Industry Overview

Equity | Pan-Euro | Other Financials
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All change...the new normal asset management world

Bank of America Merrill Lynch

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History repeats itself vs. this time it's different

2010 will be a tug of war between these two stock sayings, in our view. We think that the financial crisis will represent a decisive break with old patterns of investing, and that in future people will operate in two dimensions rather than one, managing risk as well as return. We expect this change will not happen all at once, but it will happen rapidly.

History repeats itself?

Historically, demand for a particular asset class has bounced back relatively quickly following a market sell-off. There is good evidence for this across multiple asset classes. So, the argument runs, the recent recovery in equity markets, even if somewhat less clear in 2010 than the latter part of 2009, will drive demand.

This time it's different?

Our view is that recent performance is a strong factor in consumer behaviour. On the other hand, we also believe that investor demand will have been changed by the credit crisis. There is now ample evidence to suggest that risk control works. What's more, risk controlled funds are becoming more easily available on both sides of the Atlantic.

Early signs of demand

Whilst the data is hardly conclusive, there are pieces of solid data which we can point to which suggest that investors are opting for these nextgen products.

Index – still growing

At the same time, index funds have continued to make progress, both in mutual funds and ETF format. We believe that these two developments represent a painful pincer movement on mainstream managers.

Investment implications

We believe that these developments are handing a competitive advantage to companies which combine strong onshore distribution and advanced products. They are also positive for derivatives usage.

Refer to important disclosures on page 39 to 40. Analyst Certification on Page 38.

Contents

Rapid, technology-led change

This note is our fifth annual commentary on what we see as the key developments in asset management, and the European asset managers we cover. 2009 was, to put it mildly, an unusual year. It encompassed both the deepest gloom, and the most rapid bounce back, that we can recall.

The asset management industry's fortunes inevitably mirror broader markets, and so the industry overall has experienced a turbulent year. However we arrived at 2010, though, the key question now is "what happens next". Given we have no faith in our ability to call the short term direction of asset markets, this question in our view boils down to whether patterns of demand will change, or revert to type. We characterise this debate as being between the "rear view mirror/history repeats itself" and "this time it's different" schools of though. Our view is that this time, it genuinely is different, in that demand will move more towards diversifying assets and index funds, away from core mandates with low tracking errors. Whatever happens, 2009 truly was the "year of the fruit fly" when evolution speeded up. Our view is that this rapid evolution will continue into 2010 and beyond.

From destruction to evolution

Exhibit 1: Fruit fly

Source: Wikipedia

Last year's note started with a reference to the Chicxulub Crater, an ancient impact crater in the Yucatan peninsula which is widely blamed for the apparent rapid destruction of the dinosaurs. The point we were making was that this represented a clear discontinuity. If you wound the clock back to say 66m years BC, you would need to watch out for a wide range of dinosaurs stomping around, often with unpleasant personal habits. Roll forwards 2m years, and you would not. Admittedly, 2m years is quite a long time in human terms, but in terms of evolutionary history, it isn't really. The change which was brought about was catastrophic.

This year, we feel that the fruit fly, drosophila melanogaster to you, is a more appropriate image. The great thing about the fruit fly is that it has an extremely short life cycle. You could cram over $7*10^7$ of them into the 2m years we were talking about earlier. This, combined with the fact that the fruit fly is easier to handle than a live T. Rex, explains why it is so favoured by biologists studying heredity.

The shift we are pointing to is from discrete to continuous change, from revolution to evolution, but, and this is a big but, to evolution **speeded up**. Our view is that the asset management world has avoided catastrophic change, but it is confronted with speedier evolution, which we saw beginning to emerge in 2009. Asset management at the end of 2010 will superficially look the same as at the start of it, but it will be different, and this change will be more rapid than for other seemingly steady as she goes years.

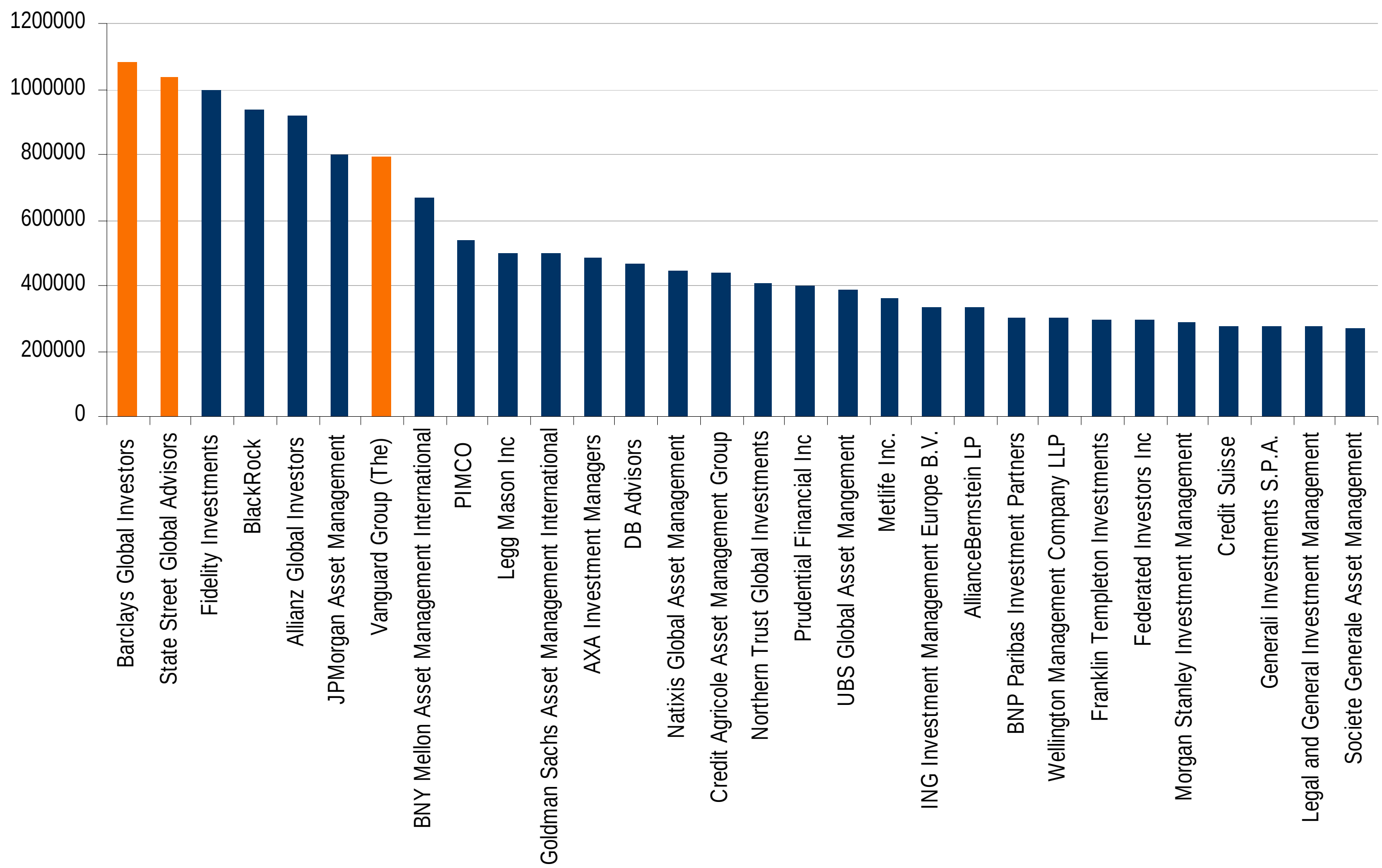
This note starts, as usual, by putting together data on the asset management industry historically, setting out the view through the rear view mirror, before moving to the view through the windscreen.

AUM 2008

Each year, in a sector note, we have tried to start with a picture of how the industry shapes up in terms of AUM.

We stress each year that this a simple question to pose, but a difficult one to answer. So, to come out with as accurate an analysis as possible, we have combined two useful industry surveys, IPE and P&I. We have taken their data, tried to resolve conflicts where they exist, and as a final check compared our 2008 data with data for a year ago. This produces the following chart. We have, to make a point, shown companies which boast a considerable proportion of index funds in ochre.

