



Trends in the Asset Management Industry

By Robert Huebscher

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Depressed asset values, volatility, and a flight to quality have forced every sector of the asset management industry to reexamine its business model. Radical transformations are on the horizon. To underscore the magnitude of the changes that will unfold, consider these remarks from Bob Rodriguez, CEO of First Pacific Advisors, in the February 23 edition of *Barron's*:

The investment industry has some real issues and questions to answer, just like it did post-1974. Since that era, we went through all the slicing and dicing and we had all these little style boxes — but that's been blown away. ...

We own only a couple of industries, and we ignore everything else. That was considered too risky, but I said, 'Well, your diversification that you think you have is not really diversifying the risk.' I have been waiting for several years for what I would call a flushing out to finally demonstrate what I have been talking about. Thus, the investment industry over the next five to 10 years is going to look materially different from the investment industry pre-2008. [Our emphasis]

We spoke with three industry experts to understand the key trends within the industry and the repercussions for advisors and investors.



Chip Roame is the founder and CEO of Tiburon Strategic Advisors, a market research and strategic consulting firm based in California.



Robert Ellis oversees Celent's wealth management group from the firm's New York office. His research focuses on wealth management corporate strategies and the use of technology throughout the retail financial services industry.



Geoff Bobroff is the president of Bobroff Consulting, with a practice focused on the mutual fund industry.

With revenues directly dependent on AUM, mutual fund companies have seen their profits evaporate and the stock prices of publicly traded companies plummet faster than market indices. What will distinguish those fund companies that are successfully able to navigate their operations through this market from those that will fail?

Bobroff: Not only have investment managers witnessed significant declines in equity assets (causing a decline in revenue), but their mix of assets has shifted to fixed income and money market funds where the revenues are less (or almost non-existent). Margins are being challenged on all fronts. The most successful mutual fund managers are those that probably are privately owned and have the willingness to rationalize product. Today there are over 8,700 funds — before you even look at the classes of shares — and this industry needs to significantly reduce that number through mergers, sales or liquidations. Downsizing or rightsizing is essential for money managers, as this decline will be with us for a long period. Fund companies need to address how they fit in the new industry. Boutiques will become the norm rather than the exception, as full product line vendors (except the very large groups) will become a thing of the past.

Ellis: Asset management firms have to differentiate themselves from their competition, through superior investment performance, innovative products, superior marketing, or a better value proposition. No more than one or two investment managers can occupy the far right of the performance curve consistently. Investor demand will force migration of managers from public mutual funds to private money. There are few or no innovative products; it is too easy to copy other mutual funds due to required disclosure. Superior marketing may have a chance, but fund companies been consistently bad marketers, and they are hobbled by regulatory requirements.

For mutual fund companies, the only hope and the only sustainable advantage is an enhanced value proposition. This may come from lower prices, improved access to managers, access to seminars or other elite forms of communications, or better targeting by segments. Funds are trying these now, but getting it wrong.



Roame: The key is being diversified on multiple levels. Asset managers preach this to investors, and now they must practice this as companies. Are they diversified by product? If consumers go to cash or to short-term bonds, do they have an offering? Earning a small number of basis points on these assets is still better than nothing. If ETFs or SMAs are the hot new product, are they in the market? Are they raising money in multiple markets? The 401(k) channel, for one, is still picking up assets. Are they diversified geographically? For example, Franklin Templeton earns 60% to 70% of its revenues outside the U.S., which is a nice little hedge. Fund companies covering multiple distribution channels are more likely to navigate their operations through this market.

Of course, they must cut costs and stop hiring or paying bonuses. Keeping revenues up and expenses low is the short-term key to surviving.

Longer term, what will be the landscape of the mutual fund industry? Do you expect broad consolidation in the industry? Will there be opportunities for new entrants with niche offerings?

Bobroff: Today, Lipper tracks over 600 managers for the 8,700 mutual funds. That number needs to shrink dramatically. As mentioned above, the day of offering a full product line is gone for all but the very large vendors. What we will see is boutiques with the staying power; otherwise they will go the way of the Model T.

The real question on the horizon is what the distribution landscape will look like. It has recently been thrown into a blender with the uncertain future for Merrill, the consolidation of Morgan Stanley and Smith Barney (retail systems), the acquisition of Wachovia, which moves A. G. Edwards to Wells Fargo, and the uncertain future for the brokerage and financial planning arms of AIG.

The broader question is how long it will be before equities return as the staple of financial planners. If the post '73-'74 period is a guide, we may be looking at 10 years. On the other hand, fixed income could become a very important segment of the industry. In the late 70s and 80s, the industry created de novo fixed income funds which did not have portfolios of existing bonds and thus were able to capture high yields right away. Funds today face a much more efficient fixed income market. Capturing higher returns entails recognizing losses on existing bonds, affecting performance history (good or bad), which in turn affects their Morningstar ratings.



