funds europe

What's next for funds?

Disintermediation and the future of fund distribution

A funds europe survey in conjuction with Clearstream

A world of change

Highlights from the report

DISINTERMEDIATION is transforming the way funds are distributed, which is why it is a fitting subject for the first in a series of research reports, written by *Funds Europe* in association with Clearstream, that examine what the future holds for the funds industry. Among the highlights of our survey:

- 80% of respondents believe customers get a better deal when their providers offer open architecture (a range of funds from competing fund managers)
- 59% think open architecture is under threat from financial and regulatory pressures
- 48% believe robo-advisers will become the industry standard for dealing with retail clients (those with less than $1 million of investable assets)
- 14% think robo-advisers will become the industry standard for dealing with high-net-worth clients (those with more than $1 million of investable assets)
- 67% believe passive funds such as ETFs will gain a bigger proportion of fund flows than actively managed funds in future
- 58% think today's investors are more sophisticated than they were five to ten years ago (but 21% disagree)
- Respondents believe, in future, online direct models will be the main channel for distributing funds, performance the most important driver of investment and advisers the main place investors go for advice

A total of 192 funds professionals participated in the online survey. See 'survey methodology' (page 14) for more information.

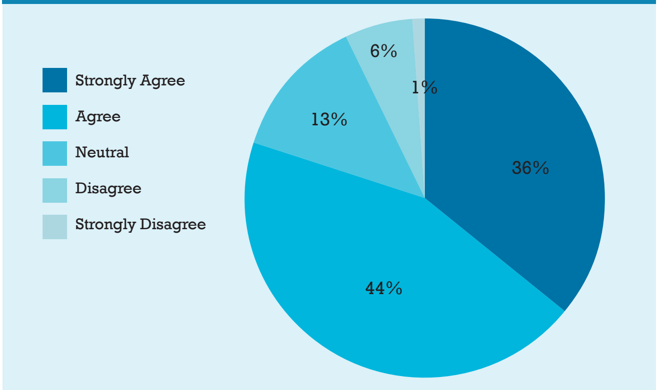
Disintermediation and the future of fund distribution

Technology and changing consumer tastes are revolutionising the way funds are bought and sold. A survey by *Funds Europe* and Clearstream gauged the sentiments of the asset management industry.

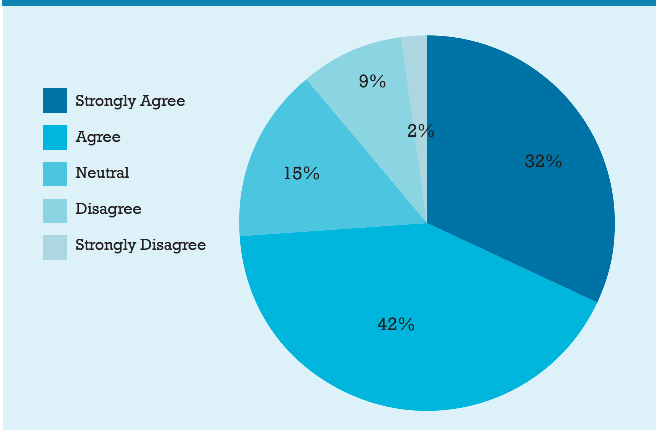
TWENTY YEARS AGO, a middle-aged couple who planned to go on holiday might walk into the premises of their local travel agency, choose from a list of destinations and leave it to their agent to book the flights, hotel and transfers. Today, it is relatively rare for prospective holidaymakers to leave it all to an agent. The popularity of price comparison websites for airlines, and access to user-generated reviews of hotels, restaurants and resorts, have emboldened foreign travellers – both young and old – to do much of their research and bookings themselves.

The funds industry is undergoing a similar change. Whereas in the past, the channels for distributing funds were well established – the couple in our above example might have gone to see their financial adviser, or a representative at their bank – today, a far greater number of people are likely to do their fund research themselves. That has led to a rise in investment

1. WHEN DISTRIBUTORS OFFER AN OPEN ARCHITECTURE PLATFORM – A RANGE OF FUNDS FROM COMPETING FUND MANAGERS – INVESTORS GET A BETTER DEAL



2. OPEN ARCHITECTURE SHOULD BE THE STANDARD METHOD OF DISTRIBUTING FUNDS ACROSS THE INDUSTRY



on fund platforms as investors take advantage of the opportunity, offered by the internet, for them to direct and manage their fund portfolios themselves.