Chart 1: Global asset management industry - end 2008 by AUM (€m)



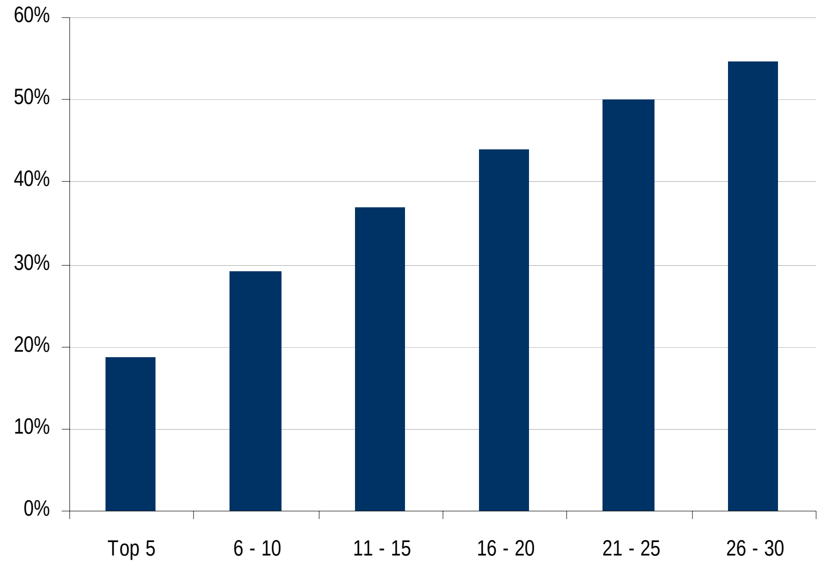
Source: IPE/Pensions&Investments, BofA Merrill Lynch research

The eagle-eyed might well notice that this data is fourteen months out of date. This reflects (apart from the human desire to have a piece published close to the start of a year) the fact that the survey data we use creeps out in the second half of each year.

We take this data, and the asset breakdowns which accompany it, and break assets down into seven buckets; high margin equity, high margin fixed interest, indexed equity, indexed fixed interest, other high margin, balanced and the rest, which is taken to be low margin assets. We would not pretend this is scientific or accurate; we would love to have the data to perform an accurate, scientific analysis. However, we do believe that what we have done is directionally correct, if broad brush.

One way of presenting this is to look at revenue concentration. We show this below.

Chart 2: Revenue Concentration - 2008



Source: IPE/Pensions&Investments, BofA Merrill Lynch research

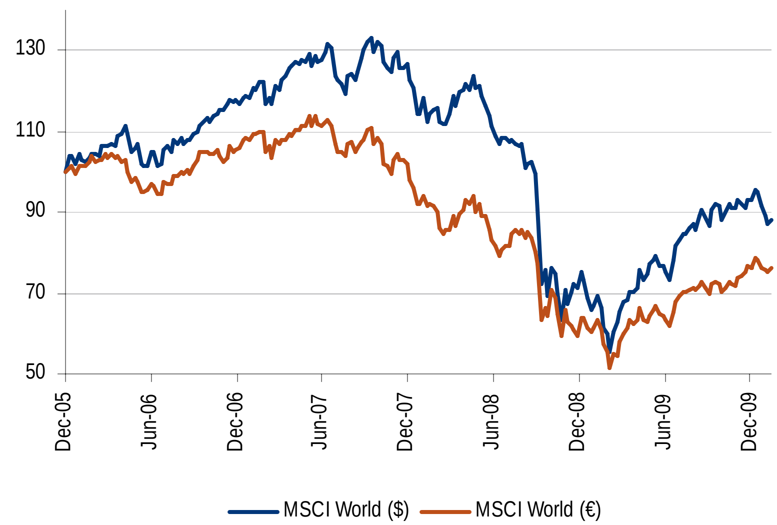
On our estimates, the top thirty companies' market shares have been just north of 50% since we commenced this study.

Rolling forwards

Given that 2008 is a long time ago, we have updated our survey, as much as possible, to take account of events in 2009. To do this, we have applied market movements to our data for the end of 2008.

2009 was in the end a cheerful year, although it did not always feel like it. We show the performance of the MSCI World Index below. There are additional exhibits in the Appendix.

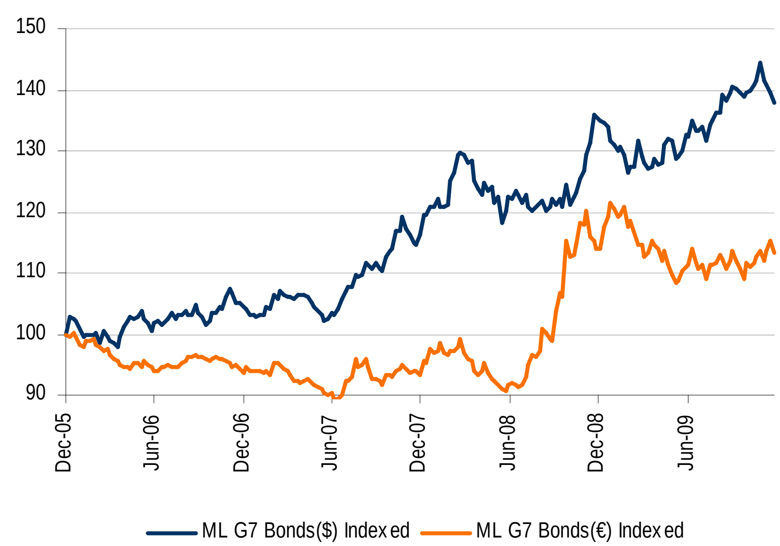
Chart 3: MSCI World - $ and € (indexed)



Source: Datastream/BofA Merrill Lynch research

Bonds overall were decent in Dollars, less so in Euros.

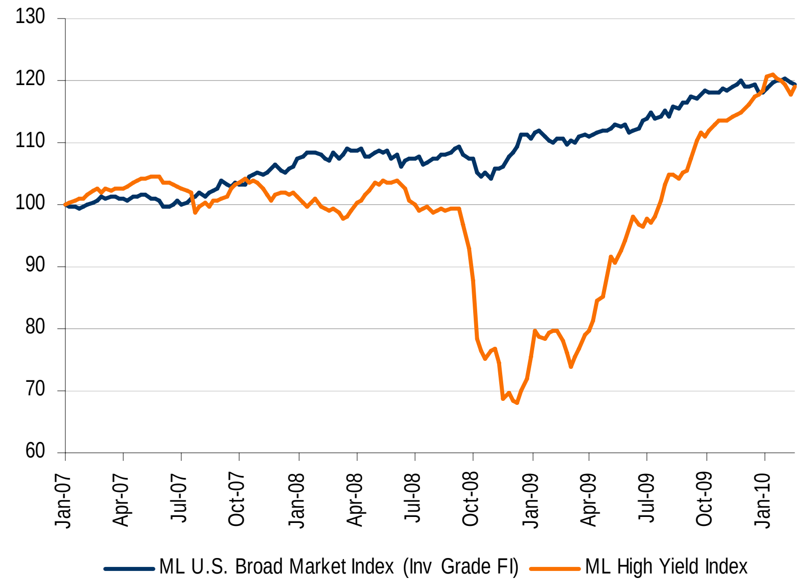
Chart 4: ML G7 Bonds - $ and €



Source: Datastream/BofA Merrill Lynch research

Within bond-land, the most striking returns were in high yield, which had a dreadful 2008.

Chart 5: High grade and high yield bonds ($)



Source: DataStream, Bloomberg, Banc of America Securities-Merrill Lynch research

Our estimates for revenue run rates at the end of 2009 try to take account of this very divergent experience for different classes of fixed interest. We have assumed a 27% increase in fixed interest overall for the year.

Alternative Assets - Private Equity

Although deal volumes were dismal in 2009, AUM actually is unlikely to have contracted much. Over the medium term we would expect AUM to fall, as the fundrisings from the glory days run off. As a style, though, we are relatively optimistic about private equity.

Demand

Demand for access to private equity unsurprisingly weakened in 2009. According to Prequin, the private equity research firm, total fundraising fell 61% on 2008, with Q409 representing the lowpoint of the year and the lowest quarterly total since Q303.

