Funds industry in 2013

What do Luxembourg professionals think about the global funds industry? Our panellists say fees are mostly justified, distribution costs still too high, and challenges still remain for the development of Ucits. Chaired by **Nick Fitzpatrick** and edited by **George Mitton**

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Funds Europe: How much further does the funds industry need to go to achieve optimal efficiency? What are the main problems, and what is preventing change?

Philippe Seyll, Clearstream: The issue we face is that those who would pay to get the efficiency changes are not those who would benefit from them. Fund buyers say they have no issues because when they sell a fund, they put the efficiency burden on the other side of the fence. Those on the manufacturing side tell us they are perfectly capable of handling the business the way it is today, and don't have to spend money on efficiency, because they charge the other side of the fund. In the end, who pays? The fund and the investors.

Antonio Thomas, RBS Fund Services: We see many investment managers embarking on fund rationalisation programmes. There are many drivers for this, including platforms that struggle with suboptimal fund sizes and with too many share classes, and the need to focus on a narrower set of activities - for example, they no longer wish to be a manufacturer or no longer want to be a distributor. In one case, the board of the investment vehicle is the driver for change, challenging the product owner over the number of different sub funds and strategies, where only a few of those investment strategies have critical mass or performance track records capable of attracting additional in flows from the market. These are some of the triggers, compounded by increased costs from implementing regulatory changes in recent years, that are giving rise to to the needs to rationalise product. Investment managers are looking at running fewer but bigger, more optimal and therefore attractive, investment vehicles.

Michael Ferguson, EY Luxembourg: One of the real issues continues to be the fragmentation of the industry. We keep talking about consolidation, but we have talked about this for the past 20 or more years. When you look at the numbers of products, and the number of share classes, there has been only a slight reduction over recent years. Even if you look at the biggest players, their market share is still only a small percentage of the overall industry. A lot of the operational challenges are due to fragmentation both at the asset manager and service provider level. There is, however, due to the never-ending regulatory agenda, the real possibility that many of the smaller players will be squeezed out over the coming years.

The other real challenge is distribution. It is simply too expensive, especially in continental Europe, and, given the ban on commissions, the concept of "open architecture" will remain just that, a concept.

Serge Weyland, Caceis: The biggest challenge we face in Europe is on the distribution side. It is difficult for US players, especially smaller ones, to enter the European market in a cost-efficient manner. The fund industry's main aim should be to push for a unified distribution landscape in Europe.

Just look at some of the protectionist local regulations in force in Italy or France. The only way we can achieve greater efficiency is if regulators establish a standardised, pan-European regulatory framework for distribution, because differences in regulations between individual member states hamper efforts to bring costs down. The task of efficiently monitoring a distribution network as well as ensuring regulatory compliance across many countries in Europe is also extremely complex and time consuming.

Much of the work necessary to ensure compliance is still carried out manually by the product manufacturers and service providers. And this is a major reason why the industry has not delivered on efficiency targets. In contrast, if you look at custody and fund admin, we've made serious progress in terms of automation.

Seyll: The number of players is a key issue. You've got maybe 1,000 fund administrators in the world, then you have the custodians behind, say another 1,000, many of which are the same companies. So you have 1,000 banks, dealing with another 1,000 banks. Now, if you look at the distributors, you've got millions of distributors, dealing with 1,000 administrators, so the sheer number of players involved makes things complex.

Keith Hale, Multifonds: I don't think there are 1,000 administrators out there. In our target market of administrators, I struggle to get above 80, and I think that number will be closer to 40 in five years. There is a lot of consolidation in the market, maybe not as much on the asset management side, or the distributor side, but certainly administrators are all about

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efficiency. They do need to bring down costs.

For example, STP [straight-through processing] rates have gone from about 72% two years ago across the 8,500 funds on our platform to about 79% today. That's not because of our software as such, it's to do with how automated communication with the distributors and managers has become. But the real efficiency gains also come from how efficiently administrators undertake their core functions, such as fund accounting, or transfer agency, as well as STP.

The efficiency metrics vary significantly in our experience, across the fund structure types and asset classes. For example, on the alternatives side, particularly private equity, everything is an exception, so there's no automation and typically there isn't a distribution structure. So the story on efficiency varies considerably across the plethora of asset classes, and in my opinion, moving forward, it will be important to bring together long-only controls and automation with the flexibility in capabilities required for alternatives.

Jon Griffin, JP Morgan: A definite theme at the moment is that a number of houses are going through fund rationalisation, or optimisation programmes, which means acknowledging that they've had a three-year opportunity to get assets, three years to gather a performance level, and if the assets aren't there, or the performance isn't there, it is time to consider other options such as fund mergers or closures.

Funds Europe: What have been the most significant changes to the Ucits fund structure in recent years? How would the panel make the Ucits structure better, or can its current form not be bettered?

Ferguson: I believe the question of whether Ucits IV has delivered is still unanswered, perhaps it is still too soon to conclude. Take master-feeder structures, which were a cornerstone of Ucits IV. While some have been created, it remains only a handful.