Clearly, distribution is changing. This research project, which is planned to be the first in a series of reports in association with Clearstream, takes a high-level view of a key theme affecting the evolution of fund distribution, disintermediation. By threatening the conventional gatekeepers that historically separated fund investors from fund managers, disintermediation is opening up new possibilities, and new business risks, for the asset management industry.

This report will provide a basis for future surveys, with an in-depth report on exchange-traded funds (ETFs) scheduled as the next in the series. Our hope is that, by examining the sentiment of the funds industry on the factors affecting it, we can predict how the future of fund distribution will look.

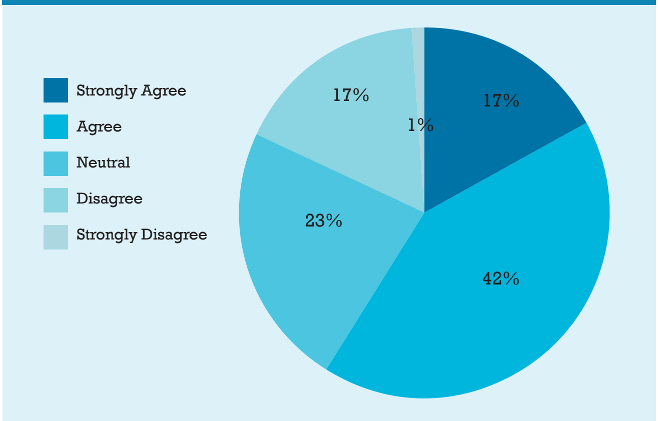
Open architecture

Open architecture is not a new concept for the funds industry, but its application is certainly in line with the trends of the digital age. Describing a system that offers access to funds from a wide range of providers, open architecture is prized by fund platforms, which boast about how many funds they can offer. (In this respect, fund platforms are similar to travel comparison engines, such as Skyscanner, which markets itself as having access to a very wide range of airline websites.)

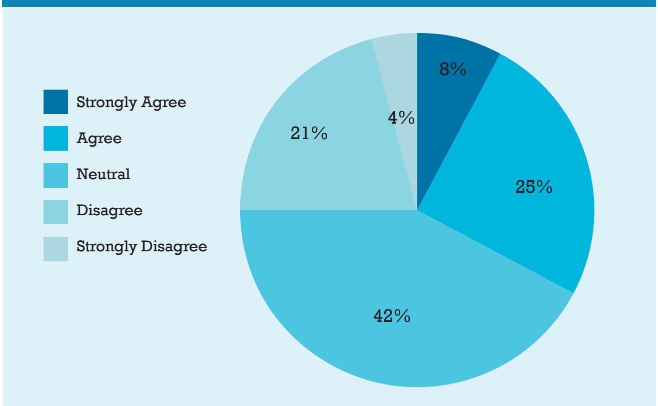
Our survey revealed a strong belief among respondents that open architecture was in the interests of the end investor (see page 14 for survey methodology). Of the 192 respondents that answered this section of the survey, 80% agreed with the statement that, 'When distributors offer an open architecture platform – a range of funds from competing fund managers – investors get a better deal' (figure 1). Of this, 36% strongly agreed. Only 7% disagreed. As far as our respondents were concerned, open architecture is clearly a boon for fund buyers.

Given this belief that open architecture benefits investors, it should be no surprise that almost as large a majority agreed with the statement that, 'Open architecture should be the standard method of distributing funds across the industry'. Nearly three-quarters of respondents, 74%, agreed with this view – of which 32% strongly agreed – while only 11% rejected it (figure 2). It is reassuring that our respondents

3. OPEN ARCHITECTURE IS UNDER THREAT FROM FINANCIAL AND REGULATORY PRESSURES



4. TECHNOLOGY, SUCH AS ROBO-ADVISERS, HELPS INVESTORS MAKE BETTER DECISIONS

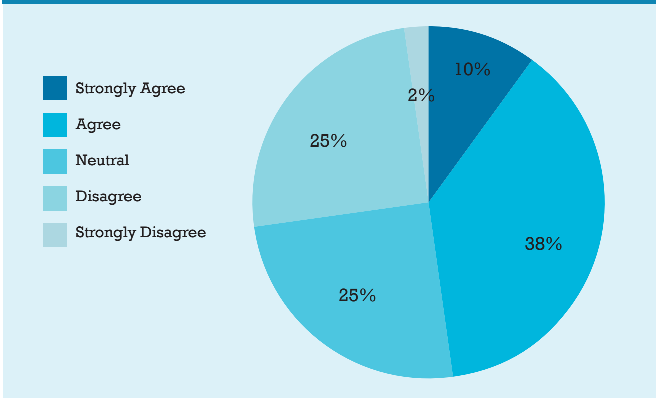


wanted the industry to do what they believed was in the interests of its customers.