Deals

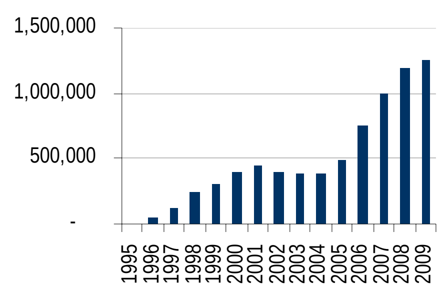
Dealflow was hardly healthier. We show European buyout volumes as calculated by S&PLCD later in this note. According to Candover's 'unquote"' survey, overall European private equity completed €29bn of deals in 2009, down from €86bn in 2008. We have no reason to believe that global dealmaking was more feverish.

Private equity AUM

Asset Under Management in the private equity industry is a slippery concept. From the GP's point of view, Asset Under Management corresponds to invested capital as well as committed capital; we therefore define AUM as cumulative raised capital minus divestments.

Since investing fell as sharply as asset gathering, and realisations were also low, we would estimate that AUM actually was pretty static in 2009.

Chart 6: Total AUM ($mn) in private equity



Source: Venture expert, Merril Lynch estimates

Private equity revenues

We approach this in two stages.

Management Fees

The private equity industry typically charges 2% of committed capital; we estimate that the industry earned $16.5bn from management fees in 2009, roughly unchanged on the previous year.

Carried Interest

Since the industry charges a 20% carry on gains on capital returned to investors above a hurdle, this tends to be lumpy and back end loaded. To estimate carry, we have taken the average "money multiple" of an LP of about 1.3 times (source: VentureXpert) for 2003 funds, a reasonable vintage which will be starting to mature, and applied this to all funds raised between 1999 and 2005. As funds take at least 6 years to mature, we have divided this amount by 6 to arrive at our performance fee estimate. We have applied a pretty severe haircut of 75% to this number, as realisations were pretty scanty in 2009.

The issue which the industry faces at the moment is in effect what is its deal capacity in future? It may well be unable to gather assets at the previous rate, especially in the mega buyout area, unless it can show evidence of being able to put money to work. Our sense is that deal volumes will settle down at something below previous peak levels, which would tend to mean over time somewhat reduced AUM. To the extent that either equity contributions rise, or deal size surprises on the upside, AUM will be boosted. In a sense, this is just the lagged effects of the market falls in 2007/8 working their way through. Because private equity does not mark to market, AUM can tread water for some time after other asset markets have fallen. This is what we have seen in 2008 and 2009.

We share the consensus view that there will be a consolidation of managers, with some global mega-players becoming increasingly dominant, a trend which was already becoming evident before the crunch.

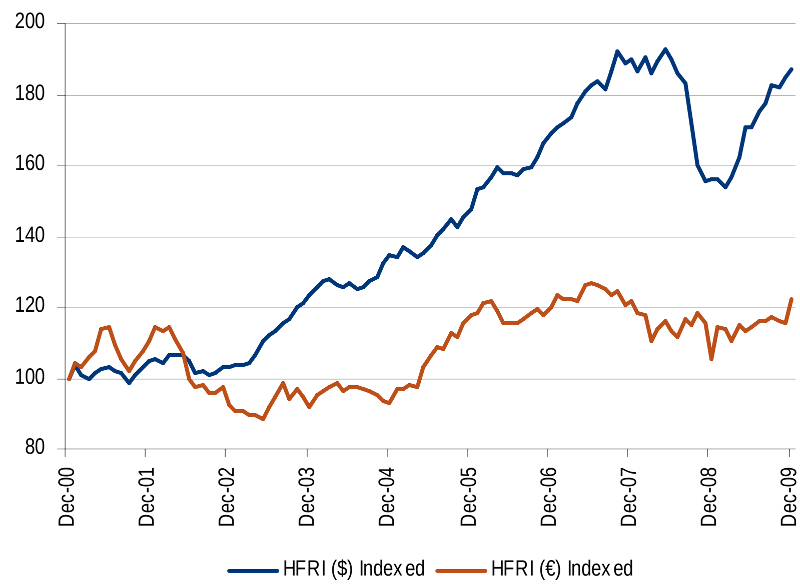
Alternative Assets – Hedge Funds

Hedge funds had a very good 2009 overall; performance, at 20%, was the best of the decade, and AUM increased by around 10%. Flows were disappointing overall, but on a positive trend throughout the year.

Performance

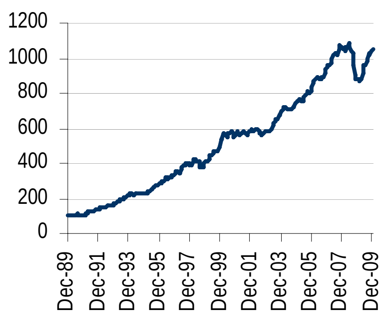
The twelve months to the end of 2009 represented the best twelve months' performance of the "noughties". We show below the HFRI, the index where we have the longest performance record, since the end of 2000, with some longer term data in the margin.

Chart 7: HFRI Composite (in $, and converted into €)



Source: HFR, Datastream, BofA Merrill Lynch research

Chart 8: HFRI Composite



Source: HFR, BofA Merrill Lynch research

Below, we show the annual performance of this index for as long as we have data.

Chart 9: HFRI Composite - 12 Mth Perf.

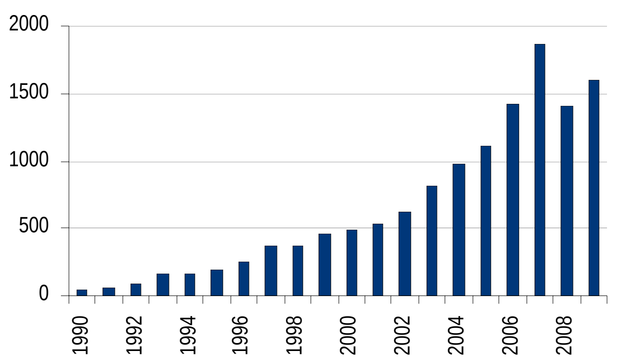
Source: HFR, BofA Merrill Lynch research

Recent performance has, therefore, been very much at the top of historical experience, although last year was way below the bottom of historical experience, to be fair. The HFRI has not yet regained its highs (it is around 3% below the May 08 high).

Flows

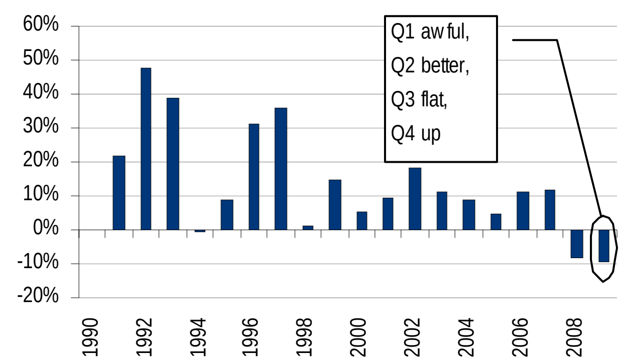
Flows were no better than performance.

Chart 10: Hedge Fund Universe ($ Bn)



Source: HFR

Chart 11: Hedge fund flows vs starting assets

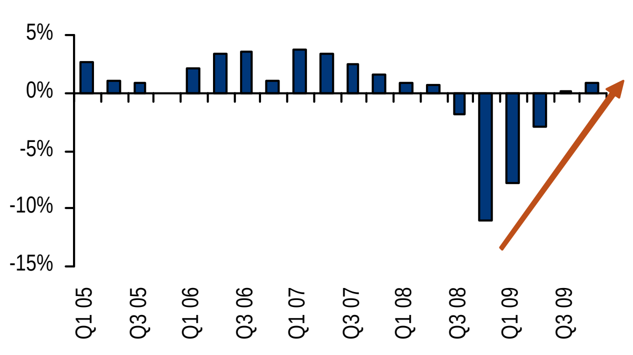


Source: HFR

2009 has seen the industry begin to recover from the depths of 2008. The improvement overall has been driven by performance not flows, as overall the industry saw outflows in the year.

