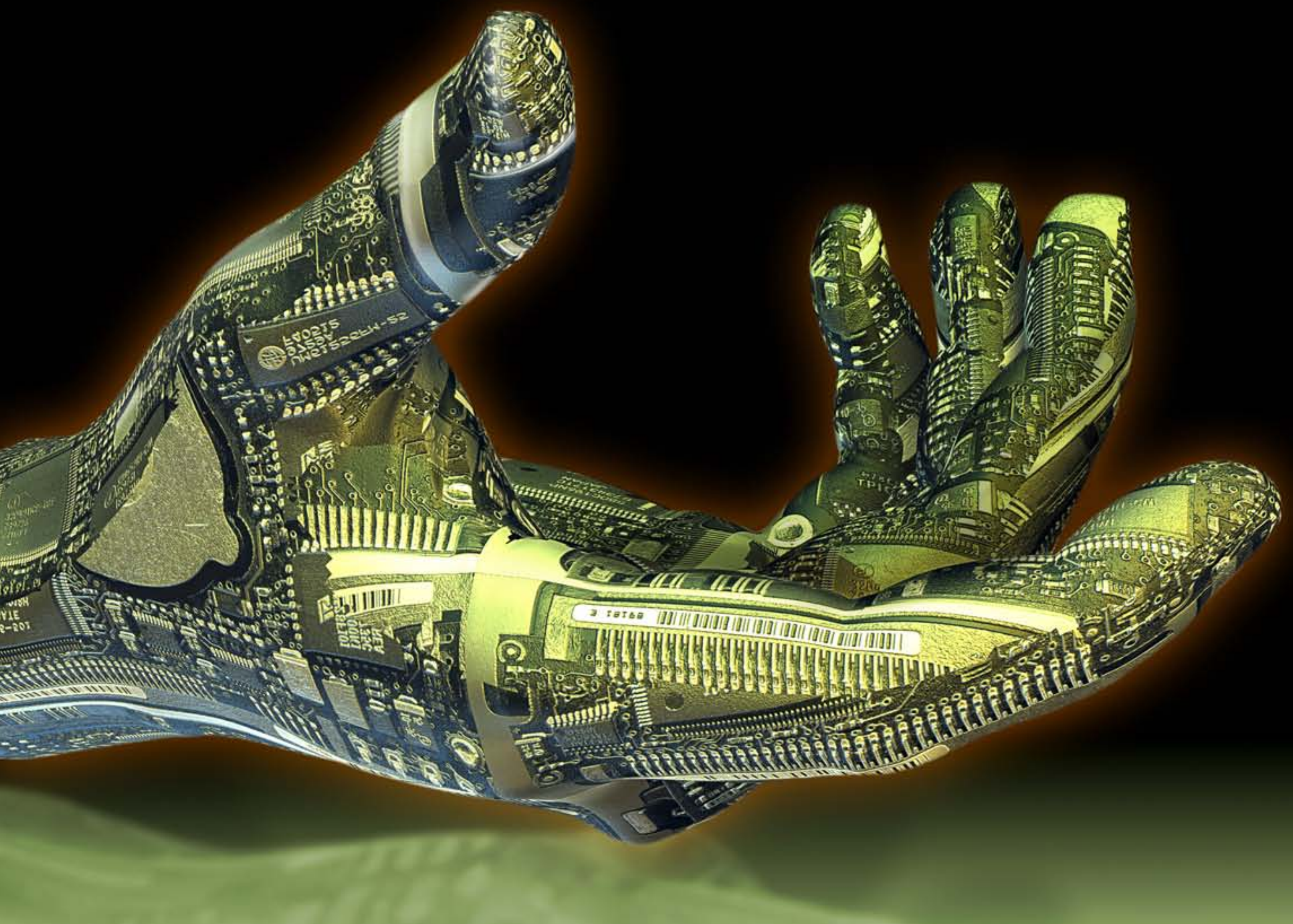
The End of Innovation?

Survey of the future of fund management

Research survey 2013



SAS THE POWER TO KNOW.

IFI Global

Introduction

Over the months of March, April and May 2013 IFI Global's research department interviewed fund managers with $1.9 trillion in AUM on the future of the industry. Both alternative and mainstream managers were surveyed.

