Profiting from Proliferation?

A LIPPER FMI WHITE PAPER

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Profiting From Proliferation?

"Read all about it!" The new story sells, be it a newspaper, a car, or, it seems, a mutual fund. But just how far does this phenomenon reach into the world of mutual funds? Is an entire industry based on the continual need to come up with new ideas to sell to clients?

This report goes behind the headlines to dig deeper into the phenomenon of sales of new fund launches relative to existing funds. For example, does this relate to all asset classes and all fund markets? The aim of burrowing into the figures in this way is not to compare individual companies, but to see how the industry *en masse* behaves and where investors' interests may lie. This idea has greater weight in an industry where products tend to be sold rather than bought.

Next up are the implications of the resulting product proliferation in Europe. There are over 35,000 mutual funds established in Europe, which is generally criticised for being too many (there are only some 8,000 funds in the US). But it is worth asking, 'So what?' In other words, what are the problems that product proliferation produces and why should a fund company reduce the number of funds that it offers?

By the time readers of this report get to the back pages, they will not find the sports news, but they should have gained some new insights on these topics to help further discussion for the benefit of both the industry and investors alike.

To help companies exchange ideas on these and other issues, Lipper FMI will continue its series of Breakfast Briefings in different European cities through 2009 and beyond. These events not only give the opportunity to present up-to-date analysis of European and Asian fund markets, but also to understand the interests and issues of clients and other groups.

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About Lipper FMI

Lipper Fund Market Information (Lipper FMI) is the London-based fund market research and analysis division of Lipper, a Thomson Reuters company. It specialises in all aspects of domestic, pan-continental and cross-border mutual fund markets in Europe and Asia.

Against a background of continual change in the mutual fund markets, Lipper FMI's objectives are:

- to overcome fragmented data and market opacity problems
- to reveal the major changes taking place,
- to share latest insights into marketplace complexities,
- to identify companies either leading the field or setting the pace.

Lipper FMI's senior directors are leading market practitioners and have been associated with major projects for many leading investment management groups, as well as being advisers to, or participants in, EU Commission mutual fund industry research and various other fund industry think-tanks.

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1. Executive summary

- New launches drive a significant proportion of mutual fund sales; the number of funds has increased by 70% over the past ten years; percentage management fees do not fall as assets rise. Coupled with the impact of the financial crisis, these findings suggest that there is now an opportunity for the European funds industry to begin the **move from 'product push' to 'client value'**.

- Launching new funds has been a significant feature of the European industry for the last decade, with over 2,500 mutual funds launched each year. Even with the recent increase in fund closures, **the impetus to launch new funds remains strong** and a fundamental part of the business model for many organisations — one partly encouraged by the historical focus of European regulators.

- The financial crisis provides the perfect opportunity to demonstrate that **investors' interests lie at the heart of the mutual fund structure**. One of the obstacles to this is the sheer number of funds that roll off the production line: there is around one mutual fund for every 1,000 active investors. The resulting emphasis placed on distribution (the ability to reach these investors) has been inevitable. Differences in sales patterns between key fund markets shed light on the ways in which funds are distributed, notably the roles of retirement plans in the US and of IFAs in the UK.

- The **appeal of launching new funds** was clearly shown in 2007 and 2008: while new fund launches attracted positive net sales of over €120bn in both years, the level of redemptions from existing, or 'backlist', funds grew from €200bn to €500bn.

- The **relative sales of new fund launches and backlist funds differ greatly between banks and 'pure' asset managers**. Over the past seven years, banks saw net sales of new launches average €92bn, while backlist funds suffered average annual redemptions of €68bn. The equivalent figures for asset managers are much more evenly balanced, with backlist funds attracting a greater proportion of net sales than new launches each year from 2002 to 2007.

- The **emphasis on new fund launches, but without a consistent trend of closures, has led to a proliferation of products** in the industry. The number of small funds remains disproportionately high with the median fund size standing at €25m, although this pattern is not consistent across the industry, for example, the median size of funds for the largest cross-border groups is €56m.

- Fund size is important in the way that this relates to the annual fees that investors bear, however, an assessment of **economies of scale** in the industry reveals that the relationship between the two is not as straightforward as might first appear.

- Particularly when looking at funds' management fees, insights from the US are useful. In Europe, management fees generally include annual distribution fees, both of which are not linked to fund assets when costs are passed on to investors. **This limits the extent to which any fund rationalisation will benefit investors through reduced TERs**.

- Just as the launching of funds and the assessment of a fund's profitability remains an individual business decision, so fund **companies cannot be expected to reduce their management fees through altruism rather than self-interest**. This report aims to shed new light on aspects that may help some in the industry to square this circle.

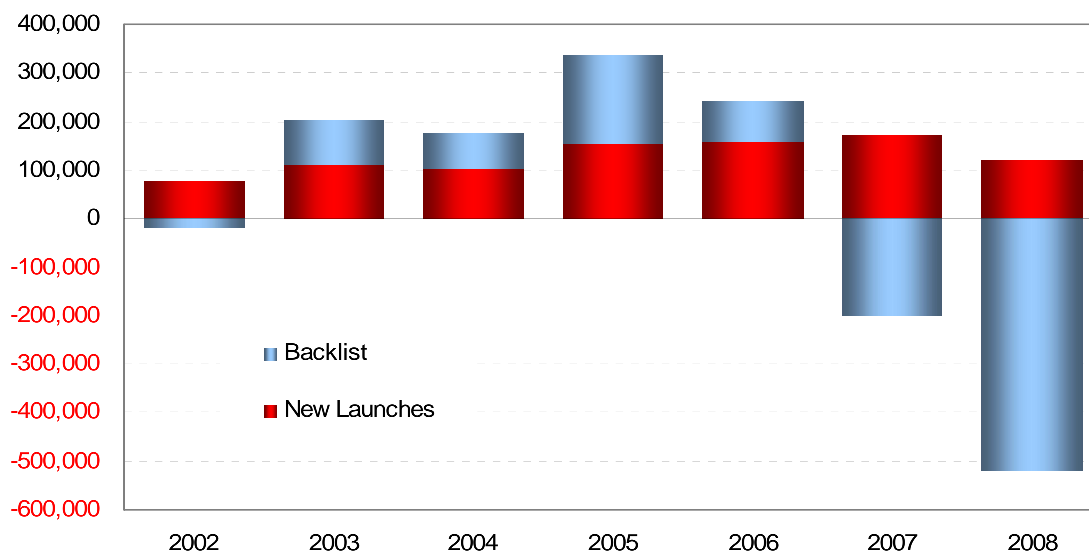
2. New stories sell

Over 2,500 mutual funds have been launched in Europe each year from 1998 to 2008. Only amid the current financial turmoil has the expectation arisen that this number might fall to levels last seen before the late 1990s boom, when equity fund investment had not fully established itself among continental European retail investors. But even this recent development is not likely to change the fundamental, longer term structure of the industry. So the preference for new funds — equating to around 10% of the total number of funds each year — needs to be looked at to understand whether such a trend is sustainable.

The estimated net sales of mutual funds across Europe can be split between those funds launched in the current year (new launches) and those funds that were launched in previous years (backlist funds[1]). In 2008, while backlist funds suffered net redemptions of some €520bn, funds launched during the year enjoyed positive net sales of over €120bn, which comes to an average of €40m across some 3,100 new funds, but -€15m for the backlist of 35,700 funds.[2]

By analysing the data in the same way for the previous six years, the historical trend reveals that new launches do seem to guarantee positive sales activity.

Figure 1. New launches and backlist fund sales (€m)



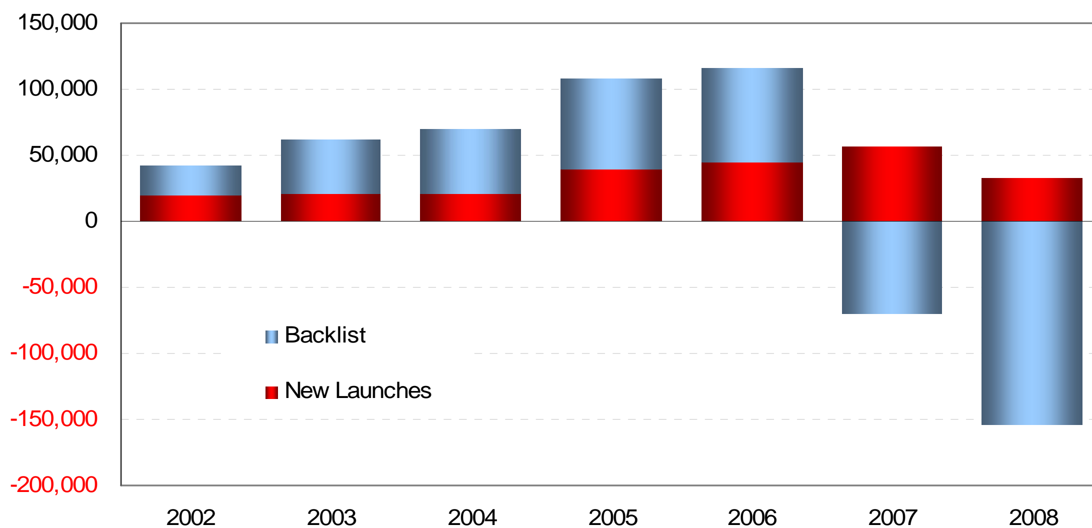
[1] 'Backlist' is originally a publishing term that refers to the list of older books available from a publisher, as opposed to newly published titles (the 'frontlist'). Building a strong backlist has traditionally been seen as the primary means to create a profitable publishing house, as the most expensive aspects of the publishing process have already been paid.