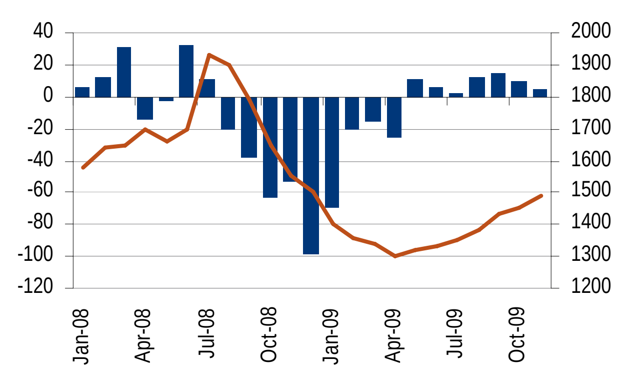
This, though, masks the real progress which the industry has made since Q1. We show the quarterly HFR data, as well as the EurikaHedge monthly estimates. Both paint a picture of improving momentum from the grim Q4 08. Anecdotally, GlobeOp confirmed in their Q4 IMS that hedge fund flows had been increasing sequentially by quarter since the start of the year confirms this picture.

Chart 12: HFR - Hedge Fund Flows vs Assets



Source: HFR/BofA Securities Merrill Lynch research

Chart 13: Estimated net inflows, AUM ($bn)

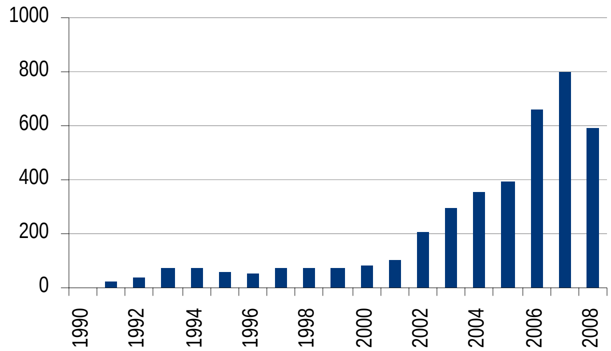


Source: Eurikahedge

Fund of funds

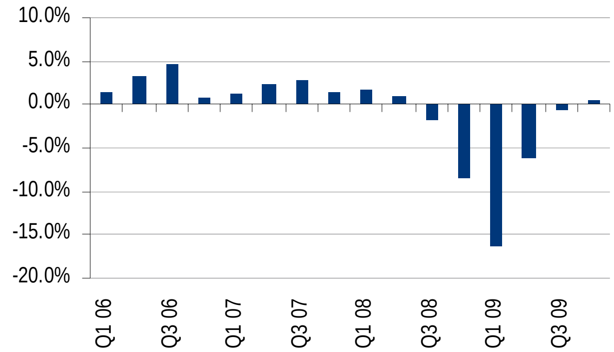
The fund of funds industry was arguably one of the major sources of outflows from the industry. As you might expect, fund of fund outflows appear a little lagged compared to the funds themselves, so Q1 09 represented the nadir here. Fund of funds flows, too, seem decisively to have turned from the trough.

Chart 14: HFR - Fund of fund assets (U$ bn)



Source: HFR/Banc of America Securities-Banc of America Securities-Merrill Lynch research

Chart 15: HFR - Fund of fund flows vs assets

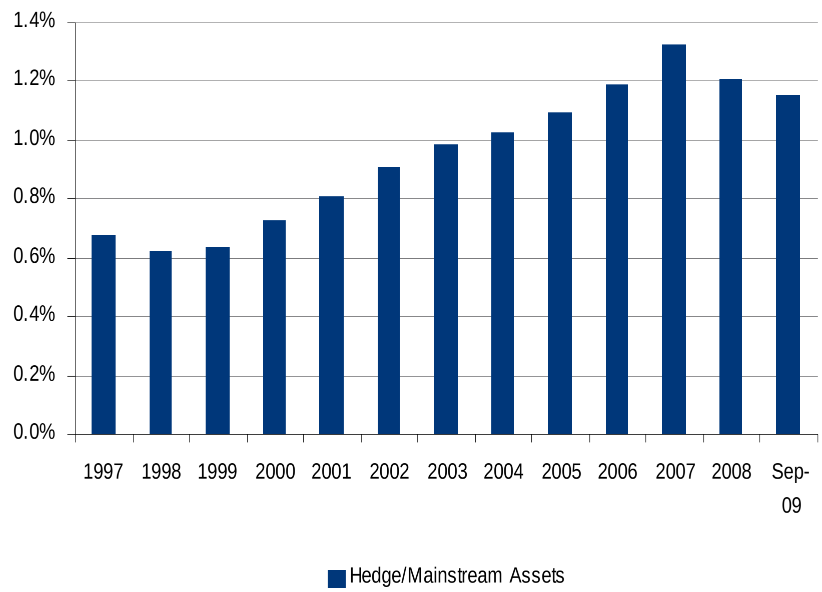


Source: HFR/BofA Securities Merrill Lynch research

Market size, hedge fund "bubble"

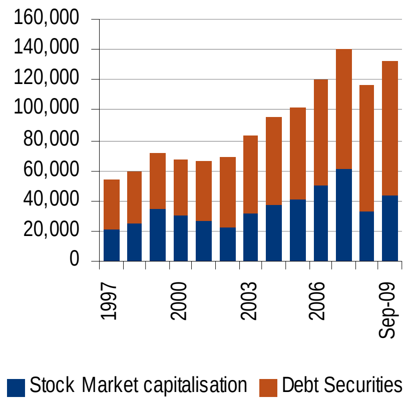
We have for some while contrasted the size of the hedge fund universe with mainstream assets. We have updated our work here. To start with, we show our calculation of the hedge fund world as a percentage of the mainstream world.

Chart 16: Hedge Fund Assets vs Mainstream Assets



Source: HFR, World Federation of Exchanges, BIS, Tremont, Banc of America Securities-Banc of America Securities-Merrill Lynch research

Chart 17: Conventional Assets - $bn



Source: World Federation of Exchanges, BIS

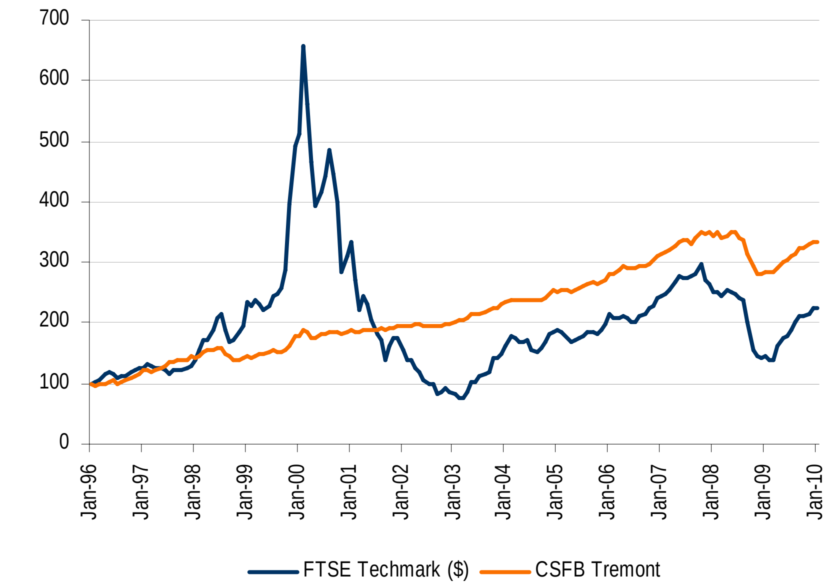
In the margin, we show the data on which this is based.

We have only taken this to the third quarter of 2009, as we do not have more up-to-date date for debt securities. We would expect the industry to return to its previous pattern of modest growth over time. A large reason, we think, why the industry market share fell for the past couple of years has been the buoyancy of debt markets.

Bubbles?

Another longstanding chart of ours is the comparison of hedge fund performance with that of the FTSE Techmark, a sensible proxy for European technology. The Techmark is down more than 24% from its near term peak (and 66% below its all time high), against around 5% for the hedge fund industry on this measure[1].

Chart 18: Hedge Funds - the Bubble Continues?