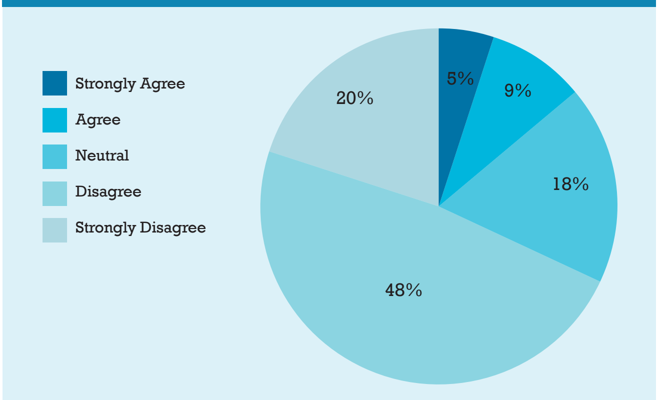
However, there has been some media coverage in the past few years that suggests fund distributors are facing financial or regulatory pressures that may discourage them from maintaining open architectures. Some banks have reportedly stopped selling third-party funds in order to push their own branded products, while some advisers have dramatically reduced the number of external managers they use in order to cut down on operational complexity or to reduce client servicing costs. Regulation such as Mifid II, by setting rules on payment of retrocessions to improve transparency, will have a big impact on the sector.

Our respondents recognised these concerns. A majority, 59%, agreed that 'Open architecture is under threat from financial and regulatory pressures' (figure 3), of which 17% strongly agreed. There were some doubters, however, with 18% disagreeing with the statement. Nearly a quarter, 23%, maintained a neutral stance, a figure that perhaps reflects the complexity of the issue.

5. ROBO-ADVISERS WILL BECOME THE INDUSTRY STANDARD FOR DISTRIBUTORS AND FINANCIAL ADVISERS TO DEAL WITH RETAIL CLIENTS



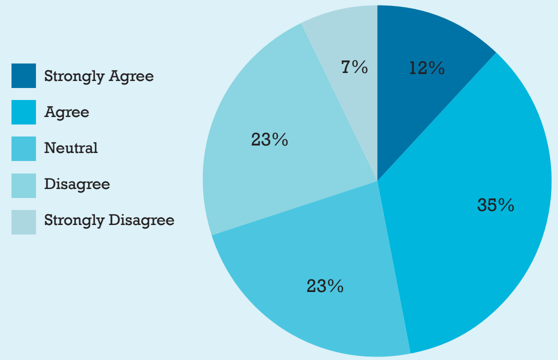
6. ROBO-ADVISERS WILL BECOME THE INDUSTRY STANDARD FOR DISTRIBUTORS AND FINANCIAL ADVISERS TO DEAL WITH HIGH-NET-WORTH CLIENTS



Technology

Perhaps the most divisive issue examined in this survey concerns

7. ROBO-ADVISERS WILL NEVER BECOME THE INDUSTRY STANDARD – INVESTORS WILL ALWAYS NEED HUMAN INTERACTION



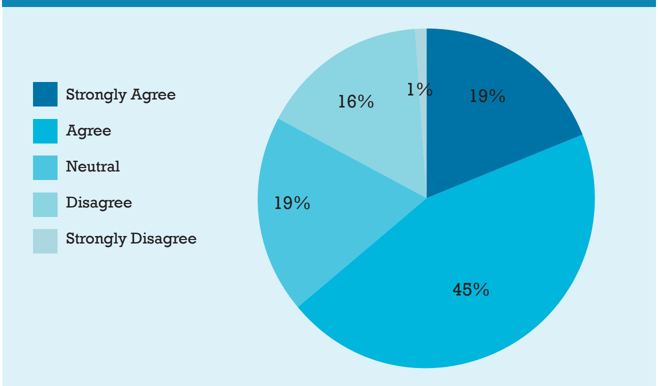
the role of technology in guiding investors to make the right choices. Robo-advisers, which use algorithms to propose investment suggestions based on user inputs, are being touted as a revolutionary development in the world of fund distribution that will allow millions of investors to get personalised investment advice at much lower costs than if they were to go to a human adviser. But robo-advisers are bitterly opposed by many traditional distributors, who argue there is no substitute for the human touch.