[2] These totals exclude the positive impact of money market funds, which reduced total industry outflows to just below €300bn. Excluding these funds gives a better view of long-term investment products and also avoids the distorting impact that can result from volatile institutional flows in and out of money market funds.

Having presented a pretty clear-cut picture, one cannot ignore the presence of seed money nor the fact that it takes time before investors could wish to withdraw from new funds: in one sense, overall positive figures for new fund launches are inevitable. What is more interesting is how the total varies each year relative to the sales for backlist funds.

To look more closely at this data and to see what variation exists, three main asset classes are assessed: equity funds, bond funds and mixed asset funds.

Figure 2. New launches and backlist equity fund sales (€m)

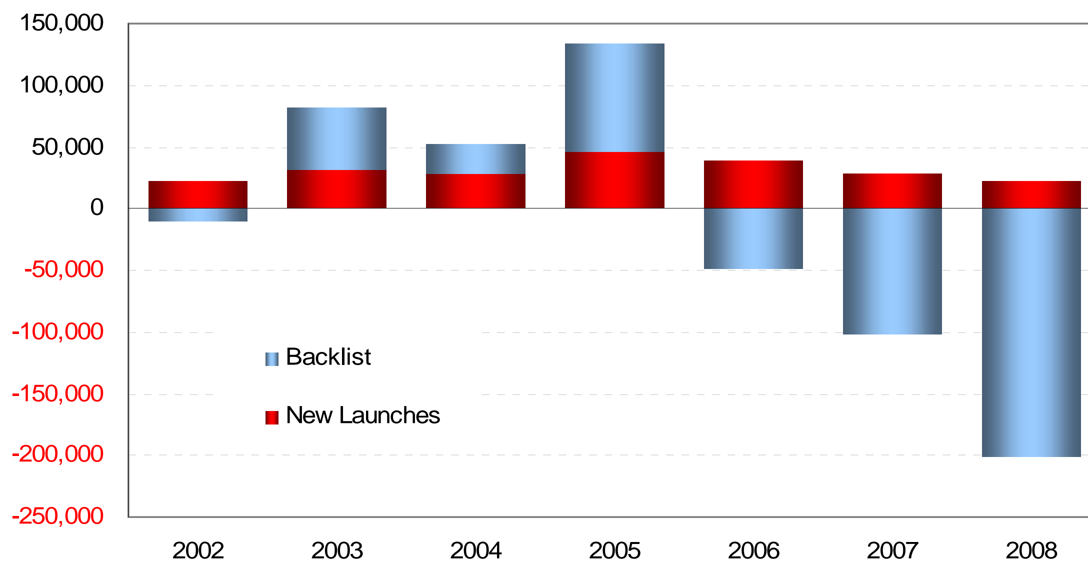


While sales of newly launched equity funds do grow over this period (peaking in 2007), they are lower than for backlist funds in each year until stock markets suffered in 2007 and 2008. Comparing these findings with broad movements in stock markets reflects the relative financial climate: when times are good the backlist sells, when times are bad everything reverts to new products. But this is not a totally straightforward relationship: while stock markets fell through 2002, equity funds still attracted inflows of nearly €43bn, more than half of which moved into backlist funds. What is behind this phenomenon?

The timing of withdrawals — notably in late 2007 and January 2008 — were the result of profit taking. Needless to say, the opportunity to take profits from a recently launched fund is inevitably limited in principle and, in particular, will not have been an option for many of the fashionable launches in 2006 and 2007: absolute return and 130/30 funds.

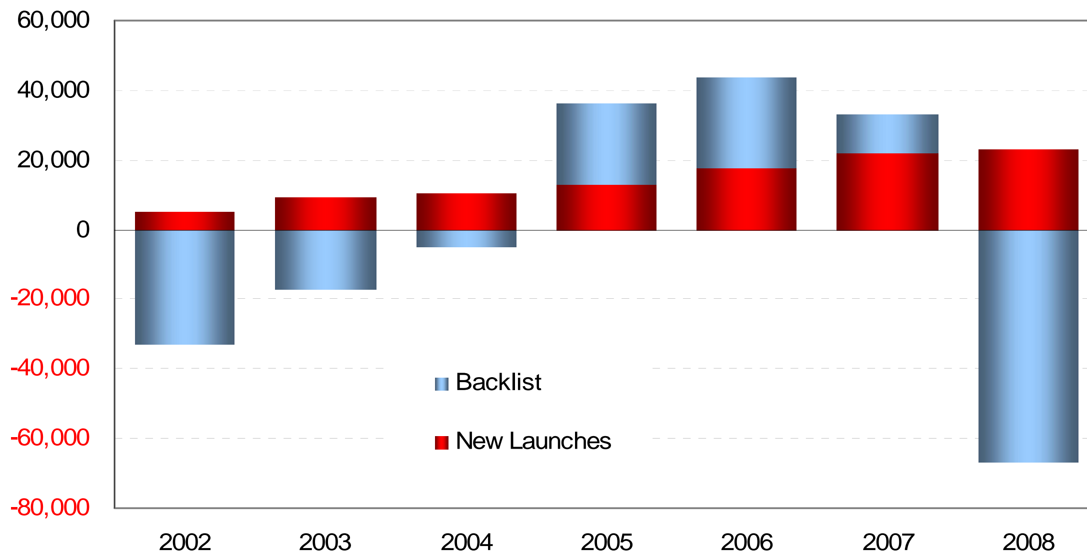
For bond funds, backlist sales appear more volatile than for equity funds. Looking at the broader status of bond funds in 2008 reveals that the majority of the decline in fund assets relates to outflows (rather than performance), while the reverse is true for equity funds. Taken together, this suggests that the overall bond fund outflows each year from 2006 will have been all the more painful for asset management companies, not least because bond funds have traditionally been the staple diet of continental European investors.

Figure 3. New launches and backlist bond fund sales (€m)



The recent slide in European asset management fortunes has undoubtedly been exacerbated by a bond fund sell-off steered by the large domestic bank franchises. Different types of fund provider will be looked at in the next section, but as far as bond funds are concerned, traditional products have been severely culled, with client money being redirected either directly into bonds issued by local banks or into deposit accounts. The most extreme example of this wholesale asset transfer has been Italy where banks have managed to stave off the liquidity problems suffered by their European counterparts by shifting €120bn of bond fund assets back on to their balance sheets over the past three years. The asset management industry, once the beneficiary of product cannibalisation, is now the jilted party in a relationship that favours other financial offerings.

Figure 4. New launches and backlist mixed asset fund sales (€m)

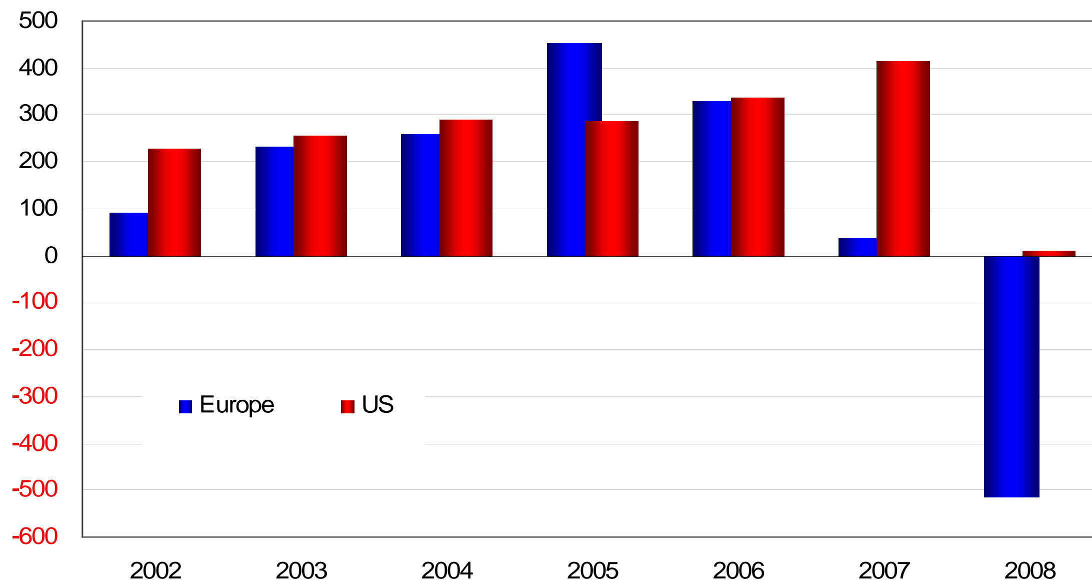


Historical trends for mixed asset funds offer another variation on the pattern seen so far and provide some insights into the ongoing re-invention of traditional 'balanced' funds. Out of favour in the early years of the decade, the subsequent upturn lasted through 2007. This development was bolstered by the rise in asset allocation funds as part of the 'new wave' of absolute return funds. If launching new funds is a sensible business strategy to attract new money, then mixed asset funds provide the most compelling argument for doing so: net sales of newly launched funds have actually increased each year over this seven-year period.

3. The enigma of market variations

Looking across the Atlantic reveals a contrast in sales trends over recent years. The period between 2003 and 2006 suggested that Europe was not far off the pace of American sales flows, and even exceeded them in 2005. 2007 then exposed the vulnerability of European sales, while strong bond sales in the US ensured that total industry sales that year actually increased. And while US investors' equity redemptions in 2008 ensured that net sales were essentially flat, it was nothing compared to the bloodbath experienced in Europe. The struggle to attract European investors is all the more painful when compared with the positive inflows that the industry was able to achieve as markets fell in 2002.