Source: DataStream/CSFB Tremont/Merrill Lynch research

Revenues in 2009

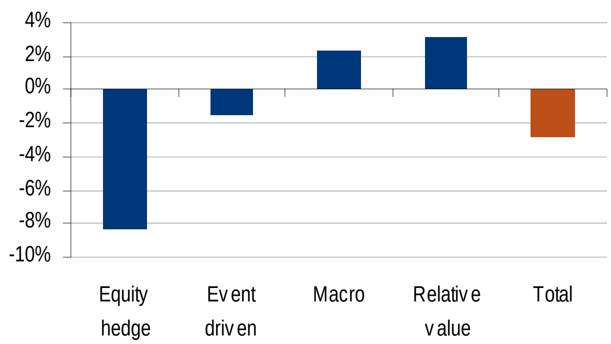
This is usually a pretty straightforward calculation. We assume that the industry charges “2&20”, i.e. a 2% flat fee on AUM and 20% of performance over a high water mark. There was a lot of talk at the start of 2009 about this charging structure coming under significant pressure; in fact, we have seen a bit of slippage in base fees and virtually no slippage in performance fees. At the end of 2009 assets were around €1.1bn (source: HFR, Merrill Lynch research). Performance in US$ was around 20% on the HFRI. However, the index is still below its previous highs. This would imply that the industry would earn no performance fees in 2009. The actual number will be greater than zero, as:

- Averages are simply that: there is a significant spread of returns.
- Some styles have ended 2009 at or around highs: macro and relative value as segments have done this.

[1] The CSFB Tremont differs fractionally from the HFRI, referenced earlier.

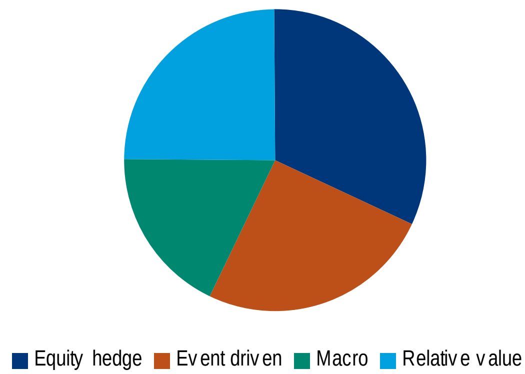
We have therefore used the broad categories of equity, event driven, macro and relative value to estimate performance fees. We show the data we have used below.

Chart 19: Performance against high water mark



Source: HFR, BofA Merrill Lynch research

Chart 20: Hedge fund industry by style, Q3 09



Source: HFR, BofA Merrill Lynch research

When you weight the sectoral performances by the weights the various styles represent, you find that it equates to roughly 1.2% performance across the board. This forms the basis of our 2009 estimates, which we regard as underestimates, but at least consistent with previous methodology.

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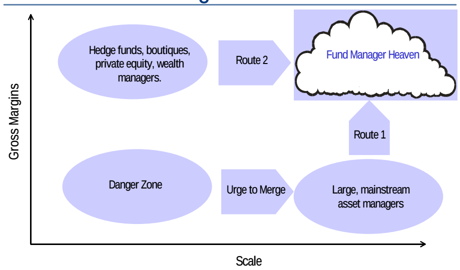
Industry estimates for 2009

In this section we look at where revenues have been generated in 2009, on our estimates. 2009 shows overall a bounce in run rate revenues, and the beginnings of a hedge fund fight-back from the dismal 2008.

Chart 21: Fund Manager Heaven



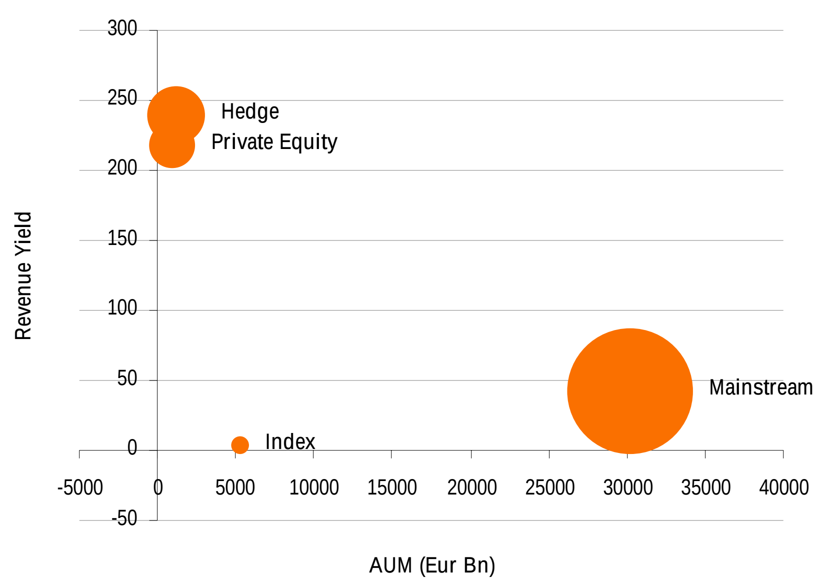
Source: BofA Merrill Lynch research

Fund manager heaven

Adding together our estimates for mainstream, index, hedge and private equity managers produces our beloved "fund manager heaven" bubble chart. This marries the idea between our old diagram, shown in the margin, which argues conceptually that managers should be aiming for a combination of scale and margins if they want to maximise revenues, with some facts.

We show this below. We have used the estimates for the various buckets as described earlier.

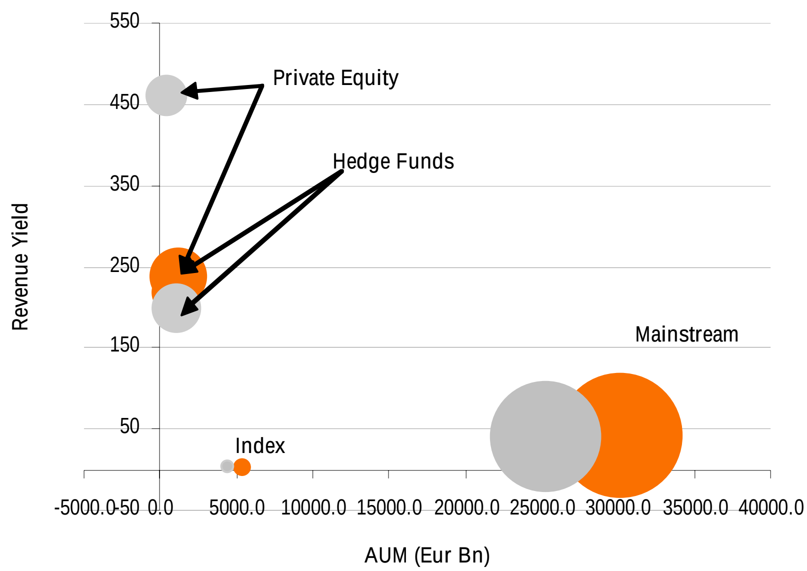
Chart 22: Asset Management World - end 2009 (Estimates)



Source: IPE, P&I, HFR, VentureXpert, BofA Merrill Lynch research

We compare this with our (slightly revised, on the basis of more accurate data) numbers for 2008 in the chart below.

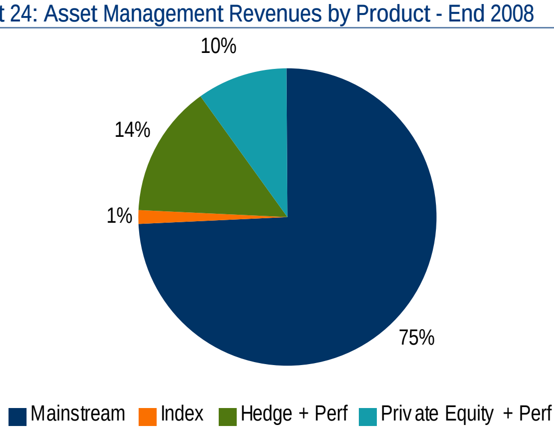
Chart 23: Total Industry - 2008 (gray) and 2009 (ochre) Compared



Source: IPE, P&I, HFR, VentureXpert, BofA Merrill Lynch research

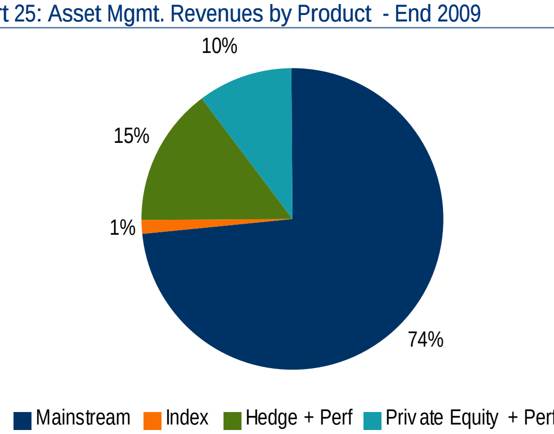
The revenue yield in private equity has fallen because of the poor realisation environment. We show below the revenue shares of the four styles for 2008 and 2009.