While I have been suggesting for years that we will see significant consolidation in the industry, it hasn't occurred because of the ease of entry for equity managers. At the end of 1992, the top 30 mutual fund, variable fund and closed-end managers held 71.8% of the industry assets. As of December 31, 2008 the top 30 held 79%. Many of the top 30 are different today and are dominated by groups with significant money fund assets, but it is clear there has not been a lot of consolidation in the past 17 years. There should be broad consolidation but I can't envision where it will come from. Capital at this point is not readily available and the most recent past buyers — foreign entities from Europe — are not able to do much on the acquisition front. Consolidation usually occurs not at a market bottom but when the markets start to climb out of the cellar. So it might be several years before we see much movement. At the same time, we will see acquisitions at the margin, but they will hardly move the needle.

The ease of entry for new entrants with niche offerings is on hold for a while. Some firms will try their hand at ETFs or even actively managed ETFs, but they will see limited success. It is hard to predict what the appetite will be from the financial intermediaries and what will be the product of choice. If interest rates rise significantly in the future, we will see several new firms try their hand at fixed-income ETFs. Sometime during the next five to 10 years, Microsoft and/or Google could offer low-cost mutual funds only available via the Internet, and the boomers' kids would be adopters of this simple way to invest and keep track of the investments they own.

Ellis: I expect considerable consolidation in the space due to the following reasons:

- Too many similar or undifferentiated funds
- No consistent net of fee benefits from actively-managed funds
- High pricing
- Superior tax and net of fee performance from ETFs
- Lack of marketing resources for smaller firms
- Lack of distribution access for smaller firms and firms without brand name credentials

The industry could rapidly decline to around 2,000 to 3,000 funds. Many asset managers will try to move to the SMA/UMA space, where they will find themselves at the mercy of sponsors and platform providers. The only mutual fund survivors will be those tied to defined contribution plans, as long as they keep paying campaign contributions to politicians. The majority of other investments will move to ETFs and managed accounts.



While there are always opportunities for the innovator or the better value proposition, starting a new mutual fund will be looked upon in a similar vein as developing a new word processing program to compete with MS Word!

Roame: The playing field consists of about 650 mutual fund companies, with about 50 to 75 that are owned by redundant parents, meaning one parent – like Natixis – owns multiple fund companies. What will happen to them? The “barbell effect” is alive in every financial services industry. Many “experts” have claimed that if you do not grow to some level of scale, you will not survive. I disagree. There is room for new entrants in every market segment. For instance, look at community banks, RIAs, and other segments. While the big get bigger, there are always new entrants. Acquisitions will continue. Those in the middle are most vulnerable. They are too big to claim a niche but too small to take advantage of distribution and technology economies of scale. Meanwhile, while the big are buying the medium and some portfolio managers may break off from middle-size firms and become next little guy. Yes, consolidation will happen, but there will also still be new entrants.

Unlike the view many “experts” claim, I believe that 40-Act funds are here for a while and are not going down the drain. They will not be supplanted by hedge funds or separately managed accounts. ETFs are a legitimate product structure, but it is less clear whether their future will be a function of a product structure trend or an indexed trend. Thus far, ETFs have supported an increased use of indexing. If the ETF structure is better, then active funds will move to that structure. In any case or product structure, the business of managing people’s money for 50 or 75 basis points is here for a long time.

How long-lasting will be the shift of investors to more conservative asset allocations, and what will be the impact on the asset management industry?

Bobroff: It is hard to say, but if history is any guide we have truly burned a generation during the past 10+ years, especially the boomers who now probably have to work forever. The real money is in the boomers’ hands, and they have crawled into their shell. It is hard to see what will bring them out, except for double-digit, risk-free government returns, which last existed in the late 70’s and early 80’s. It is likely that with all the fuel that has been and will be injected into the economy, we will see significantly higher interest rates, although the level is unclear. We will need something to bring investors back to the industry, and I am not sure what it



will take. I could envision some reasonably priced guaranteed products (I recognize that may not be possible in the current environment, but that may be necessary for the boomers — where all the money currently resides).

Ellis: The current crash will reside in memories for a similar period of time as did the Great Depression. Too much wealth evaporated and the trust level of various asset managers has never been lower. Conservatism will be evident in considerable increases in insured bank deposits, fixed income products, and fixed annuities. Declines will occur in variable annuities and equity mutual funds, as hedge funds arbitrage away positive returns. In the HNW space, growth will be in managed accounts and low cost structured products made up of fixed income instruments with guarantees combined with equity kickers through derivatives. Retail hedge fund assets will decline, due to fraud, lower returns, and because they won't ever reach their high-water mark again.