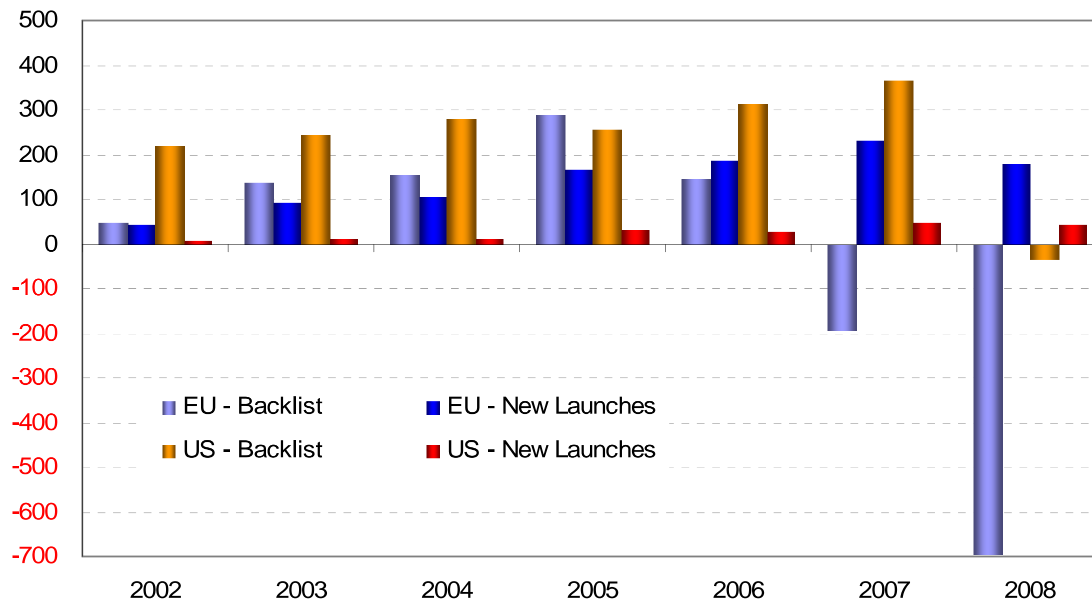
Figure 5. Europe v US fund sales (US$bn)



Looking beneath these headline numbers and at new fund launches and backlist funds draws out another transatlantic contrast: the relatively small role that new launches have played in the US, while providing the most reliable source of new money for European asset managers.

US mutual funds' emphasis on building a track record of performance in order to generate sales flows also seems to have the knock-on effect of fund companies being much more willing to close funds. Over the past six years, new fund launches represented an annual average of 6% of the total number of funds, while closures and mergers represented 12% of the total. The equivalent figures for Europe are nearly twice the percentage of launches (10%) but less than half the number of closures (5%).

Figure 6. Europe v US: New launches and backlist fund sales (US$bn)



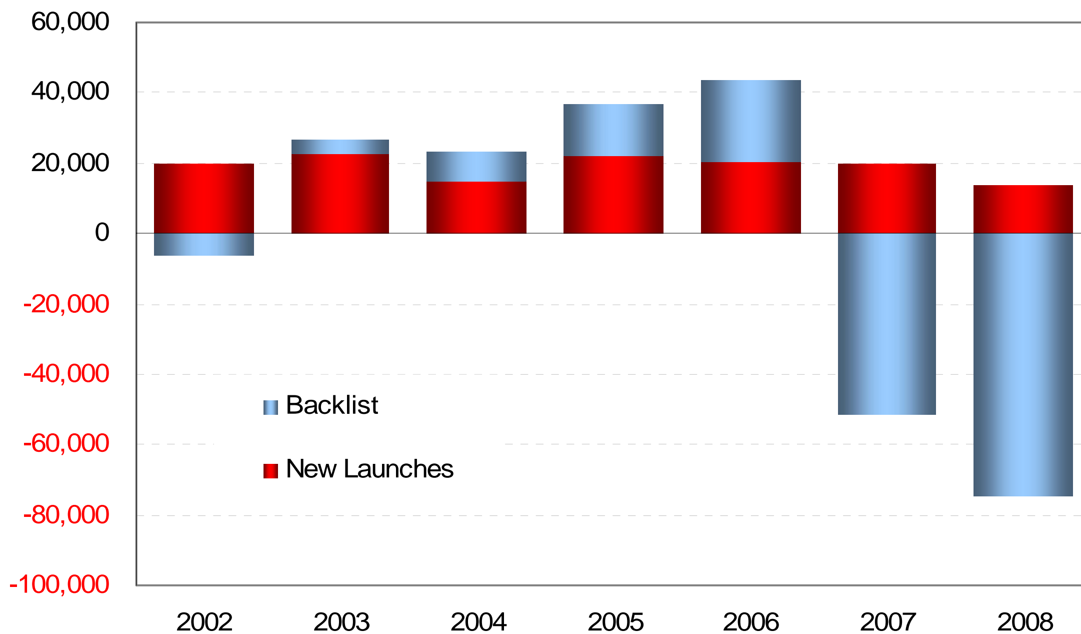
These findings will certainly be partly — if not largely — influenced by the different distribution structures of different fund markets. In the US retirement plans, such as 401(k), are a crucial means of selling funds: in 2008, 68% of mutual fund-owning households held funds through such schemes.[3] In addition, of those buying funds outside retirement plans, while 77% do so via a sales force (such as a financial planner), a sizeable 48% invest directly with a fund company or via a discount broker.

The importance of distribution means that it is essential to break down European fund data between key markets, as well as looking at activity in cross-border funds.[4]

French investors' nervousness in 2002 as markets began to recover from the dot-com crash was expressed by net withdrawals from backlist funds. Confidence then grew each year through 2006, with backlist fund sales increasing year-on-year, surpassing those for newly launched funds along the way. The reversal in 2007 was sharp and was followed in 2008 by the lowest level of sales for new funds in this seven-year period.

[3] Source: ICI, 'Profile of Mutual Fund Shareholders' (February 2009).
[4] Switzerland, Spain and Italy exhibit some of the characteristics seen in other European markets, but have been excluded for the purpose of this report as a result of some distortions.

Figure 7. France: New launches and backlist fund sales (€m)

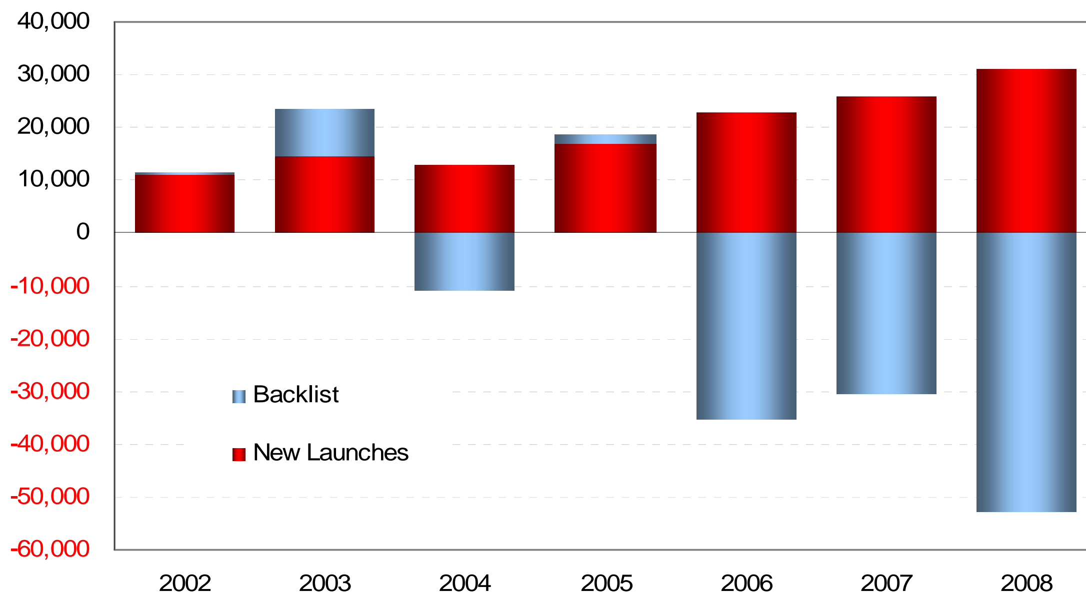


German investors' preference for new funds is clear, only in 2003 did they show any significant interest in backlist funds (boosted by some €10bn in net sales for real estate funds, an appetite that has subsequently evaporated). Furthermore, 2006 saw redemptions from backlist funds (lead by both equity and bond funds) greater than those in 2007. As many German investors were swept up in the tech boom, this early withdrawal is likely to have been accelerated by profit taking. Taking an optimistic view, evidence that new launch sales continue to increase each year could indicate that not all of those profit-takers have since given up on mutual fund holdings altogether, as may have been supposed. Also, the backlist trend may partly reflect the increased use of cross-border funds in preference to domestic products.[5]

Germans' apparent slavish following of new launches raises the issue of the way in which funds are sold. This point is picked up below, but specifically for Germany, a BVI[6] survey indicated that banks have a 70% market share in the sale of funds, compared to less than 15% each for Insurance companies and Independent Financial Advisers (IFAs). Many German banks' strategy seems to be simply selling the latest new product. It is legitimate to ask where clients' interests sit in such a structure.