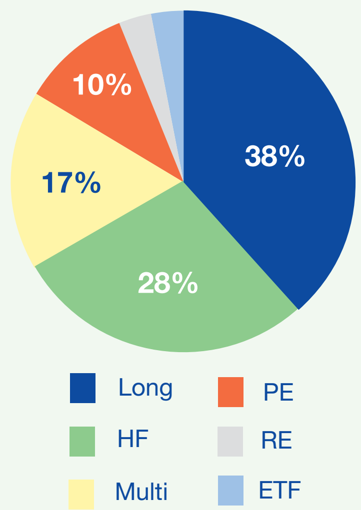
IFI Global spoke with firms that specialise in ETF, hedge fund, mutual fund, private equity and real estate management. Most of the interviews were done with larger players in their respective sectors but boutique managers, particularly in the private equity and hedge fund space were also included. Interviews were conducted mainly with COOs or CEOs.

Over the past five years the fund industry has had to contend with a combination of challenging market conditions along with a number of regulatory and operational issues. The costs of running a fund management business have risen substantially, especially on the alternative side of the industry, whilst for many investor inflows have declined, in some cases heavily, in comparison with the period up to 2008.

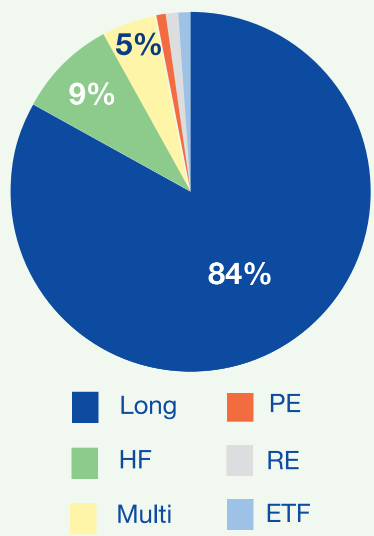
This survey was undertaken to see how the industry's senior management has coped with the obstacles that have arisen since the market crisis. Regulation, of course, is a particular concern. But there are other issues too. Many of those that IFI Global spoke to believe that this industry is going through the most profound period of change in its relatively short history.

The purpose of this project is to find out if there is consensus amongst the business's senior management as to what kind of industry will emerge from this challenging period. In particular, we wanted to find out if asset management will look much the same in five years as it does today. If not, how will it be different?

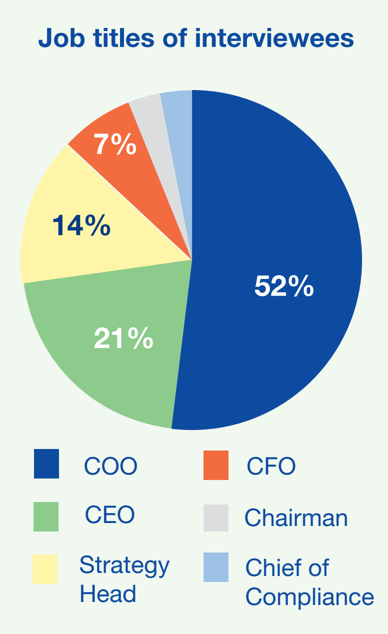
Breakdown of Managers Interviewed



% of total AUM represented by manager type



Introduction



Whilst there are many fund management surveys undertaken there are very few, if any, that cover all the main sectors of the business. If, as many believe, there will be a convergence between the alternative and mainstream sides of the business then surveys such as this one will likely become more common in the future.

Most agree it is likely that the fund industry will be less 'siloed' in the years ahead. The days when hedge fund, ETF, mutual fund, private equity and other sectors are able to carry on undisturbed in their own world appears to be coming to an end. We could be returning to something closer to one holistic industry structure in Europe. In this region there is much talk of an industry run mainly for European investors based in the EU fund domiciles, with a significantly smaller role for the offshore centres.

IFI Global would like to thank the CEOs, COOs and others that gave up their time to participate in this project. 30 fund management groups, all based in London, were interviewed for this survey.