Chart 24: Asset Management Revenues by Product - End 2008



Source: IPE, P&I, HFR, BofA Merrill Lynch research

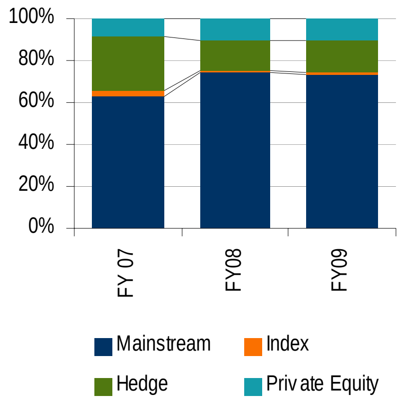
Chart 25: Asset Mgmt. Revenues by Product - End 2009



Source: IPE, P&I, HFR, VentureXpert, BofA Merrill Lynch research

Hedge funds have seen their wallet share move modestly upwards; mainstream has been boosted by the strong asset performance seen in 2009.

Chart 26: Revenue Share by Style



Source: IPE, P&I, HFR, BofA Merrill Lynch research

We make the same point in a different way in the margin chart. Private equity has been steady because it typically does not mark to market. Our view is that hedge will expand its share in 2010, as flows remain positive and performance fees become more prevalent.

Flows

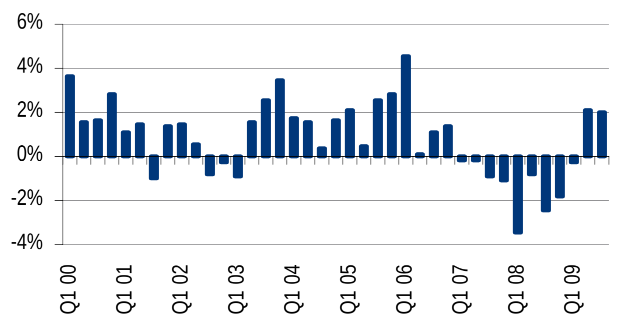
We have provided data for alternative flows in the section above. Here, we look briefly at mainstream flows.

Key data – retail

The best data here is retail. For Europe overall, data collection is far trickier than you would assume. This is partly down to Luxembourgeois and Irish funds, which are typically sold cross border and where there seems not to be a trade body with especially good visibility. The data we usually cite comes from trade bodies, rather than Government agencies, and these clearly have no power to force disclosure.

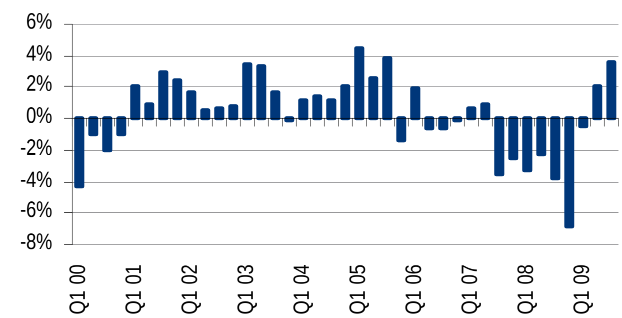
Anyway, we show below some data for the European asset management industry. The longest run data is quarterly, and so a bit of a lagging indicator. We show the four most obvious asset classes below.

Chart 27: Equity Flows - UCITS Funds



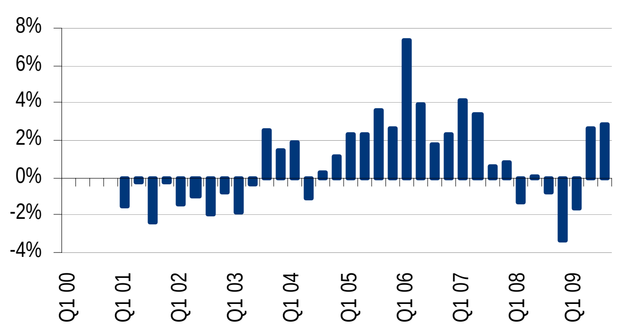
Source: EFAMA/BofA Merrill Lynch research

Chart 28: Bond Flows - UCITS Funds



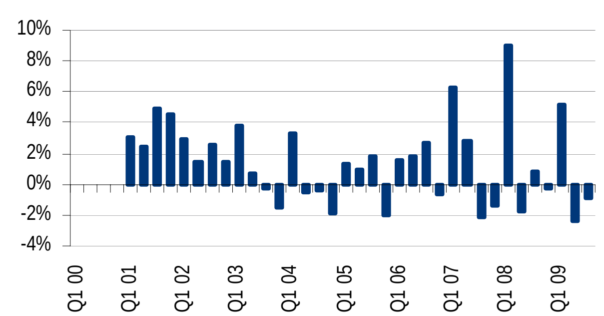
Source: EFAMA/BofA Merrill Lynch research

Chart 29: Balanced Flows - UCITS Funds



Source: EFAMA/BofA Merrill Lynch research

Chart 30: Money Mkt. Flows - UCITS Funds

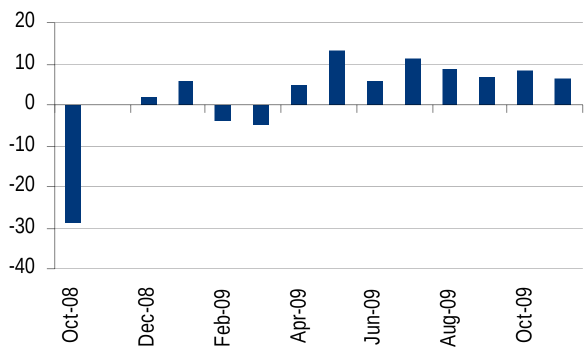


Source: EFAMA/BofA Merrill Lynch research

There is a clear pattern here. Risk assets saw flows at their most negative in Q4 08; outflows fell in the first part of 2009 before turning positive. Money market flows have been more eccentric.

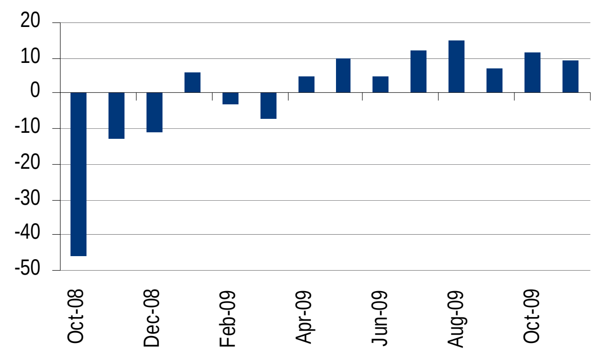
Recently, EFAMA has started, helpfully, to provide monthly pan European flow data, which we summarise below.