[5] Another element to be aware of is the switching of existing investors into newly launched funds. While this may well be occurring — notably for target maturity funds — this is virtually impossible to assess and does not impact on the fundamental trend that has been identified.
[6] Bundesverband Investment und Asset Management, the German funds association, www.bvi.de

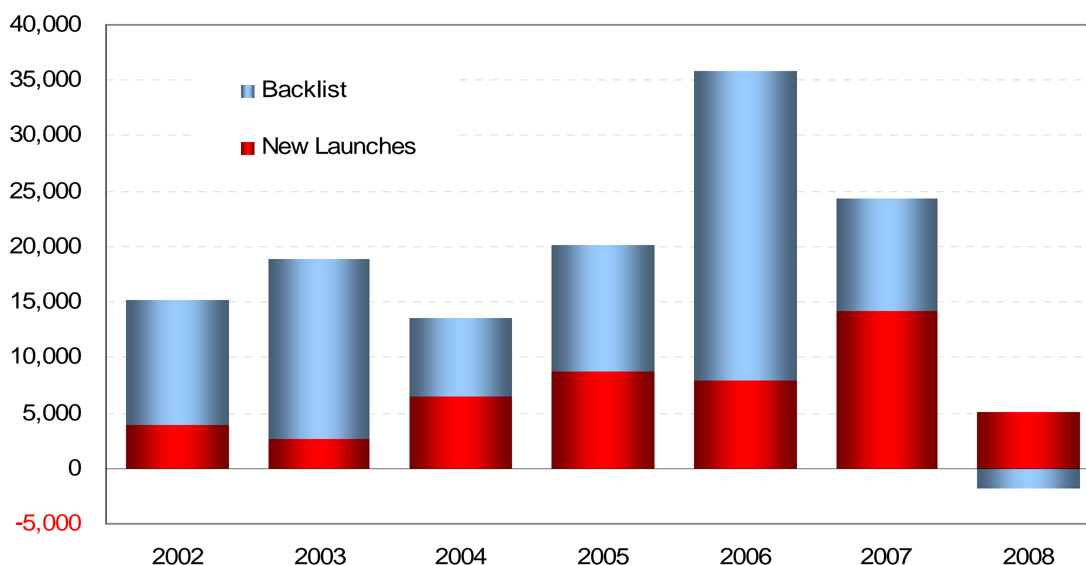
Figure 8. Germany: New launches and backlist fund sales (€m)



The UK provides a contrast from all other major European markets. Only in 2008 could net redemptions be found for backlist funds, while in each year between 2002 and 2006 backlist funds actually out-sold new launches. In 2007, the sales of backlist funds fell significantly from a high in 2006, most likely as a direct result of ceding ground to new product types, such as those utilising the Ucits III 'toolbox'.

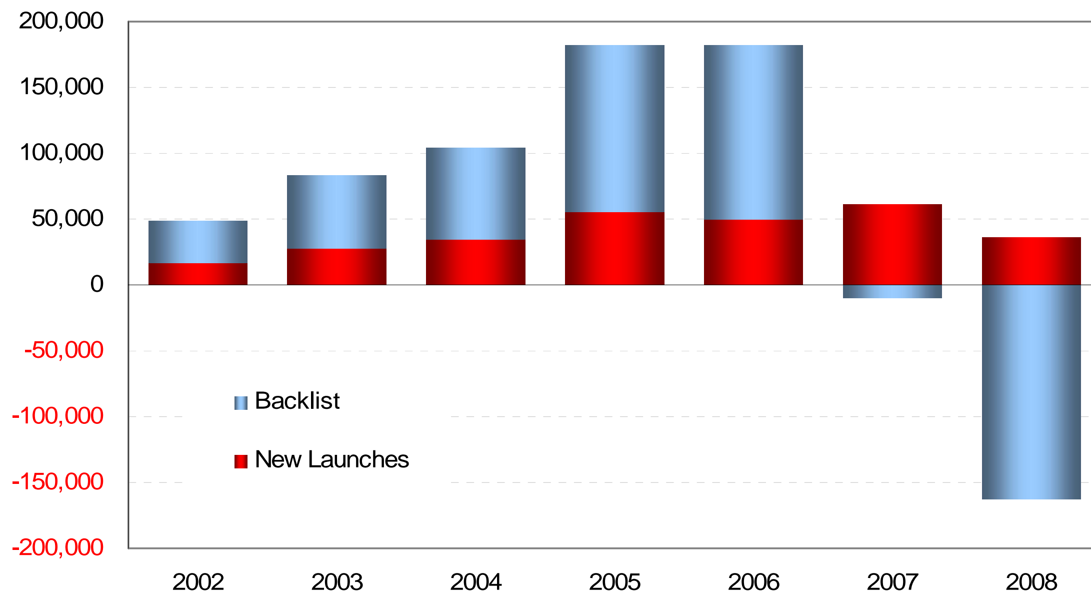
In contrast to other European markets, the role of IFAs is a crucial factor for the general strength of sales of backlist funds in the UK, and the need for multi-year performance track-record has echoes of the US market.

Figure 9. United Kingdom: New launches and backlist fund sales (€m)



International, or cross-border[7], backlist funds built an impressive record of sales in the five years before 2007. That these assets were not sufficiently 'sticky' became apparent in the sheer scale of redemptions seen in the second half of 2007 and through 2008 as cross-border outflows dwarfed those seen in European national markets. Even among cross-border funds, where backlist sales have generally outstripped those of new launches, there is a need to build a stronger culture of longer-term investing.

Figure 10. International: New launches and backlist fund sales (€m)

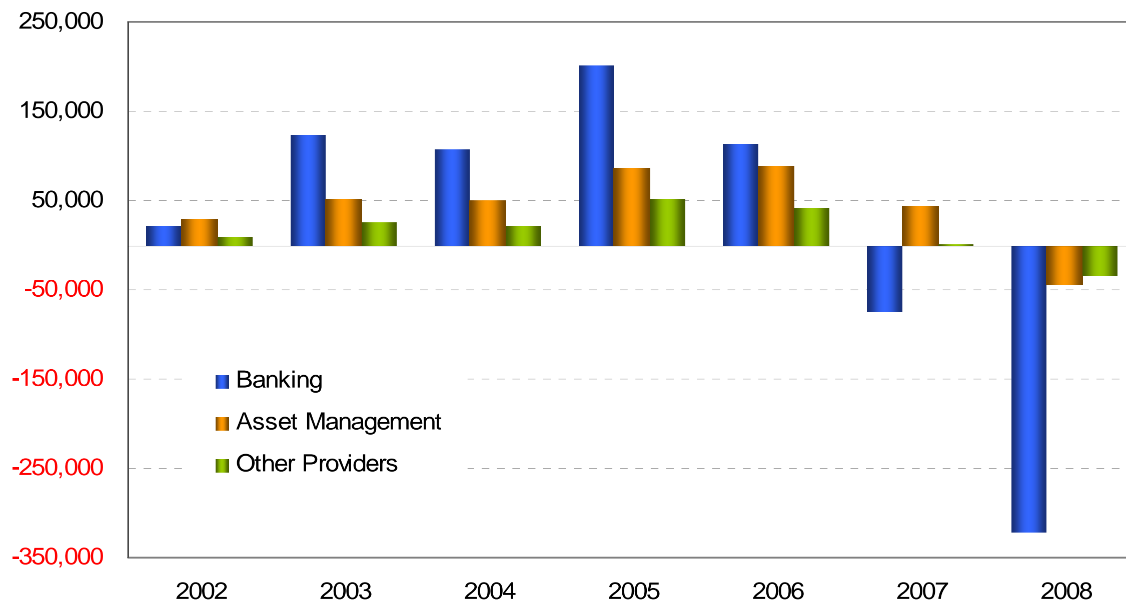


[7] In other words, those funds sold into multiple, primarily continental European, markets.

4. Opening Pandora's box

Now that the Pandora's Box of sales for newly launched funds has been opened slightly, there is little to do but open it further and see what emerges. Opening this box begins to reveal the types of business offering funds. For the purpose of the current report, the focus will be on the largest fund providers — banks and 'pure' asset managers.

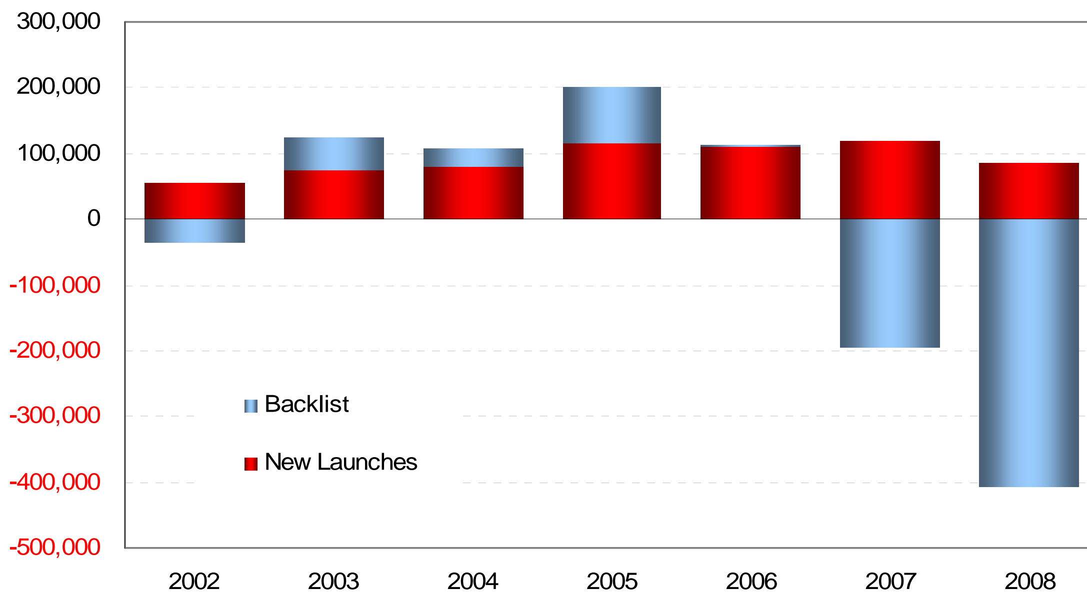
Figure 11. Fund sales by business type (€m)



Comparing the net sales of European funds by different types of product provider does not, on the face of it, provide any new insights. The broad picture already illustrated is re-iterated in the chart above. To a large extent this chart is one way to illustrate that banks dominate the European funds landscape — around 60% of products are provided by banking organisations and overall sales flows mirror this.