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Summary of the findings

- The future of the fund industry will look more like the 1980s than the 1990s or 2000s
- The fund management industry will be dominated by a relatively small number of very large players
- The business will be less 'siloed' in the years ahead
- There will be substantial increase in the importance of fund manager branding
- The fallout from the crash still governs investors' thinking and risk reduction (both portfolio and operational) will continue to be critical for a very long time to come
- The rise of cross sector fund industry M&A resulting in firms that do everything from private equity to ETFs
- Distributor power will continue to grow with the largest players requiring yet higher fees to put managers of their platforms
- AIFMD will a have substantial negative impact on the growth of alternative UCITS funds
- Most survey respondents do not believe that the new regulatory environment will be of help to investors
- The negative impact on performance of the regulatory cost burden could discourage investor allocations and start-ups

Summary of the findings

- There will be a greater customisation of investment activity both on the long only and alternative sides of the industry
- The Caribbean fund domiciles are expected to look more like they did up to the early to mid 1990s, before the alternative fund boom
- There will be a very substantial increase in risk management activity and possibly the emergence of a risk governance industry
- Private equity and ETF managers were the most optimistic about the period ahead. Hedge fund managers were the least optimistic, with the mutual managers being between the two

The main forecasts

A future that looks like the 1980s

The environment that the fund industry is going into will likely have more in common with the 1980s that the last decade or the one before. Comments made by 87% survey respondents, from all areas of the business, suggest that the fund management industry will be run by a relatively small number of very large players. Whilst they will be strong and robust entities they are not expected to be innovative.

Interpreting many of the survey comments has led us to conclude that the 1990s and 2000s will be a temporary aberration in the industry's long term development. Many interviewees expect that there will be significant advances made by the industry in its use of technology. But this is different from product creativity and has nothing to do with investment innovation.

Entrepreneurial fund management, as characterised by the rise of the independent boutiques, is believed by all of those that interviewed to be in decline. 73% of respondents characterised it as being in 'steep' decline. Managers fear that the boutiques, on which much of the industry's innovation has depended, will have difficulty surviving the regulatory 'Tsunami' that is approaching.

The consensus is that fund management will in future be dominated by a few brand named players that will create (as one larger managers interviewed put it) 'a cartel'. Somebody referred to this as the rise of fund management 'factories'.

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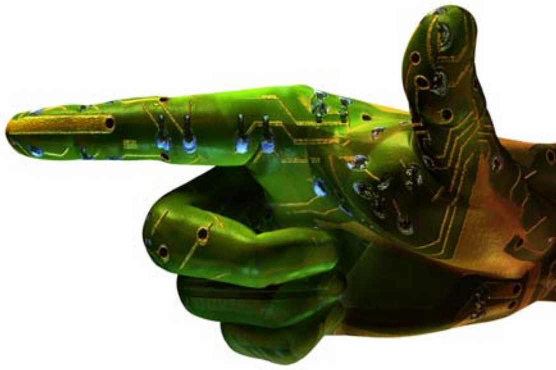
The main forecasts



The rise of fund management branding

57% of interviewees say that fund groups' brands will become more important factor in the future.

Most of those surveyed said that to date the fund industry, at least the part of it that is aimed at professional and institutional investors, has attached relatively little importance to brand. The track record of an individual fund manager has usually been considered to be more important than the name of the firm he or she works for.

That is anticipated to change. The view expressed by all those surveyed is that investor reassurance will be paramount in future. The same 57% of respondents that forecast more attention to branding also said that investors, including many sophisticated institutional allocators, will plump for the well known named houses to a greater extent in the future than they did in the past. This is the fund management equivalent of 'no one was fired for picking IBM.'

In the present environment investors want the robust infrastructure and deep resources that the larger firms have. The fallout from the crash still governs investors' thinking and risk reduction (both portfolio and operational) is expected by all to be critical for a very long time to come.

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The main forecasts

The rise of cross industry sector M&A

A significant growth in fund industry M&A over the next five years was forecast by 60% of survey respondents.

In particular cross sector fund industry M&A is expected to be on the rise (especially more mutual fund firms acquiring specialist alternative boutiques). The first wave of fund industry M&A was driven by the internationalisation of the industry. Most of it was firms from one country acquiring others in their own area of expertise. This did not affect the structure of the fund business as it went cross border.

But cross sector M&A might well have an impact on the industry's future structure. In years ahead the business will likely be dominated by a few global players offering investors every available type of fund (ie private equity, real estate, hedge, ETF as well as mutual funds and others). Today there are large numbers of managers that offer investors mutual funds and hedge funds. But few, if any, of these include the full range of areas covered by fund management activity.