Chart 31: UCITS Equity flows (€bn)



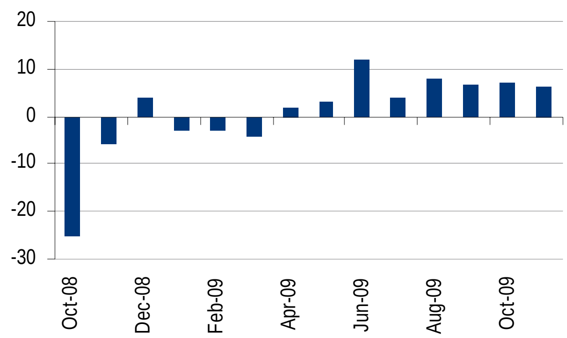
Source: EFAMA/HFR/BofA Merrill Lynch research

Chart 32: UCITS Bond flows (€bn)



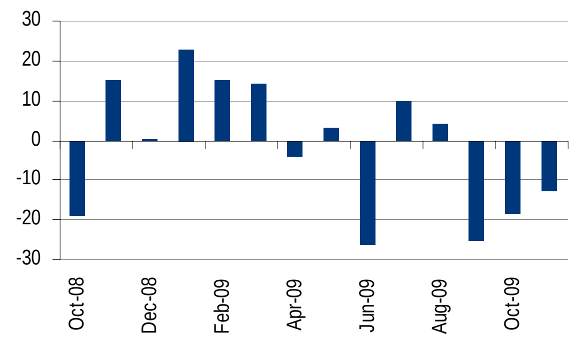
Source: EFAMA/HFR/BofA Merrill Lynch research

Chart 33: UCITS Balanced flows (€bn)



Source: EFAMA/HFR/BofA Merrill Lynch research

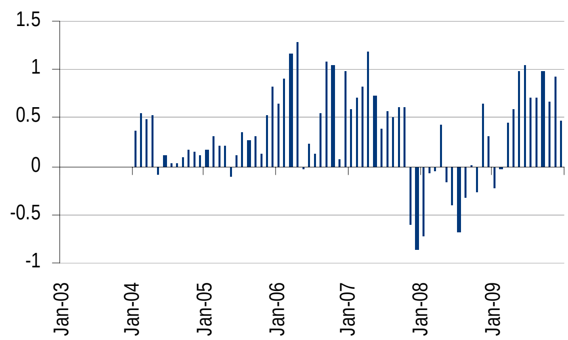
Chart 34: UCITS Money market flows (€bn)



Source: EFAMA/HFR/BofA Merrill Lynch research

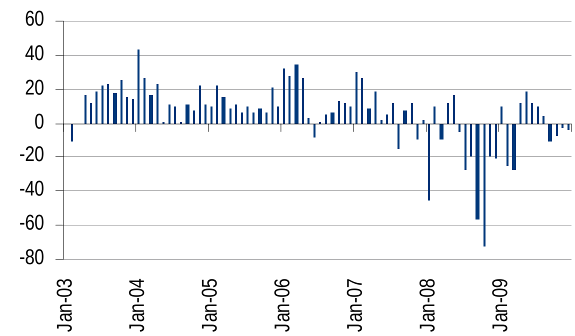
Lastly, we show below monthly data for UK and US equity flows, simply because these are big markets with relatively timely, representative data.

Chart 35: UK Equity flows



Source: IMA, BofA Merrill Lynch research

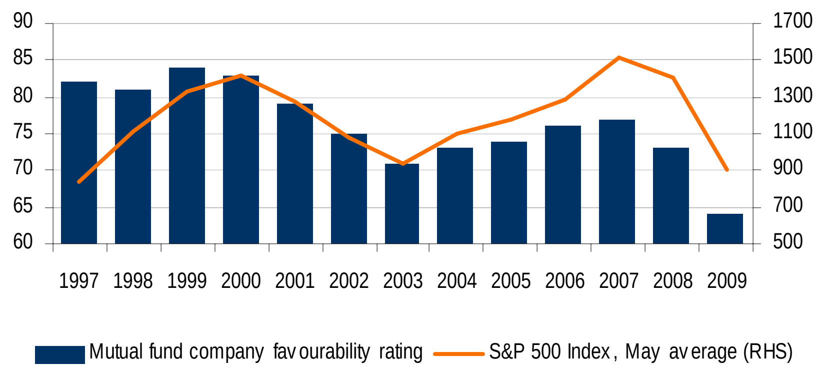
Chart 36: US equity flows



Source: ICI, BofA Merrill Lynch research

The ICI, the US trade body, produces an entertaining data series, which tracks investor perceptions of mutual funds, and shows how this relates to index levels.

Chart 37: Mutual fund favourability rises and falls with market performance

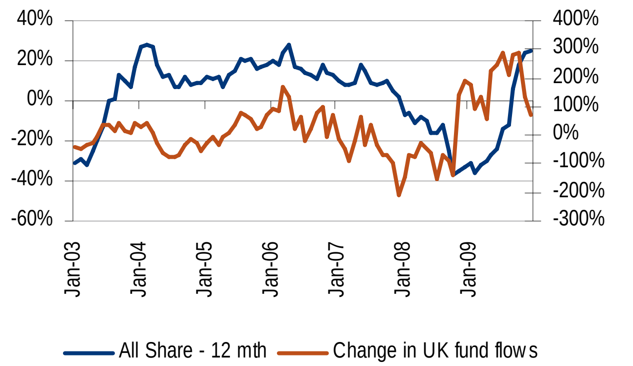


Source: ICI, Bloomberg

Smart, or even vaguely sentient, money will presumably be on the favourability rating bouncing a bit this year.

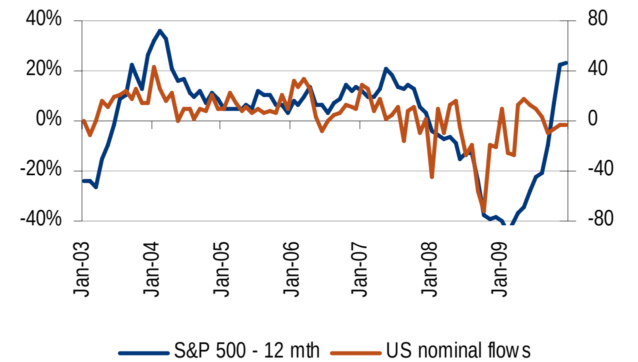
This relationship is yet another example of something we regard as a core truth about mainstream asset management; flows in the past have reflected lagged performance. We show below a couple of our favourite charts here.

Chart 38: UK - change in flows vs. market



Source: IMA/DataStream/BofA Merrill Lynch research

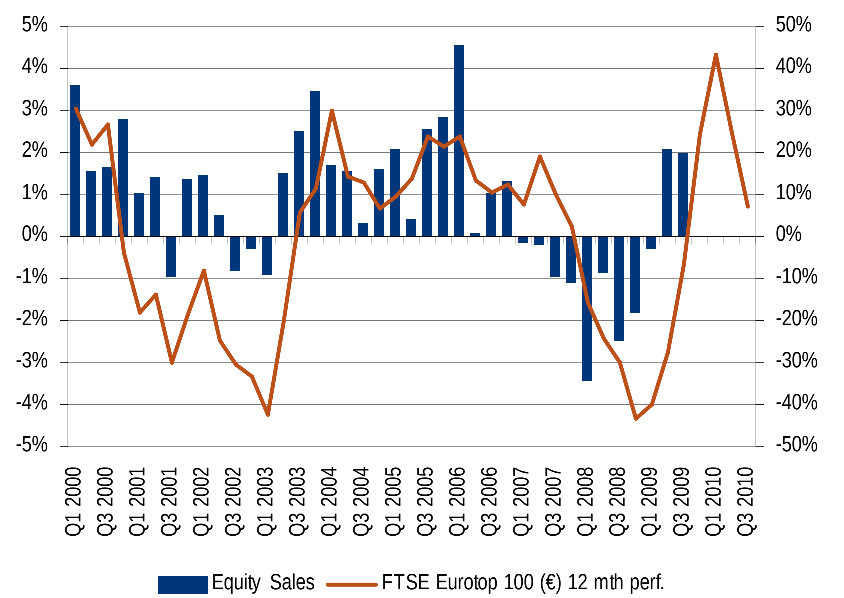
Chart 39: U.S. - equity flows vs. market



Source: ICI/DataStream/BofA Merrill Lynch research

We show below another old favourite of ours, a chart which shows European equity flows against market performance. We have rolled forwards the spot market to provide our data for future performance here.