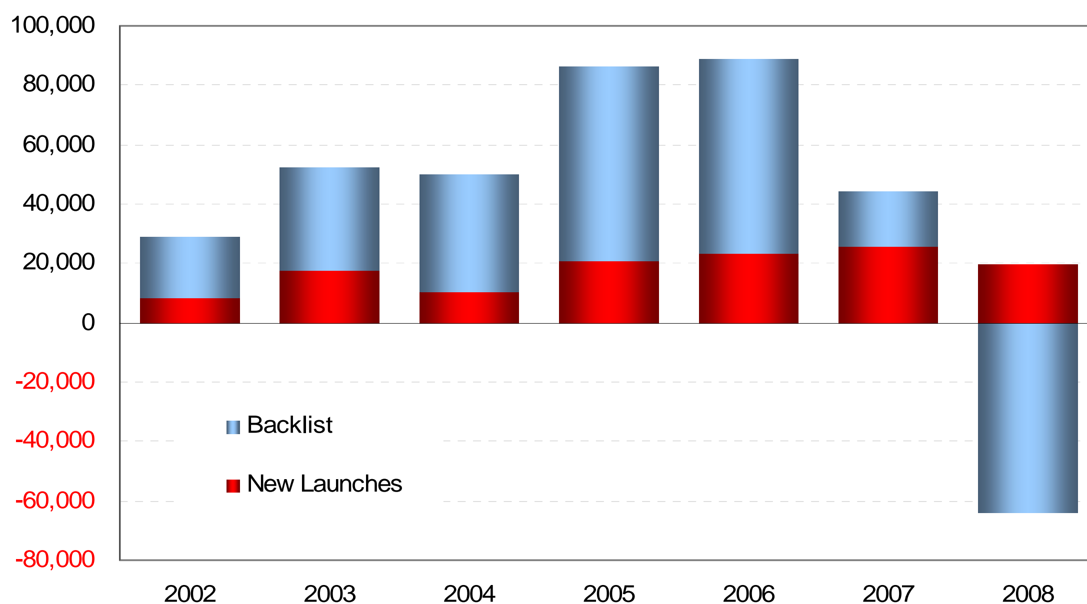
For the purpose of the current report the relative size of sales flows each year is perhaps less relevant than the way in which these flows have varied each year and whether those funds are new launches or from the backlist. Banks and asset managers can be examined separately to look more closely at what is going on.

Figure 12. Banks: New launches and backlist fund sales (€m)



These two types of product provider offer an interesting contrast in the relative reliance on new products. Banks' reliance on new fund launches is hard to deny, with sales of new products far exceeding backlist sales in each year through this period. The most successful year for banks' backlist funds was 2005, when these funds accounted for 42% of total net sales — flows into new funds were still nearly one third greater.

Figure 13. Asset management companies: New launches and backlist fund sales (€m)



Asset managers may well point to the dominance of sales of their backlist funds, which averaged 70% of total net sales between 2002 and 2007, and peaked at 80% in 2004. But the scale of redemptions that followed in 2008 should give these same companies pause for thought — echoing the variations seen earlier for cross-border funds.

Over 50% of the products offered by asset management companies in 2008 were equity funds, while it was only 40% for banks. This difference is worth noting, but even for banks this asset class is still easily the most significant (by number of funds).

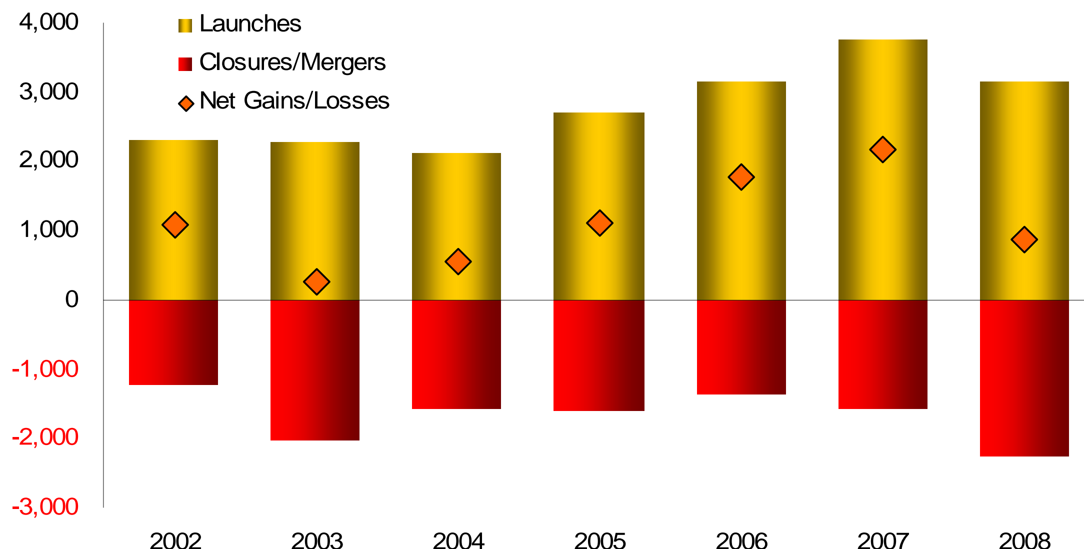
This picture raises questions about the ways that banks sell funds, not only because of the impact on investors directly, but also because of the adverse impact this has then had on banks' mutual fund assets. For example, outflows from banks' backlist funds in 2007 and 2008 (€600bn) were greater than inflows into all of their funds between 2002 and 2006 (less than €570bn). While undeniably painful, 2008 outflows relative to previous years' inflows appear to have hurt less for 'pure' asset management groups than banks. In the most recent two year period total net sales only just tipped into the red (-€200m), compared to inflows in the previous five years of just over €300bn. Having said this, it cannot be ignored that banks are able to shift client money into other financial products, or on deposit, while asset managers are reliant on asset class switches.[8]

[8] Money market funds have been excluded from these charts.

5. Product proliferation

The dynamics described above have led to an ever-increasing number of mutual funds available to European investors. To see the impact of this development on the industry as a whole, data on fund closures and mergers needs to be examined.

Figure 14. Trend in European fund launches and closures (ex-guaranteed funds)



This data highlights that the number of funds in the European industry continues to grow each year and that the speed of this growth increased in the bull market years between 2003 and 2007. The total number of funds has grown by 30% over this period and is nearer to 70% over ten years. The financial crisis that beset the world in 2008 resulted in a significant fall in the net increase of funds, with new launches declining (although still above the seven-year average) and closures increasing to a seven-year high.

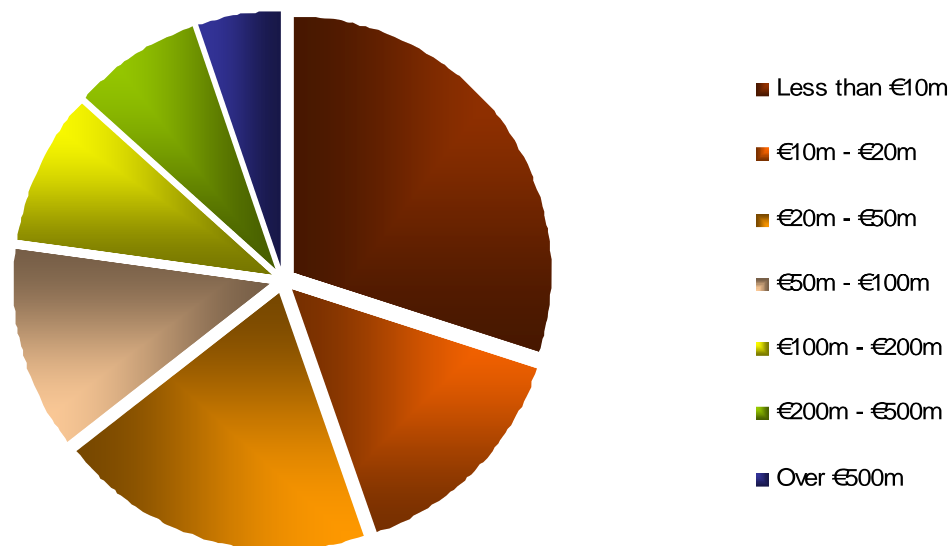
With funds struggling to generate positive returns every year, the increase in the number of funds must build further pressure on managers to stand out from the crowd. Furthermore, on the basis that consistently generating alpha is already a supremely difficult skill, it seems likely that more fund managers will result in an increase in the proportion of those that are sub-par.

