and the resulting benefits. In particular, the advent of the Alternative Investment Fund Managers Directive (AIFMD) will act as a further catalyst to create 'super ManCos' which can manage both UCITS and non-UCITS across any EU domicile.

The only aspect to be fully tested is whether non-EU regulators in target distribution markets will accept the notion of a fund being managed from a jurisdiction different from the fund domicile. To mitigate this risk it would seem sensible to use a jurisdiction for your ManCo that is most likely to host your cross-border vehicle; Luxembourg or Ireland would therefore seem the most appropriate choices. Once this is accepted practice, there is little doubt that this method will contribute to the restructuring savings that fund managers need to make.

3. Shift in product mix and design

A possible response to the increased cost pressure on mutual funds may be a switch in emphasis towards lower-cost products, such as ETFs and index trackers. However, a low-cost product does not always mean good value for investors with a long-term savings horizon, or even those with a shorter-term horizon in a bear market. In addition, it is these lower-cost products that would be hardest hit by a transaction tax, if introduced, given the need for such products to trade with greater frequency than a buy-and-hold fund.

A second area to consider is whether there should be a more balanced sharing of the risk of the targeted outcome or performance of the fund being under- or over-achieved. There has been much debate about performance fees, but in their simplest form—from a consumer perspective—they are a construct that may allow for a fee to be paid when performance targets are reached or exceeded, provided there is a similar formula to return fees to the investor where the required performance is not achieved. If structured in a transparent manner and administered economically, such an arrangement could be very attractive to retail investors, who are increasingly questioning why a manager should collect full annual management charges if he has underperformed.

There is certainly room for innovation in the way that savings and investment products are packaged, especially at the 'non-advice' end of the market. Here, investors are looking for research, filters and selection tools that will help them make informed choices of packaged products designed for particular outcomes (further education, marriage, second home, etc.). Rather than presenting a fund as the product, retail investors in particular want a product that is 'pre-packed' and outcome-oriented.

Perhaps the industry could also consider a new standard for measuring 'value for money' relative to risk, to be assigned to funds and included in the Key Investor Information Document (KIID). The much maligned Synthetic Risk and Reward Indicator (SRRI) is considered confusing, and is limited in terms of the information provided to investors—what the consumer wants to know is 'am I getting value for money from my investment?' Failing this, perhaps it should be a fiduciary obligation on the boards of funds to periodically (perhaps annually) certify that a fund offers 'value for money'—something along the lines of the trustees of pension funds in Australia. Adding such responsibility to boards may help to focus attention on the fund's performance, and hasten the closure of products that are not delivering a reasonable return to investors.

There is plenty of scope for product design and packaging to play a key role in rebalancing the economics of the European mutual fund. If the industry does not address this, one very unfortunate consequence may well be a 'do-it-yourself' approach, whereby retail investors conclude that they could compile their own portfolio through basic internet 'stock-picking' offerings. While they may be tempted by an apparently lower cost, there will almost inevitably be lower returns and higher risk, hence the converse of what policy makers set out to achieve.

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4. Service provider contribution

While the cost of core services such as custody and administration collectively account for a very low percentage of the total, there is a lot a service provider focus can do to contribute to the rebalancing of the economics.

First and foremost, it is likely that the fund will pay less for its overall service bundle if it is procured from one provider rather than an unbundled approach across several service providers. Regulatory change that promotes greater oversight of the core administration elements also points to the virtues of a single, integrated service model where risks can be better managed.

As the role and responsibilities of the management company become ever more prescriptive, it is incumbent on the ManCo and custodian to work together to ensure that controls are not duplicated, but are performed effectively and in the most appropriate location. If this does not take place, there will be a proliferation of duplicate controls driven by a perceived need for one or the other party to believe it is his responsibility.

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The biggest contribution, however, could come from an expansion of the traditional service bundle into elements designed to enhance the efficiency of portfolio management. This could consist of a range of services including clearing and collateral management, risk and margin solutions, cash and liquidity solutions, share class hedging and currency overlay, tailor-made synthetic positions, prime custody, asset class financing, securities lending and increasingly, outsourcing of middle office services.

The question for asset managers is: to what extent are they prepared to consolidate services with a single provider in pursuit of procurement efficiency and enhanced investor returns?

Conclusion

Legacy fund structures in Europe are in need of serious overhaul. The catalyst for action is the likely increase in additional costs required to achieve compliance with new regulations, on top of relatively high inflation rates which are further eroding returns, greater transparency on costs and the existing high-cost structures inherent in these legacy structures.

Fund managers may consider at least four areas of focus to transform the cost base, position their product for the future and reach the new distribution channels of tomorrow.

A 'do nothing' scenario is likely to result in severe margin dilution or a disenfranchised investor base. Solutions are available and the service providers are ready to support the pioneers and visionaries of the fund management industry as they look to rebalance the economics of the European mutual fund.

To the **point**:

- Inefficient legacy fund structures together with increasing cost and transparency pressures from new regulations requires new solutions to rebalance the economics of the European mutual fund
- The average European fund is 1/7th the size of its U.S. equivalent
- Four areas in particular may provide substantial benefits to the objective
  - Transformation of distribution remuneration arrangements and channels:
  - Fund restructuring and 'super-sizing'
  - Innovation in product mix and packaging
  - Service provider leverage
- A 'do nothing' scenario risks driving retail investors into a self-service or 'do-it-yourself' approach, and therefore largely outside the protections EU policy makers have carefully constructed
- Solutions are available and being increasingly deployed as the pioneers and innovators of the fund management industry lead the way, and industry-wide competencies evolve around successful case studies