The asset management industry will not return to its incredible rates of return on its capital or assets in my lifetime. The industry has no one to blame but itself; complacency and greed have killed the Golden Goose.

Roame: First, I am not a stock market or economy guru, so I will pass on trying to forecast the direction of the market. But understanding the consumer impacts of the current decline is critical to understanding the direction of the asset management industry. We conduct weekly consumer focus groups to understand what investors are doing with their money. Over and over, we are learning that, for as bad as it has gotten, consumers have held their own despite the humungous drop in the market. Hence, we at Tiburon believe that when the market starts turning back up, consumers will get more aggressive. They will be told, over and over by their financial advisors and 401(k) plan materials, that with six to 20 years to retirement, they must get more aggressive to meet their financial goals. Consumers have reacted better than we may have expected to this depressing market, and hence I believe that once the market turns up they will shift back to more aggressive allocations.

For asset managers, this will signal a shift back to revenue growth.

Will passive or active strategies increase share over the next several years? Among passive strategies, do you expect index funds or ETFs to increase share?

Bobroff: Mutual fund managers need to recognize that large cap domestic equity has become a commodity, with index funds and ETFs



winning the day. Active large cap managers will need to look to other areas to support their business. I am not sure yet whether the same applies to mid or small cap. On the international stage, clearly there is no specific index that effectively models those markets, so active management still works. Variable annuities that offer guaranteed benefits — accumulation and withdrawal — funded with actively managed portfolios are now switching to mostly indexed-based products. Managers failed hedge the risk and took significant losses in the fourth quarter and first quarter of this year. One the problem — failure to adequately price the guarantee — hit the industry squarely in the face, it moved to an unexciting approach of relying on index funds.

Ellis: Passive strategies will prevail until we can find active managers who deliver a positive return beyond funds that can short the market like 130/30 or hedge funds. In the passive space, ETFs will eat the mutual funds' lunch.

Roame: Looking three to four years ahead is difficult as the economy could still be limping along, but over the next ten years I believe that the industry will revert to a steady state, so it is easier to forecast. Indexing — or what we call “market-linked products” — will be up as a share of assets under management in every segment — individuals, endowments, pensions, etc. Pensions and the “smart money” are already headed there. RIAs, who are the wisest fiduciaries, are headed down this path. Academics support this path. In ten years, I feel quite certain that indexing in the broadest sense will be up as a share of assets.

Certain asset classes cannot be beat over the long haul. This is generally accepted. Similarly, it is nearly impossible for actively managed fixed income funds to beat indices after fees and trading costs. And some funds are so big — in terms of the number of their holdings — you are buying the index anyway. Indexing is here, and consumers are getting smarter.

But I think it is a trend beyond just simple indexing. A host of enhanced strategies will emerge to beat indices, such as DFA's block purchase strategies in small caps or the leveraged and inverse funds of Rydex or Pro Funds. The various weight strategies and other leading-edge thinking will carry us a long way towards better indexing.

Target date funds (TDF) have failed to deliver acceptable results. Most notably, near-term funds have been too aggressively invested. Will these funds gain popularity or fade into the background?



Bobroff: The industry will do a 180 as it did in the late 1990s. Initially, TDF or risk-based fund-of-funds (FOFs) were designed to be more fixed income-oriented as they neared the risk horizon. But the equity markets of the late 80s and the 90s suggested that investors were really under-weighted in equities and were going to live longer, so they needed much more equity exposure. The products shifted just in time for the great bear market. I don't believe that we have seen the end of the TDF, although it will morph, giving investors and/or intermediaries more choices in the mix. They offer an important benefit by eliminating accounts that invest small amounts in different funds to gain diversification. We, as an industry, have to make them work. The wild card here is that Congress seems to have become excited about the poor performance of short-dated TDFs and out of this we could see some bad legislation or knee-jerk regulatory reaction. Stay tuned.

Ellis: TDFs and guaranteed payout funds have a place because mutual funds will become relegated to the defined contribution space. Sponsors and participants will continue to look for easy solutions and will utilize these funds extensively, no matter how poorly they have performed. They will continue to perform poorly, as funds will over-weight equity in order to earn higher fees than on fixed-income funds.

Roame: I have two views on this issue, and they are somewhat conflicted. TDFs are a great idea, despite being clobbered by bad performance. Are they too aggressive? Were they designed incorrectly? Or were they just introduced into one of worst markets ever? I am not sure. To judge now is easy Monday morning quarterbacking.

TDFs are an obvious answer for 401(k) plans and for small clients. They are a good, solid American product, but historically such products often stumble early on before finding their footing. Online trading started out as DOS-based box-and-ship software and struggled for five years, which no one remembers. Mutual fund supermarkets were criticized as a fad before catching on. TDFs will have some growing pains but will be here for the long run.