The recent increase in the number of funds closing might suggest that the survival of the fittest is belatedly coming to the European funds industry — 200 years after Charles Darwin's birth! But some scepticism on this point would be wise: while performance will help sales flows, it is not the 'be all and end all' and must go hand-in-hand with effective distribution. While many funds that have closed will have had a poor performance history, the deciding factor for a fund company looking to cull funds must be profitability.

The European industry has reached a stage where there is about one fund for every 10,000 adults. Considering that mutual fund ownership in Europe is around 10%,[9] there is maybe one mutual fund for every 1,000 active investors — before accounting for those investors with multiple mutual fund holdings. In such a crowded environment it must be hard enough for a fund company to get their fund's 'story' in front of an investor, before even achieving a sale: the importance placed on effective distribution (the ability to reach these investors) is inevitable. The sheer number of European-domiciled mutual funds is well illustrated by the fact that there are nearly three times as many funds as there are companies listed in Europe.[10]

One of the main impacts of this product proliferation is on the average fund size. In fact the average (mean) fund size in Europe is €142m. The more thorny issue related to fund size is the sheer number of smaller funds.

Figure 15. Number of funds by size in Europe



This chart highlights that while the average fund size looks quite healthy, the median fund size is just €25m (and is down by nearly 50% in many fund markets from the bull market peak in 2005). Viewpoints vary as to what the minimum profitable fund size is, but €25m cannot be too far away from it. Of course the problem is not that small funds cannot generate decent performance, but that they may not be economically viable for a fund company to run. This, in turn, will depend on the size and structure of the company.

A small company with only a handful of funds may pass on set-up and servicing costs that are high relative to a small pool of assets to the investor, relying on the fund's performance track record and a very targeted, or limited, approach to distribution. At the

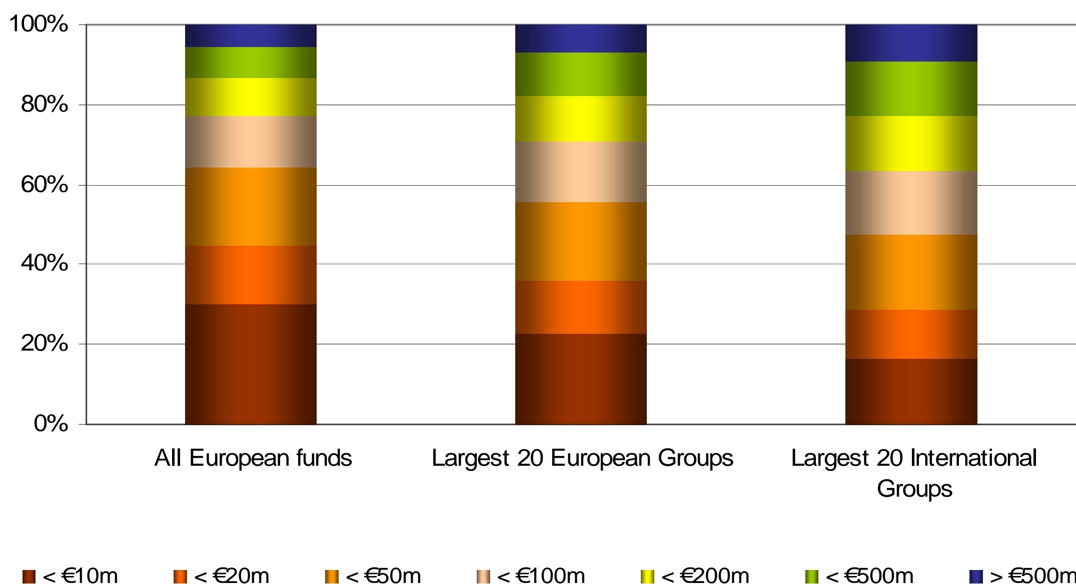
[9] Based on European Central Bank and EFAMA analysis quoted in INVESCO Think Tank report (2009).
[10] Over 12,000 companies listed on European exchanges in Feb 2008, source: World Federation of Exchanges.

other end of the spectrum, a large fund company is more likely to absorb such costs and wait for assets to rise through a sophisticated distribution network. Or else these larger companies may be willing to bear some funds that are individually unprofitable, but are needed within a wider range in order to support a particular distribution channel.

While some have sought to encourage a reduction in the number of funds in Europe in order to reduce costs to investors (based on the perceived inverse relationship between fund assets and annual expenses), the most persuasive case for each of the managers of the bulk of smaller funds in Europe will be that based on benefits to their bottom line.

So what about the larger fund companies? Are they any closer to getting the median fund size to a more reasonable level?

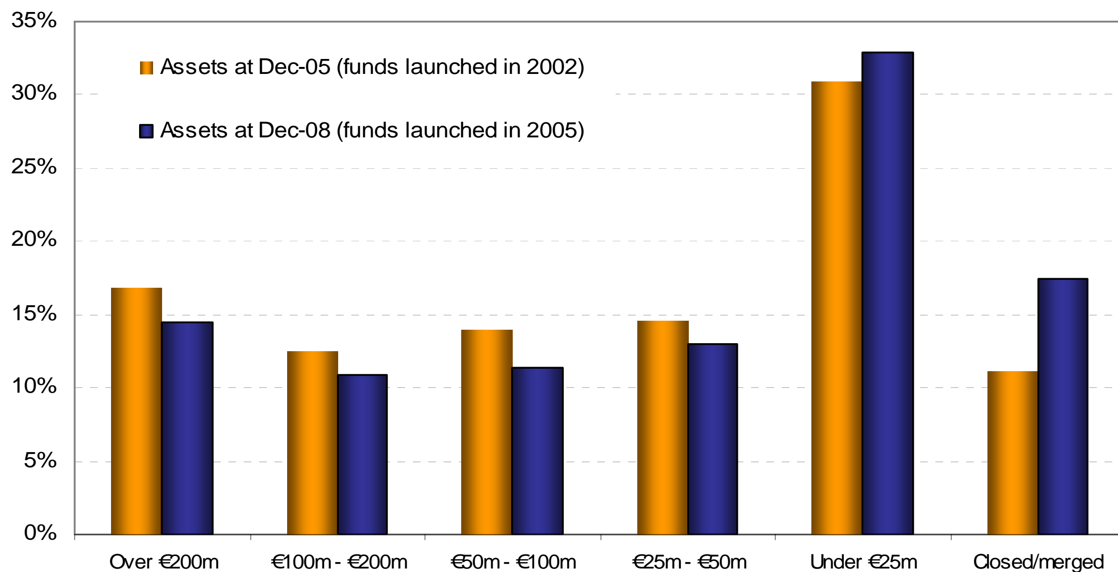
Figure 16. Number of funds by size for larger companies



Europe's largest twenty fund groups have an average fund size of €157m and a median size of €38.5m. When this universe is filtered to look only at cross-border funds, the average rises to €191.6m and the median to €55.8m. While larger fund companies still have a number of smaller funds, they certainly seem to be able to increase significantly their median fund size relative to the industry at large.

No significant distortions resulting from the current market conditions can be seen by cross-checking the size that cross-border funds reach after three years. This reinforces the view that new fund launches are a key business driver for many companies. Looking at funds launched in 2002 to see the number of funds with different asset levels by the end of 2005, as well as funds launched in 2005 with asset levels at the end of 2008, two very different 3-year market cycles produce two relatively similar patterns of fund sizes.

Figure 17. Fund sizes of 3-year old funds



Two reference points are useful as a quick guide to this data: the suggested minimum fund size of €25m and the average fund size for large companies of €200m. Interestingly, one major cross-border group has recently stated that €200m is their *minimum* size for a fund to be profitable.[11]

Looking at the details, two findings stand out. First, the differences are relatively small between funds in the two periods. For example, 17% of funds launched in 2002 exceeded €200m after three years, while this figure was 15% for funds launched in 2005. Second, the cumulative effect of the small differences between the two periods is that 50% of cross-border funds launched in 2005 had either failed to reach €25m by the end of 2008 or had been closed. This figure was nearly 10% lower for funds launched in 2002.

These findings highlight companies' greater willingness to close funds today. As previously noted, our expectation is for 2009 to post the first net contraction in the number of European funds for a decade. The closing of funds will already be having an impact on the median fund size as funds that are too small, and unprofitable, are most likely to be culled. At the same time it cannot be ignored that the level of assets that funds achieved after three years was not drastically higher in the boom period of 2002-2005. So what is the commercial impact of these findings or, more precisely, to what extent can one see economies of scale in action?