The 188 respondents who answered this section of the survey were divided almost equally between the 33% who agreed that 'Technology, such as robo-advisers, helps investors make better decisions' and the 25% who disagreed (figure 4). Interestingly, the most popular position on this question was to withhold judgement, with 42% of respondents staying neutral. The large number of people who have yet to form a judgement on this question suggests the case for robo-advisers has not yet been satisfactorily made.

Respondents were also split on the question of whether 'Robo-advisers will become the industry standard for distributors and financial advisers to deal with retail clients (those with less than $1 million of investable assets)'. Although nearly half, 48%, agreed with the statement, a sizeable minority, 27%, disputed it, while a quarter stayed neutral (figure 5). Retail investors with relatively low wealth are usually seen as the most appropriate users of robo-advisers, but, clearly, not everyone believes this is the best option for them.

There was less dispute when it came to richer clients. The statement, 'Robo-advisers will become the industry standard for distributors and financial advisers to deal with high-net-worth clients (those with more than $1 million of investable assets)' was opposed by more than two-thirds of respondents, 68% (and among that, 20% strongly

8. ETFS ARE A SUITABLE CORE INVESTMENT FOR RETAIL CLIENTS (THOSE WITH LESS THAN $1 MILLION OF INVESTABLE ASSETS)



opposed it). A mere 14% agreed with the statement, suggesting the industry is a long way from integrating robo-advisers into, for instance, private banks. The message is clear: when it comes to wealthy investors, human advisers are here to stay.

The ambivalence towards robo-advisers was reflected in the final question on this section of the survey. Respondents were asked to agree or disagree with 'Robo-advisers will never become the industry standard – investors will always need human interaction'. Nearly half, 47%, agreed, while 30% disagreed and 23% stayed neutral (figure 7).

Passive funds

Another trend that is upending establishing models of fund distribution is the growth of passive investment, especially exchange-traded funds (ETFs). Low-cost and transparent, ETFs are gathering more and more assets. The benefits to institutional investors are clear – exposure to equity or bond indices at a fraction of the cost of actively managed funds. But some have argued ETFs are not suitable for retail investors.

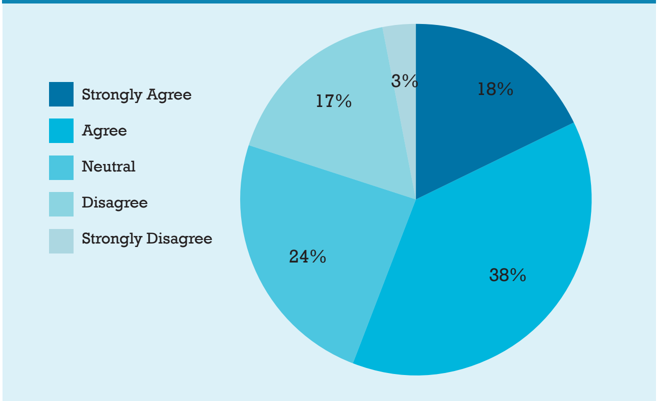
Our respondents generally felt ETFs are suitable for retail investors. A majority, 64%, of the 184 people who answered this section of the survey agreed that 'ETFs are a suitable core investment for retail clients (those with less than $1 million of investable assets)', of which 19% said they strongly agreed (figure 8). Only 17% disagreed.

Respondents were less sure when the same question was asked of richer clients. A slim majority, 56%, agreed that 'ETFs are a suitable core investment for high-net-worth clients (those with more than $1 million of investable assets)'.

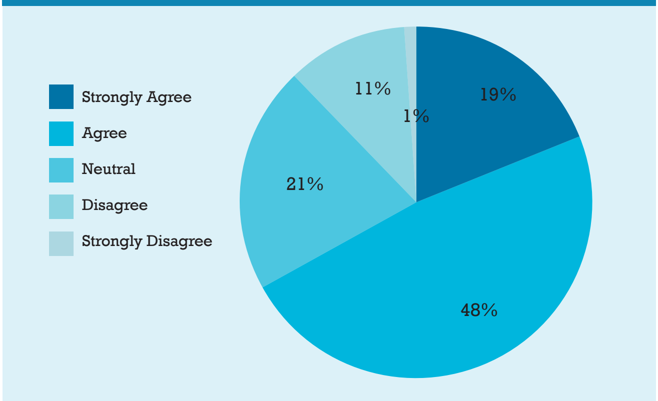
A fifth disagreed with this statement, while slightly more respondents than in the previous question were neutral (figure 9).