My other view is that TDFs don't get used properly and, as an industry, this needs to be addressed. If you study client portfolios, you see that TDFs are often being used as one piece in the investor's asset allocation, often alongside substantial equity allocations. Hence, if a consumer buys the 2020 fund but adds other equity funds to their holdings, that then becomes the 2030 fund. What's the point of this? Even if they are a great idea, if consumers won't use them correctly, their value is destroyed. This issue needs more attention.



For financial advisors, do you foresee a shift away from AUM-based fees to performance-based fees in the wake of declining portfolio values?

Bobroff: I sure hope not, since most money management firms have a difficult time managing their business with traditional fee arrangements. If we were to move to performance fees where earnings are hard to quantify it will be very painful. Public money managers will do anything to keep that from occurring.

Ellis: Yes. I see a move to the following fee makeup:

- a) A base fee for custodial services and reporting on assets of around 20 basis points
- b) A fee for due diligence on managers of another 20 basis points in managed accounts
- c) A fee for active managers of 35-60 basis points on managed assets
- d) A transaction fee for individual trades in ETFs and fixed income
- e) A risk- and style-based performance fee for both managers and advisors for beating pre-determined benchmarks
- f) A fee for annual financial planning *which will become mandatory for advisor-supported clients*. This will be a stepped schedule based on asset size (starting at around \$1,000 for a plan that is slightly better than one can get for free on the internet) and complexity of portfolios and tax and estate situations.

Advisors will be only working with high mass affluent and above clients in the future, and the mass market and most of the mass affluent will be in a self-service environment. Most wealthy clients need to be in models-based UMAs for the tax and trading efficiency benefits.

Roame: While I agree that investors may get frustrated by the lack of alignment in incentives between themselves and their financial advisors, I think too many experts predict too rapid an industry shift. Some investors will move to performance fees, flat retainers, and other forms of compensation, but my guess is that 95% of financial advisors will still charge AUM-based fees.

Dunham & Associates, a San Diego-based advisor and fund manager, employs 100% performance-based fees. Some customers will use them because they have the courage to do this. It's a great strategy, correct for some.



But this industry does not change quickly. AUM fees are ingrained into the fabric of asset management. Retainer fees have the same issues. A few advisors charge retainers, but the majority charge based on AUM. It is unrealistic to pretend the whole industry will shift.

Many hedge funds and mutual funds that advertised “absolute return strategies” failed to deliver on that promise in the current market cycle (although many still outperformed broad market indices). What growth do you forecast for absolute return strategies?

Bobroff: Much like other specialty products of the past, they are not mainstream and thus it really doesn't matter. The biggest problem with these strategies is trying to manage toward a specific benchmark while investors require liquidity and can demand their assets at anytime. These products work best when the assets are stable and not moving in and out. They are really not ideal as a mutual fund.

Ellis: I see some growth in this space, but more for the related “structured product” space.

Roame: The term “hedge fund” has been bastardized. What we lump together as hedge funds is silly, since a highly diverse array of asset classes and strategies are included in the hedge fund category. “Absolute return” is a better term, as it more precisely defines a strategy.

Absolute returns and more broadly non-correlated assets are likely to be a growing part of the investing market. Consumers will seek out advisors and institutions that offer non-correlated assets. These strategies will come back and grow within the 40-Act universe and among traditional hedge fund product structures. Investors have paid such a dear price in the current market, and they want to believe that some smart guy can figure out how to properly diversify and reduce risks.

Yale endowment manager David Swensen recently said hedge fund of funds “are a cancer on the institutional-investor world. They facilitate the flow of ignorant capital.” Do you agree?

Bobroff: I agree. The managers of these products in general have failed to demonstrate that they can find the diamonds and leave behind the trash.

Ellis: I agree. Alternative investments do not always compensate appropriately for illiquidity. If you can't get your money back, how can you say that you generated a positive return? The diversification of funds of



funds has proven to be unreliable at best. The only advantage hedge funds have over regulated retail asset management is their ability to short equities. Therefore, they need a pool of long capital to short against. The most-likely victims will continue to be those poor suckers in Middle America with 401(k) accounts and mutual funds.

Roame: I agree. We have to be careful we don't create some of these problems. Funds of funds, when they started, weren't understood. Among hedge funds, there are single strategies, absolute return funds, distressed securities funds, convertible arbitrage funds, and a host of other strategies. But the use of multi-strategy hedge funds of funds rarely makes sense, other than to help one's ability to schmooze at cocktail parties. Why would an investor choose such a product? Why would an investor lump an absolute return fund and long equity leveraged fund in the same portfolio? It may sound cool, but it is not justified by any valid investment principle. Single-strategy funds of funds are logical depending on one's risk profile; investors don't need to bet on single managers. I get that, but not multi-strategy funds of funds. What is the risk profile that justifies that? Or is it just another way to collect 2% and 20%?

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