[11] *Europe needs no more than 5,000 funds*, Ignites Europe, 29 January 2009

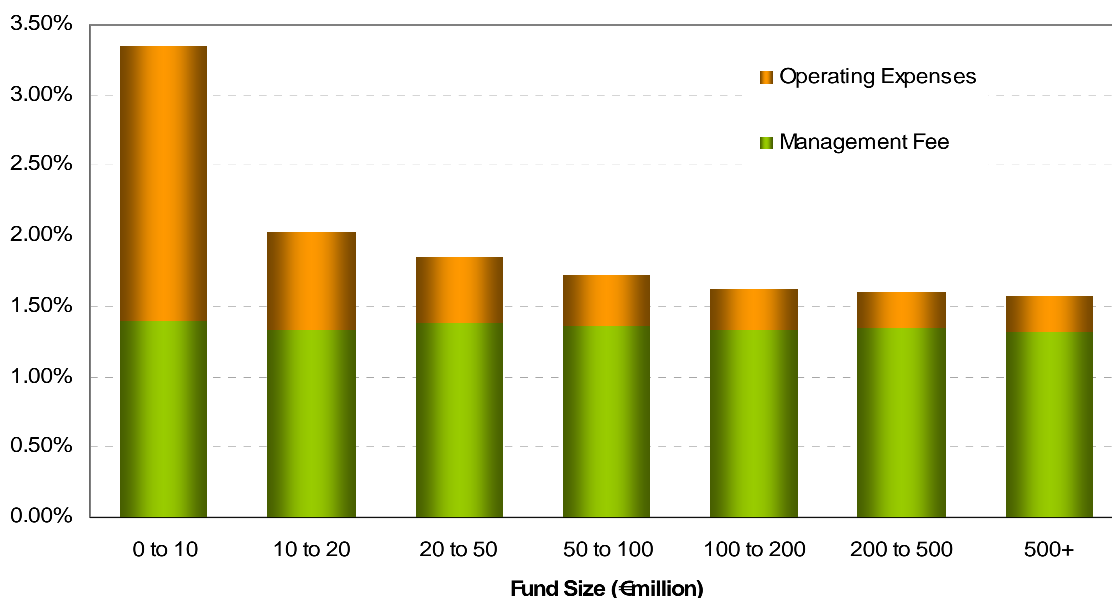
6. Economies of scale

The key criticisms of launching too many new funds are, first, that it increases the chances for mutual funds to be sold on the basis of what is fashionable, rather than what is most appropriate for an investor — which may lead to mis-selling. The second criticism is that the resulting fund proliferation increases annual fees and expenses to investors as the average fund size falls. The second criticism is the one that this paper will address.

The latter criticism has been put succinctly (and stingingly) by John Kay, 'Costs need to be high to recover the expenses of running so many different, mainly small, funds that all do much the same thing. At the same time, the high level of charges encourages financial services companies to set up even more funds.' [12]

Whether companies really do blindly launch funds due to the allure of high charges without knowing the costs of running small funds is a moot point. But for now the important issue is to establish the degree to which there is a relationship between fund size and annual charges.[13] Here European cross-border equity funds are examined, splitting annual management fees (that also includes annual distribution fees) from other operating expenses that together form the Total Expense Ratio (TER).[14]

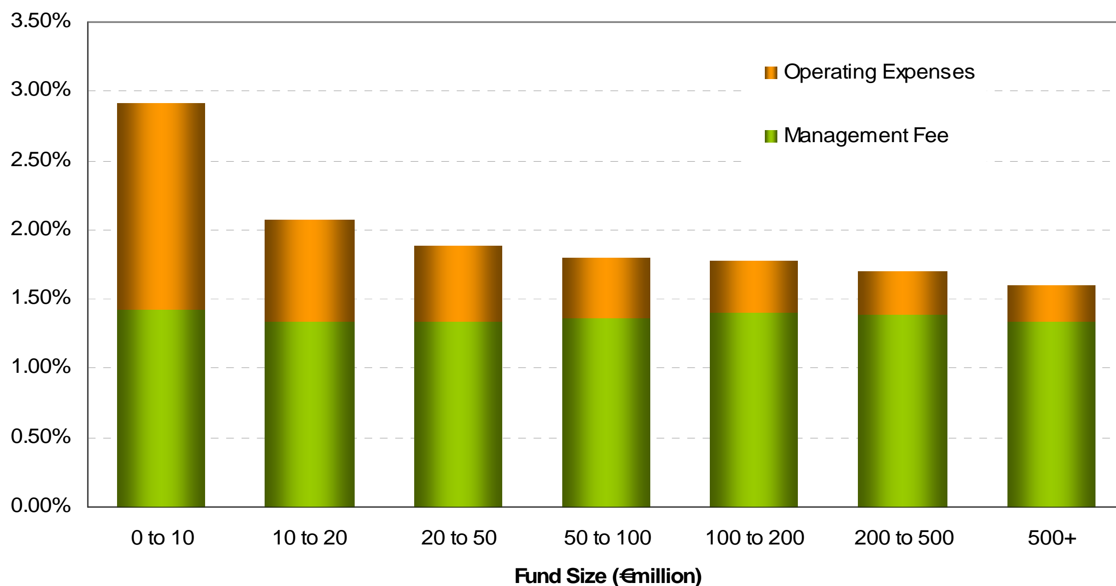
Figure 18. Average TERs for cross-border actively managed equity funds by size



[12] John Kay, The Long and the Short of It (2009)
[13] The issue of whether funds' charges are too high in absolute terms has not been examined. Issues relating to the role of 'the market', information provided to investors and how one determines what is fair lie outside the scope of the current report.
[14] While umbrella funds solely with institutional subfunds have been excluded, in order to reflect properly economies of scale, for both European and US data, this analysis is carried out at fund (not share class) level.

The economies of scale achieved as fund assets rise can be seen. However, the picture looks most dramatic because of the disproportionately high average TERs for those funds below €20m. While the average TER does continue to fall in the middle asset bands (those funds between €20m and €100m), each of the three asset bands from €100m upwards has a similar average TER close to 1.60%. The more limited nature of this correlation becomes more apparent when the funds within each asset range are examined: the charts used in this section illustrate the broader picture.

Figure 19. Average TERs for cross-border actively managed equity funds by size (2002)



Looking back to see how the TER levels have changed since 2002[15], the average TERs for the smallest asset bands are relatively similar to the latest data (particularly when accounting for distortions in the smallest fund size range). A welcome sign is that the average TERs for the larger asset bands (over €50m) have fallen by between 10 and 20 basis points each, at the same time as the number of these larger funds has risen. Also welcome is the fact that a declining number of funds are failing to control the annual operating expenses borne by investors, although this still exists for a significant minority.

However in the largest group of funds, over €500m in size, the current average TER is at a similar level to that seen in 2002. At the same time the graphs above illustrate that while non-management operating expenses fall as assets rise, management fees remain largely the same. This suggests that the industry is unable (or unwilling) to reduce management fees even for the largest funds, which would obviously have the greatest proportional impact on investors.

[15] Looking at those funds currently in existence that were also running through 2002.

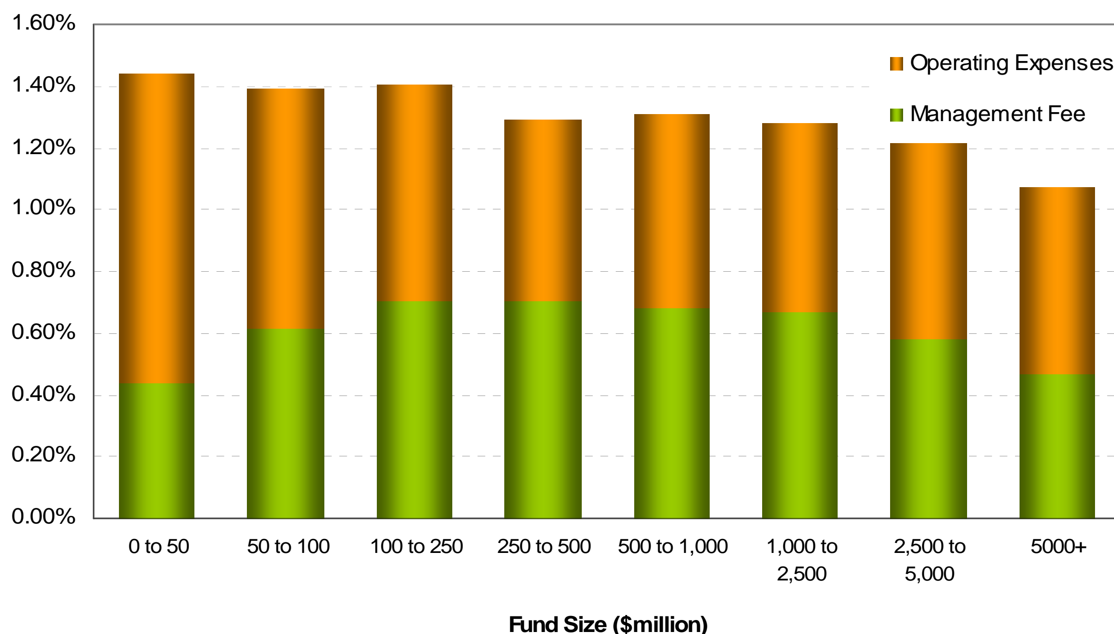
Size alone is not the determining factor for TER levels and so product proliferation — as far as it relates to fund charges — is primarily an issue for the disproportionately high TERs of the large number of smallest funds. For the industry as a whole to make further inroads into annual charges borne by investors, management or distribution fees would need to be reduced as these currently do not vary with fund assets.[16]

Even in the US it is not a simple equation between rising fund assets and falling TERs or management fees, but certainly the monitoring of management fees is closely scrutinised by the industry. As a result the US does provide relevant insights, even though the structure of the industry and the application of fees are different.

Taking the same approach for US-domiciled large cap funds as for European funds, the relationship between fund assets and management fees can be seen as a 'u'-shape. Management fees[17] are low when funds are smaller (below $100m) because the management company waives most of the fee. Then, as the fund grows, the company waives less so the average fee is higher. Finally the fund reaches levels where breakpoints and real economies of scale kick in, so management fees drop again.

With the variation in management fees, even the smaller ranges of funds do not bear high average TERs. In addition, the rate of decline in average TERs increases as assets rise. However, many European managers would not want individual funds to reach the sizes commonly seen in the US — even if the companies they work for might see the appeal.

Figure 20. Average TERs for US-domiciled large cap funds by size



[16] Specifically in relation to the way they impact on the investor

[17] US mutual funds' management fees *exclude* annual distribution fees (known as 12b-1 fees). As actual fees charged have been used here, the management fee averages will include fee waivers.