Will ETFs and other passive funds continue their healthy asset raising? Most respondents thought they would. Two-thirds, 67%, of respondents

9. ETFS ARE A SUITABLE CORE INVESTMENT FOR HIGH-NET-WORTH CLIENTS (THOSE WITH MORE THAN $1 MILLION OF INVESTABLE ASSETS)

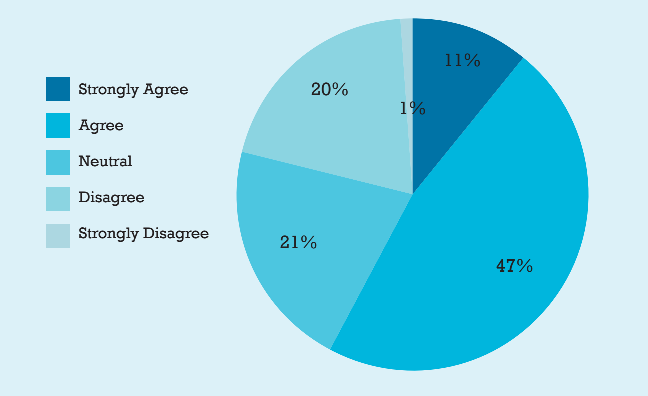


10. IN THE FUTURE, PASSIVE FUNDS SUCH AS ETFS WILL GAIN A BIGGER PROPORTION OF FUND FLOWS THAN ACTIVELY MANAGED FUNDS



agreed that 'In the future, passive funds such as ETFs will gain a bigger proportion of fund flows than actively managed funds' (figure 10). Of this, 19% strongly agreed. Only 11% disagreed, with the remaining 21% staying neutral.

11. FINANCIAL EDUCATION HAS IMPROVED – TODAY'S INVESTORS ARE MORE SOPHISTICATED THAN THEY WERE FIVE TO TEN YEARS AGO



Education

One of the consequences of a greater proportion of self-directed investors in the market is a greater need for financial education. If today's fund buyers are more empowered than before, it stands to reason that they ought to be better equipped, mentally, to determine which funds are right for them. Respondents generally agreed that investors are more sophisticated than they were in the past. The statement, 'Financial education has improved – today's investors are more sophisticated than they were five to ten years ago' met with agreement from 58% of respondents, and was disputed by 21%, while another 21% were neutral (figure 11).

Future models

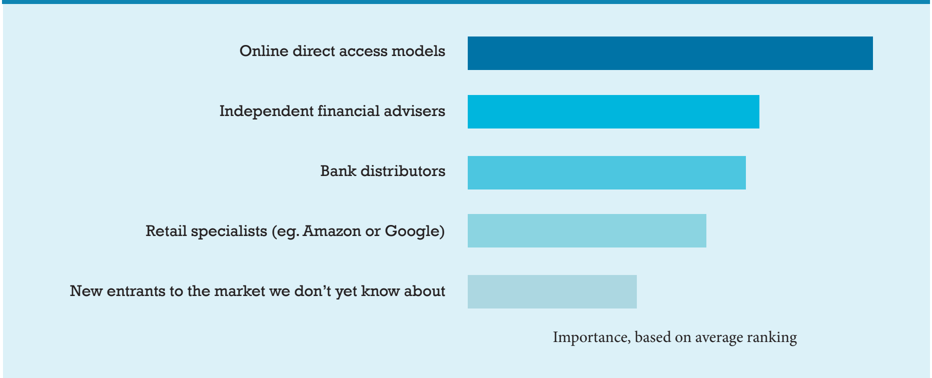
As stated at this start of this review, disintermediation is changing the way funds are distributed. But what entities will become the most important distributors of funds? We asked respondents to rank the likely importance of five channels in ten years' time (in the chart below, a higher number indicates a greater expected importance).

The channels included the traditional channels – independent financial advisers and banks – as well as online direct access models, in which asset managers sell funds directly to investors.