There have been a few cross-border mergers but again, a bit like converting to master-feeder structures, certain tax implications at the fund, instrument and investor level have got in the way.

The key investor information document (Kiid), which replaced the simplified prospectus, was definitely progress as it was a much more focused, concise and clear document for investors. The service providers and asset managers have produced many thousands of these documents. However, the question is, have they led to investors making more informed investment decisions or are they simply fulfilling a compliance procedure?

Hale: Ucits III successfully mobilised the brand in the early 2000s, globalising Ucits distribution outside the EU by expanding the range of instruments that a fund could hold. I'm more sceptical about the beneficial impact of Ucits IV. When you look at the evidence, the number of funds has gone up since December 2010, so if the aim is to consolidate the industry and make it more efficient by having fewer funds, it hasn't worked.

Ucits V may theoretically give the investor more protection than Ucits IV, if you agree that imposing depositary liability achieves that goal. Ucits VI is currently a long laundry list of many restrictions, which could take Ucits funds back to pre-the launch of Ucits III. That would potentially have a negative impact on the Ucits brand, hampering distribution and global growth depending on what gets implemented.

Griffin: Some people will always argue about whether the Kiid is as good as it could have been. It's a lot better than the simplified prospectus. It's moved the industry forward. Whether or not the end investor feels he or she got an enriched experience, is really with them, but at least everybody is having to do something on a more consistent basis.

Thomas: Many of the product initiatives which came with Ucits IV failed to really take off at the time because they came right in the middle of the crisis. The question now, as we start to emerge from the crisis and turn the corner is, will we start to see an increase in product development and the utilisation of these new eligible product types such as the master feeder type activities? I'm starting to hear that we will, but it's only now that asset managers can do it, because they've been focused on dealing with the crisis, absorbing and implementing a raft of regulatory changes while trying to keep the ship afloat and steer in the right direction.

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Partner and asset management leader, EY Luxembourg

Griffin: We said a couple of times, what are the key themes from a product perspective at the moment? Income has been a great theme over the last couple of years, in Asia in particular, but not exclusively. Investment solutions is also a big piece, which is the life supply and our industry meshing together different investment asset classes and techniques into something that potentially gives the opportunity for a higher return and less risk.

Weyland: It's also about educating regulators about our industry. Looking at alternative Ucits, the whole discussion was about risk but should have been about complexity. There is too much complexity in sophisticated Ucits products, which include certain regulatory layers which are simply not relevant. For instance, there is no objective reason why you should not be able to trade commodity futures in a Ucits, if the delivery risks can be eliminated. The US is far ahead of Europe on issues such as this.

Why, indeed, are we required to structure indices on commodity investments and have funds enter into swap arrangements to overcome these restrictions? This is an example of regulators adding complexity which is not serving to reduce risk but only to increase costs. It is something that we, as an industry, are not addressing correctly, because we are not talking to regulators effectively.

Funds Europe: Are the fees charged by fund managers realistic, fair and of true value to investors?

Hale: Fees are dependent on what kind of fund you're managing, so if you're running an ETF [exchange-traded fund], you're going to expect a low fee. If you're a very active hedge fund, with a more creative alpha strategy, you would expect a much higher fee, probably including a performance fee. Institutional investors increasing allocation into alternative funds will drive down fees because they're putting bigger assets with smaller hedge funds.

To my mind, it should be a case of putting your money or fees where your mouth is. On the whole, I think fees should reflect fair value. For example, performance fees are arguably the right model, particularly for alternative funds. Are the costs of administration coming down? Well, in some cases they should be, through efficiency gains achieved by having – I'm going to put my software vendor hat on for a moment – consolidated systems across common functions irrespective of asset classes within an efficient operating model.

The AIFMD is a potentially increased cost, based on the fact of depositary liability. We recently ran a survey and 41% of people thought depositary liability costs would be somewhere between five and 25 basis points.

Griffin: In terms of the custodian industry and fund administration, including accounting and TA, the big players are always investing in their technology. They're investing in their processes and how to optimise their operational model.

The product ranges, through a multi share class pricing structure, can deliver a solution so that an institutional investor can get what they want at the cost that they want. There's an efficiency, some would say complexity in the product,

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because you can proliferate the number of share classes in issue which need to be maintained and supported.

Ferguson: The question of performance fees is an interesting one. As we know, management fees are generally charged at a flat fee rate, so your total management fee is dependent upon your assets under management. Performance fees, provided they are properly structured, can be a good way of rewarding a manager for performance. You get it if you perform. You don't get it, if you don't perform.

Many performance methodologies being applied nowadays also build in claw-back features, hurdles, high-water marks, and so on. So in my view, if properly structured, with a clear and a consistently applied methodology, performance fees can work well for both the manager and the investors.

Seyll: What does the finance industry need to secure its future? Make a clear cut between long-term investments, suitable for pension money, and short-term investments, suitable for trading. What you just mentioned is that a performance fee might be against the long-term, steady, alpha-delivering investments, but you have to be careful not to muddy the water.