In years ahead the business will likely be dominated by a few global players offering investors every available type of fund

The main forecasts

Distributor power to grow further

The power of Europe's dominant distributors is forecast to grow yet further, both by mainstream and alternative fund manager interviewees. All mutual fund interviewees referred to the power of distributors in some way (38% of the sample).

One of these respondents quoted an EFAMA survey that showed that distributors are typically paid more than half of the management fee. Another interviewee said that the government owned pension platform in Sweden charges approximately three quarters of the management fee whilst other dominant distributors such as Allianz in Germany, Hargreaves Lansdown in the UK, and the major private banks in Switzerland also charge well over 50 percent of a fund's management fee.

There was concern expressed by 24% interviewees that fund managers' profits will be further squeezed by the ever greater dominance of Europe's main distributors. Fund managers have to foot the bill for the regulatory 'Tsunami', and other operational costs, whilst being required to give away over half their management fee to get onto distributors' platforms. One interviewee said that larger distributors are becoming ever 'greedier'. He said that this is not in their long term interests as their fees will help squeeze out the smaller boutiques, thereby limiting the choice distributors have for their platforms in future.

AIFMD: the end of alternative UCITS?

The growth of alternative UCITS funds is expected to be arrested by the introduction of the AIFMD Directive.

Half the hedge fund managers surveyed believe AIFMD will marginalise alternative UCITS funds. EU regulators are said to want UCITS funds to be used primarily by retail investors. Recent ESMA guidelines for the use of derivatives in UCITS funds are believed by respondents familiar with this subject to have an adverse impact on alternative UCITS.

Main themes identified by the survey

Regulation

73% of all those surveyed do not believe that the new regulatory environment will be of help to investors. Two of the very largest alternative managers interviewed see opportunities for market development as a result of the new measures. They believe that the more regulated environment will allow them to increase market share at the expense of their smaller competitors.

But neither said that stricter regulations would help protect investors. Just 13% of interviewees believe that the increase in regulation will materially benefit investors. (A further 10% of respondents were somewhat equivocal, in that they did not think that it will be "all bad," as one put it.) And 17% were hopeful that AIFMD will encourage more institutional investors to allocate to alternatives.

Otherwise most views on recent regulatory developments were unremittingly negative. Many pointed out that institutional investors have their own due diligence procedures. This makes AIFMD 'redundant', as one hedge fund manager put it. But whilst the regulations are of limited to no use they will add to costs.

One boutique hedge fund manager put forward the proposition that if the AIFM Directive does encourage less sophisticated institutional investors to allocate to hedge funds for the first time it could turn out to be dangerous. Investors should only allocate to alternatives, such as hedge funds, if they do able to do their own exhaustive due diligence, he said. Regulations cannot protect investors from blow-ups.

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Main themes identified by the survey

Many of the largest managers interviewed, 17% of all survey respondents, made the point that Europe needs the rest of the world more than the rest of the world needs Europe. They put forward the view that significant numbers of US based managers, as well as those from Asia and elsewhere, will come to the conclusion that the cost of doing business in Europe will be prohibitive, and more of an effort than it is worth. These interviewees predict that European investors will be deprived of their offerings as a result of the region's regulatory burden.

> The cost of doing business in Europe will be prohibitive, and more of an effort than it is worth

27% of all interviewees, and the majority of the alternative boutiques surveyed, forecast that successful European managers will move as much of the business as they can outside the European regulatory net – both to escape interference and to avoid oversight of the remuneration arrangements. One manager in this category that was interviewed said his firm is now likely to move to Singapore from London. European investors will therefore be deprived of the services of managers fleeing the region, as well as those not coming in from outside.

However no one interviewed said that the regulatory impact on the industry will be significant in the short term. But everyone, including all the largest managers, said it will be so in the long term: it will prevent start-ups from being launched and so will mean that there will be less new blood coming into the business. For start-ups '$1 bn is the new $100 million,' said one medium sized manager. The consensus is that a manager needs a minimum of $200 million in AUM to break even in today's hedge fund industry.

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Interviewees were split on whether the increased regulatory costs will be passed on to investors. Most long only managers believe that investors will not allocate to those that attempt to pass on any increase in their regulatory costs. These costs, like others, will likely be absorbed by managers. On the other hand most private equity and hedge fund managers made the point that the increase in regulation will take away from funds' net returns.