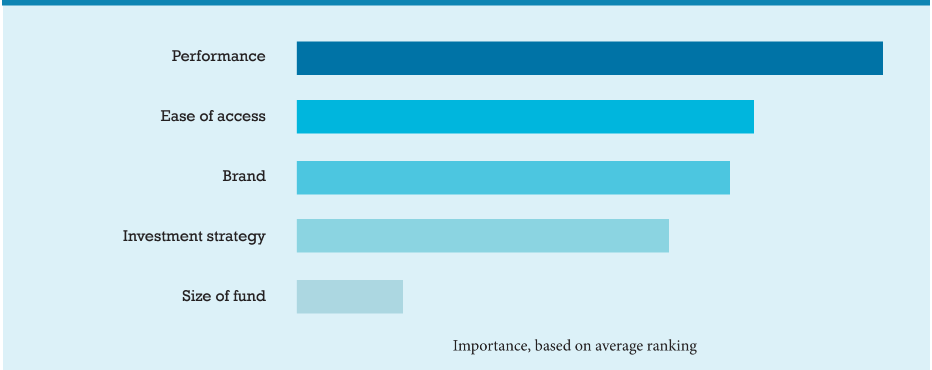
We also asked respondents if retail specialists such as Amazon or Google, neither of which is substantially involved in the funds industry at time of writing, would become important distributors. Respondents also had the chance to estimate the importance of a 'wild card' factor – new entrants to the market that are not yet known.

Based on average

12. IN THE FUTURE (10 YEARS FROM NOW) HOW DO YOU BELIEVE FUNDS WILL BE DISTRIBUTED?



13. WHAT DO YOU FEEL WILL BE THE MOST IMPORTANT DRIVERS OF INVESTMENT IN THE FUTURE?

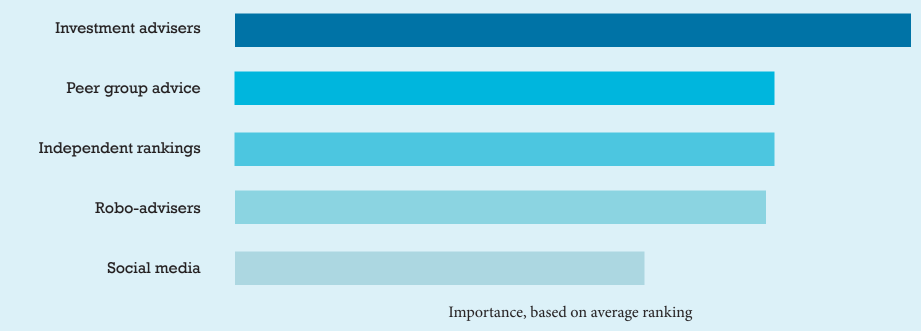


ranking, the 150 people who answered this section of the survey predicted that online direct access models would be the most important channel, followed by independent financial advisers, banks, retail specialists and unknown new market entrants (figure 12).

The survey also sought to establish which qualities among funds would be most decisive in attracting investor flows. Would brand be more important than investment strategy in ten years' time? How important would accessibility be?

The ranking was clearer for this question than for the last. Respondents judged that performance would be the most important

14. HOW DO YOU THINK INVESTORS WILL LOOK FOR INVESTMENT ADVICE IN THE FUTURE?



factor, followed by ease of access, brand and investment strategy. Fund size was predicted to be the least important factor by a large margin (figure 13).

The final question asked how investors in the future were likely to get investment advice. The average ratings were close together, indicating that respondents did not, on the whole, have a clear idea about which methods would dominate.

The good news for investment advisers is that they were predicted to be the most important source of advice in ten years' time, followed closely by independent rankings and peer group advice, which were tied (figure 14).

Robo-advisers came next, but the average ranking was close to the top three. The only method that was clearly not favoured was social media.

Disintermediation is one of a number of factors affecting the evolution of fund distribution. This survey indicates a strong belief that open architecture is in the interests of investors, that robo-advice has a role to play in serving clients (though this is disputed by some), and that passive funds are anticipated to be a key part of fund portfolios for many investors.

The future is uncertain, but the results of this survey indicate some possible directions of travel. Clearstream and *Funds Europe* plan further in-depth surveys to probe the issues uncovered in this report, with a further piece of research on ETFs scheduled as the next in the series. We hope the results of our work prove useful to those in the asset management industry who are planning their strategies for the future.

Survey methodology

A total of 192 professionals drawn from *Funds Europe*'s readership, who work in various positions across the funds industry, participated in the survey that was conducted online between November 17 and December 16, 2016. The number of respondents who completed each section of the survey is as follows:

Open architecture: 192
Technology: 188
Passive funds: 184
Education: 183
Future models: 150

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