I'm not against the AIFMD [Alternative Investment Fund Managers Directive], neither as a company nor as an investor. I want to have a clear view of where I put my eggs. Is it a safe basket, or is it a rocking basket? If it's a rocking basket, you get more eggs at the end, fine. If it's a safe basket, I prefer the safe basket for the long term.

Thomas: In some ways that comes back to how those products are positioned in the market. For example, some investors are seeking investment vehicles with certain strategies and income yields as a means to supplement or replace the lack of interest income from their bank account. That's not a surprise given deflation and low interest rates in recent years. Given that they then go for a product like you just talked about, the performance fee is justified, because that's about risk taking, and actively monitoring the liquidity and the risk to lock in the yield.

Are fees charged by fund managers realistic? They are starting to be more focused, because fund managers recognise that they need to be much more transparent about charges in today's world. As a result, there are increasingly tailored products for sale, at different fee or income criteria, to different investor channels. But also, let's not forget, we've seen in the past couple of years a rise in investor activism, such as the SRI [socially responsible investing] type investor, and that's also had an effect on fees in addition to regulatory and political initiatives.

Weyland: I still think distribution fees are a big challenge. Distribution is where both the big profits and the efficiency gains can be found, and it goes back to the whole RDR [retail distribution review] debate. I'm still inclined to think that the RDR will have unintended consequences. We may see open architecture disappear or being backtracked, and big banking groups considering rebuilding their asset management capabilities. Those trying to sell them may realise they are probably better off keeping some manufacturing capability in-house.

I'm worried about that for Europe. If continental Europe goes down the same route, we'll end up with banks saturating the distribution channels, and then we will have another problem to address. We'll have to consider who will cover the cost of educating the investors and IFAs [independent financial advisers], as well as the added distribution costs of online platforms and due diligence.

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Funds Europe: At the level of the European Commission and Parliament, are the funds industry's interests given equal treatment to those of the banking and insurance sectors? What does the funds industry need to do to secure its future success?

Ferguson: Immediately post-2008, all the regulators were focused on solving the banking crisis. This was their key focus, and all of the regulation that came afterwards was heavily influenced by how they tried to fix the banking sector. The asset management industry, fairly or unfairly - including regulation such as AIFMD - got swept into this focus on sorting out the banking crisis.

The voice of the asset management industry had been relatively silent, compared with the voices of banking and insurance sectors. This may have been because many of the largest asset managers, here in Europe in particular, are owned by the banks and insurance companies. However, notwithstanding this, the asset management industry has now begun to respond and has got much more engaged over the last five years – this will need to continue.

Griffin: I read an interesting article this week about who has spent what on lobbying, and it was concerning how few asset managers were on the list. The buy side definitely needs to speak up and be heard.

Weyland: The traditional asset management industry has been caught up in the regulator's efforts, post-banking crisis, to rein in the hedge funds and alternative strategies that were accused of triggering the crisis. We ought to make sure regulators also focus on solving the coming pension crisis, and look at how the asset management industry can help in that respect. The pension crisis needs an efficient and innovative solution, and the asset management industry can and should be a key part of that solution.

We need to promote a long-term focus for investors, and discourage short-termism and the obsession about liquidity. It is the only way investors will end up achieving stable returns. We also need to instil confidence in the asset management industry again.

Seyll: Do we believe the market share of the funds business is going to shrink? What can be done to increase the share? I feel that the future growth for the industry is not in pension money, because pensions are already fully invested into investment funds.

Griffin: Pension provision and defined contribution are key requirements for the future, meaning that more individuals need to take charge.

Hale: The industry is changing. There used to be this alternative industry, then there used to be the long-only. Those two markets are increasingly converging and overlapping, and that's changing how investors invest, how managers manage, and how administrators support that.

Funds Europe: Does anyone have any final remarks on the future of the industry?

Griffin: In Luxembourg, we're recognising 25 years of Ucits' successful growth. We still see Ucits as a continuation. It should be seen as a socially useful product framework for investors.

Ferguson: I would like to see much greater innovation, with the objective of developing real solutions where there is much greater certainty on the outcome for the investor with the manager being rewarded accordingly. That's what the industry needs to focus on.

Thomas: The industry needs to not build products for now, but for the next 25 years, and Ucits provides a recognised regulatory framework and a platform to do that to meet the increased consumer protection envisaged in recent regulatory changes.

Seyll: We need clarity about what's in the tin and on the tin. Ucits has a great brand, we all recognise it and live from it, so we don't want it to be muddied.

Weyland: I still believe we need to work on giving retail investors access to certain alternative strategies, and personally, I think the AIFMD could have a positive impact on the asset allocations of institutional investors, leading them to increase their exposure to alternative strategies. The European Long Term Investment Fund framework announced by the European Commission at the end of June, which is designed to give retail investors access to alternative strategies, is another encouraging sign for alternatives. fe

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