Some smaller private equity and hedge fund managers fear that the negative impact on performance of the regulatory burden might discourage investors from allocating more to alternatives. As one boutique alternative manager put it: "The number one priority for investors is return. By adding to costs the increase in regulation takes away from returns. This will deter investors; it will not encourage them."

> Managers fear that the negative impact on performance of the regulatory burden might discourage investors from allocating more to alternatives

Regulations are also criticised for been overlapping, and often ill thought through by 43% of all interviewees. A manager of a long-short equity fund, that he claims cannot be considered complex, said that his firm has to follow approximately one million pages of rules, some of which are overlapping. Another manager said that his firm can be required to report certain trades 11 different times.

This overlap occurs between regulators in the major capital markets such as in the US and Europe (for Dodd-Frank and Sarbanes-Oxley in the US and AIFMD in Europe) and between FCA and the regulator in the jurisdiction where the fund is domiciled. All managers interviewed said that regulators should be more coordinated. The lack of coordination adds to cost, time and frustration. It was suggested that there should be a regulators' forum that meets on a regular basis to prevent overlap.

Main themes identified by the survey

Customisation

Greater customisation of investment activity was forecast by 63% of all respondents. This view is held in similar numbers on the long only and alternative sides of the business. (But some also cautioned that demand for customisation is dependent on investors being knowledgeable enough to know what to do with the information that will become available.)

> Greater customisation of investment activity was forecast by 63% of all respondents

Long only managers surveyed are optimistic that technology will provide them with opportunities to improve their offerings. For example, it is expected that technology will allow mainstream asset managers to customise their offerings at lower asset levels than is possible today. One mutual fund manager interviewed likened what will happen in investing, including in the retail market, to what iTunes has done to music.

ETF managers surveyed report that much work has been done by indexers to provide investors with customised index structures. This is on top of the extension of indexation into highly specialised and often alternative market areas.

Alternative managers surveyed expect that there will be a significant increase in the customisation of offshore investment vehicles. These interviewees suggested that this is likeliest to occur in structures developed for family offices and other high net worth investors.

75% of the hedge fund managers surveyed anticipate a substantial increase in managed account structures. More institutions are expected to use managed accounts. Larger institutions will have their own managed account platforms whilst the smaller ones will do it via a third party platform. Managed accounts are also said to be growing in popularity with family offices.

Main themes identified by the survey

However 25% of alternative managers interviewed that do not expect to see much more use of managed account structures. It was pointed out that they do not work in all strategies and that investors need to have at least $50 million in assets for them to be economic.

Fund of hedge funds are exploring different forms of customisation, including managed accounts, for their future business models. For example some now offer investors the opportunity to pick their own managers but use the operational infrastructure of the fund of fund manager for the investment process.

Fund structuring

It is expected that there will be a migration of alternative fund structures, at least for the European market, from the offshore centres to those in the EU by the majority of alternative fund managers surveyed.

In future the offshore centres will be left to cater more for investors in the Gulf, Asia and Latin America as well as developing customised structures for the high net worth market. In other words the Caribbean fund domiciles are expected to look more like they did up to the early to mid 1990s, before the alternative fund boom.

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Allied to the migration of fund structures for the European market there will be a very substantial increase in demand for risk managers in the EU fund domiciles as a result of the AIFM Directive (and in offshore centres offering AIFMD equivalence). This was forecast by all alternative managers. Risk articulation will become more important in future. One interviewee talked about the emergence of a "risk governance industry."

Main themes identified by the survey

Optimism by fund category

Private equity and ETF managers were the most optimistic about the period ahead. Hedge fund managers were the least optimistic, with the mutual fund managers being between the two.

A significant growth of private equity investment in the emerging markets, in particular, is forecast. Sovereign wealth funds are believed to be increasing allocations to emerging market private equity substantially over the next few years. And despite being affected by AIFMD private equity managers are noticeably more relaxed about the growth in regulation than hedge funds.

ETF managers surveyed believe that their business is still at an early stage of development. One of these expects that there will be more 'active indexation' in the future as well as a much greater range of ETF products for investors to pick from. ETF managers surveyed were also not particularly concerned about the future regulatory environment.

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