7. Cutting the Gordian knot

Evidence, both statistical and anecdotal, suggests that the industry is now more ready than ever to reduce the number of funds with which European investors are faced. Yet consolidation has been predicted for over ten years, so some scepticism as to whether this will fundamentally change the size and structure of fund ranges, rather than just being a temporary move, is warranted.

As the previous section illustrated, two important causes of higher average charges are the number of small funds that have higher non-management expenses, as well as the fact that management fees — even on the largest funds — do not fall as assets rise.

The number of small funds includes many that are run by small companies and for whom a high-level perspective on the merits of reducing the number of funds, or passing on fewer costs to investors, will not hold much sway. Assessments of whether a fund is profitable will vary from company to company, as suggested earlier.

Looking more closely at larger fund companies that are willing to absorb some operating expenses, a number of these companies 'fix' their funds' annual fees and expenses. This practice provides a degree of simplicity that retail investors may find appealing. It also means that the TER for small funds is kept under control. At the same time it ensures that TERs do not fall as assets rise, nullifying any potential benefits from economies of scale that may be passed on to investors. On the positive side, it also means that fixed TERs will not rise as assets fall — as is likely in current market conditions.

On the basis that the number of funds from larger companies will fall both as a result of more widespread rationalisations during the current downturn, and also as a result of the planned Ucits IV measure on fund mergers, it is fair to say that progress is being made on fund numbers and their sizes by many of the larger asset management companies. Therefore it is in the area of annual fees — both management and distribution — that more attention could be paid if the industry wishes to reduce charges more significantly.

To cut the Gordian knot[18] of perceived high annual charges, these issues need to be grasped. If average TERs are deemed to be too high, then increasing assets or reducing the number of funds alone will not fundamentally change this: making fund mergers easier can only take the industry so far in reducing costs to investors.

[18] The ox-cart that once belonged to Gordias, king of Phrygia, was tied up with an intricate knot that had no end and so could not be undone. When Alexander the Great found that he could not untie it, he chose to slice the knot in two.

It may be that simply splitting out annual distribution fees from those annual expenses borne by the fund is one way of achieving this. Investors could then see the fees they are paying their intermediary or financial adviser versus those paid to the fund company and its related service providers. On the downside, this could make understanding charges more difficult for an investor, although the difference between an initial charge (paid directly by an investor) and annual charges (paid from the assets of a fund) already exists.

There are changes that are taking place that may already be sufficient to make real changes in the area of fees paid to distributors in Europe, such as the Markets in Financial Instruments Directive (MiFID) or, in the UK, proposals by the FSA in its Retail Distribution Review. The latter would distinguish between charges for providing a product and charges for independent advice, in addition, any payment for advisory services made through the product would have to be matched by a deduction from that product.

Individual fund companies cannot realistically be expected to reduce their management fees through altruism rather than self-interest. In the same way their willingness or ability to reduce payments to distributors — gatekeepers to end-investors — will be curtailed without external influences of the type mentioned above.

A final thought on an alternative route to restraining annual charges is warranted. In the US a more pro-active system of checks and balances is performed by each fund's board of directors, a majority of whom must be independent. While the issue of fund governance reaches far more widely than annual fees, addressing investors interests' in this way is certainly worthy of further discussion.

Conclusions

Returning to the questions posed on the front page, this paper has tried to illustrate that appetite for new fund launches is not the same across Europe, nor across different types of fund provider. Particularly in markets where banks dominate fund distribution the dominance of new fund launches in capturing the lion's share of sales can be clearly seen: **'product push' is a key business driver**. Companies with cross-border or UK funds generally seem to have taken a different approach, although in the dire market conditions of 2007 and 2008, these companies too have suffered — albeit with new launches offering a small buffer of inflows to offset the considerable redemptions.

So while the European industry as a whole is not reliant on new funds to generate sales, there are great swathes of activity that relate directly to selling a new story. Even in those organisations where inflows are not dominated by new launches, the pressure from fund companies' sales teams to have a new story to sell cannot be ignored although this is not, of itself, invidious.

Neither can **product innovation** be ignored in its role in the development of the European funds industry. Absolute return and 130/30 funds are just some of the more recent examples of how product development has moved hand-in-hand with regulatory changes, in this case Ucits III. The downside of such moves is exemplified by investor demand for technology funds at the height of the internet boom (albeit an appetite fed to the point of gluttony by fund companies), serving as a reminder of more general human behaviour in responding to 'the new'. In a funds context this in turn puts additional pressures on sales teams and financial advisers.

This research has highlighted that by no means all European companies operate simply as new **product factories**, with the UK funds industry providing a good example of the benefits of avoiding such a route. But many companies do see themselves primarily as manufacturers. The concern must be that **investors' long-term interests** may well be jeopardised by such selling practices. Also on the issue of investors' interests, previous research suggests that the UK sits neither at the top nor the bottom among European fund domiciles in terms of the annual charges investors bear, so there need not be a disproportionate price tag associated with such an approach.

The issue of fund charges as they relate to average fund size has been an important element among ways that the industry has tried to evolve. As with new product launches, this issue is seen and treated differently by different fund companies. Broadly, smaller companies' smaller funds could reduce TERs through reducing non-management operating expenses, but this is likely to make them less profitable because the most effective means to reduce such costs (relative to small pools of assets) is through absorbing them directly. In contrast, larger companies' funds tend to be larger, but their average TERs are prevented from falling further due to management and distribution fees that are not correlated to fund size. In addition, as larger companies tend to manage TER levels more effectively, there is a greater incentive to rationalise unprofitable funds.

The costs associated with managing and servicing mutual funds have never been far from the surface and the current downturn has again focused attention on this area. This report has touched on issues where there are **clear limits to downward pressure on fees and expenses within current industry structures**. If industry fee levels are to change then these would need to be addressed. At the very least, with the industry at a turning point each company is in a position to address these issues in a way that can give them competitive advantages over the longer term. The opportunity is certainly there for the industry to begin the move from 'product push' to 'client value'.

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9. Data & Methodology

Sources. The underlying data used in the creation of this report is from Lipper's quarterly *Fund Charges* volumes. Net sales and asset data are sourced from Lipper FMI's *FundFile*.

Fund Market. Lipper FMI allocates a fund to a specific market if more than 80% of assets are sourced from that country. If less than 80% of assets come from one country, the fund will be defined as 'International'.

Asset Classes. Funds of funds have been excluded throughout this report, to avoid double-counting in sales flows and distortions in fee and expense analysis. Money market funds have been excluded from sales flow analysis to give a better view of long-term investment products and to avoid the distorting impact that can result from volatile institutional flows in and out of money market funds. Exchange Traded Funds (ETFs) are included in the net sales data, unless specified otherwise. In fee and expense analysis, actively managed funds only are included, unless it is specifically stated that passively managed (index tracking) funds are included.

Economies of scale. In calculating average TERs for different ranges of funds with different assets, funds with multiple share classes have been specifically included in order to fully reflect any economies of scale being achieved. However, in order to limit distortions, umbrella funds with solely institutional subfunds have been excluded. The funds included are actively managed equity funds domiciled in Luxembourg or Ireland and authorised for sale in at least two other European fund markets: providing a universe of cross-border funds. On this basis, and as a result of managing the largest proportion of assets in Europe, these cross-border funds provide a good proxy for annual fund charges that may be paid by investors across Europe.

Total Expense Ratio. The Total Expense Ratio (TER) is a measure of the total annual operating expenses of a fund, expressed as a proportion of its average net assets. In addition to quoted management fees, funds will bear additional expenses related to funds' ongoing costs (including administration, custody, audit and distribution expenses). Because the TER includes management fees as well as these additional expenses, it is a more comprehensive and more comparable indicator of the level of annual charges borne by investors than the management fee alone.

TER calculation. Lipper, previously through Fitzrovia International, has been calculating TERs in Europe over the last 15 years, using the same, consistent methodology. Lipper calculates consistent TERs based on details in funds' reports and accounts, representing a true and fair reflection of the fund's activity over the previous year. The TER specifically excludes one-off initial/exit fees, also known as 'loads'. Over 350,000 such calculations have been made by the group over these years.

Management fees. Fees paid by a fund for its investment management, but may also include other fees, such as those for distribution. These fees are paid out of fund assets as an annual percentage of the average net assets and form part of the TER. For the purposes of this report, because the vast majority of European funds pay annual distribution fees (sometimes called trail commission) out of the management fee, such transparent distribution have been added into the management fee average, unless otherwise stated. Management fees are often quoted by funds as the 'annual charge'.

'Drag effect'. Funds' annual operating expenses indirectly impact on investors through reduced returns, even if a fund manager may subsequently make up this disadvantage through superior performance. For example, if the manager of Fund A and the manager of Fund B both generate performance of 7% over one year, but Fund A has annual charges of 1% and Fund B has annual charges of 2%, then Fund A will return 6% to an investor, but Fund B will return 5% to an investor. Such charges, indirectly borne by the investor, have a cumulative 'drag' effect over time. For example, a €10,000 fund investment growing by 7% each year reaches €19,672 after ten years, before charges. Annual charges of 1% a year reduce this to €17,908, while 2% reduces this to €16,289.

Lipper. Lipper Analytical Services was founded in 1973. Lipper acquired Fitzrovia International in 2004 and Feri FMI in 2007. Lipper continues to seek new areas on which to produce research papers and other analysis to support fund management and associated organisations, enabling them to assess and compare their competitive positioning.

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