Chart 40: Equity Sales vs Lagged Market Performance - Quarterly



Source: EFAMA/Datastream/BofA Merrill Lynch research

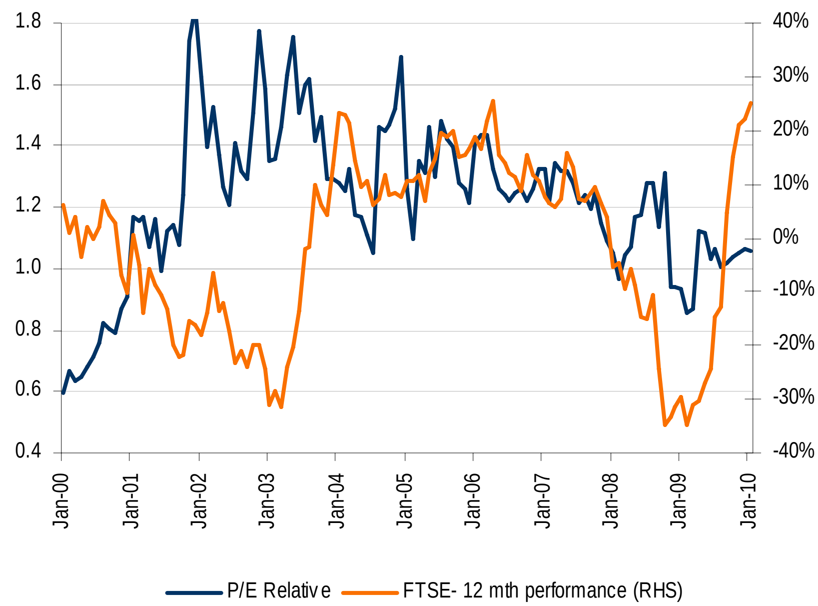
Significant gearing into markets

We continue to see multiple levels of gearing from asset managers especially into equity markets. To reiterate briefly, the four obvious elements of gearing are as follows:

- The top line is geared into markets
- New business is geared into markets
- Ratings move with markets
- Operating margins tend to move with markets

The first is obvious, the second is human nature, and evidenced by the flow data set out above. The dark side of our nature supposes that the third is human nature too; whatever, it is a pretty reliable finding, we think, as suggested by the chart below.

Chart 41: Asset Manager p/e Rating Against Market Performance - Europe



Source: IBES/BofA Merrill Lynch Global Research

The fourth simply derives from the fact that although variable comp can fall pretty quickly, there remain fixed costs. Managing an asset manager is very much a question of balancing immediate profitability with a recognition that the medium term health of the business depends on maintaining a market position, which tends to require maintaining “intellectual capital”. This is, we think, the inevitable quid pro quo of being an asset-light business.

Looking forward – demand when the dust settles?

What will investors buy in 2010 and beyond? As the dust settles, our belief is that we will see speeded up evolution, as people combine a desire to take risk with a desire to manage risk.

The great financial innovation over the past decade has been the increased ease of hedging or managing risk. Managing in two dimensions is now within the reach of mainstream managers in most key domiciles. Just as some managers have struggled to manage in one dimension, so others may struggle to manage in two. However, we believe that increasingly, active managers will have to try.

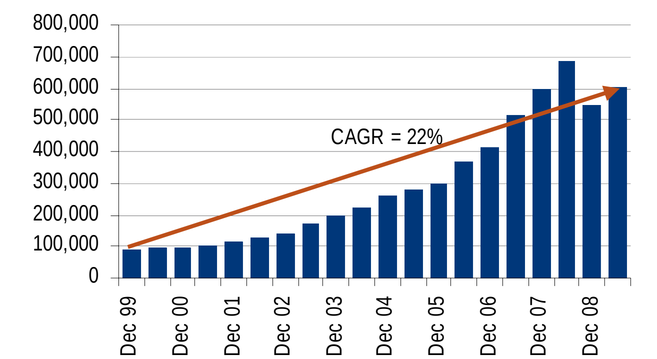
Evolution in financial markets.

We think that the last decade has seen two important, parallel developments.

Growth of derivatives

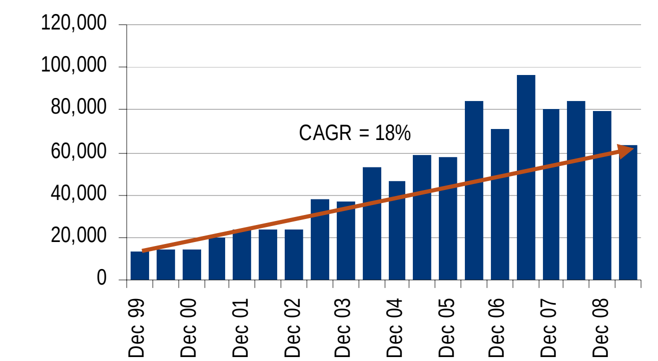
Firstly, derivative use has grown significantly. To provide a bit of context, we show below the growth in open interest in exchange traded and OTC derivatives from the start of 2000 to June 2009, the latest date when we have data.

Chart 42: OTC derivatives - notionals outstanding ($Bn)



Source: BIS

Chart 43: Exchange traded derivatives - notionals outstanding ($Bn)



Source: BIS

The growth in open interest in both OTC and exchange traded derivatives has been striking, even after the contraction following the peak in 2007. This growth has been accompanied with a significant increase in the range of straightforward instruments available, with sector swaps, effectively futures over sectoral indices, becoming mainstream and prevalent.

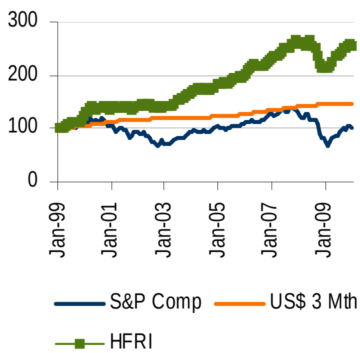
Regulatory change

At the same time, regulatory change has allowed derivatives to be used much more widely in mainstream fund management. We have talked enough about UCITS III already. We will confine ourselves to pointing out that UCITS III effectively means that onshore retail investors in Europe can access a wide range of types of risk control in a highly regulated format. Hedge fund groups have been onshoring their existing styles, at the same time as mainstream managers have been looking to broaden their product ranges.

Importantly, this is not just a European phenomenon. For instance, Man has sold significant amounts of product onshore in Japan, Australia and Canada, and has recently also accessed the Taiwan onshore market. We would not claim to be expert about regulation there, but you would assume that if Man can market its products onshore, others with more mainstream-looking products can as well. Finally, we are seeing an increased number of US hedge-fund clones being launched. We discuss this briefly in the section "This time it's different" below.

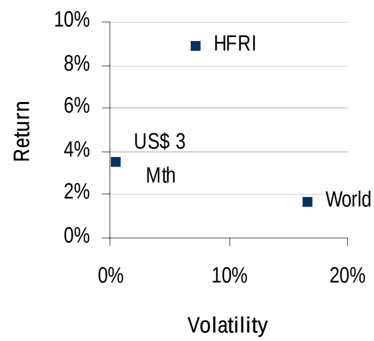
To understand why moving into two dimensions might make sense, we have reverted one of our longstanding exhibits, a triptych of charts on the relative performance of the hedge fund industry.

Chart 44: Total Return



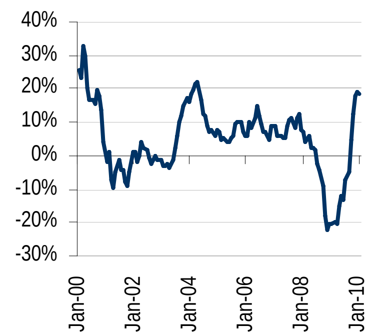
Source: BofA Securities Merrill Lynch, Datastream

Chart 45: Risk/Reward



Source: BofA Securities Merrill Lynch, Datastream

Chart 46: HFRI - Spread over 3m$



Source: BofA Securities Merrill Lynch, Datastream

The HFRI has outperformed equities and cash materially since the start of 1999 (if you take things back another ten years, you find that equities have snuck ahead of cash). Understandably, hedge funds have achieved this performance with materially lower volatility than equities, although much more than cash. Finally, although there have been periods where you were better off holding cash than a portfolio of hedge funds (mid 2008 to mid 2009 being a clear case in point), overall investors have been well compensated for taking the added risk that investing in the sector entails.

This time it's different . . .

These are widely reputed to be the four most expensive words in investment. Our view, though, is that this time it may be different, in that it is an open question whether investors will behave in the way they have done ever since we have covered asset management, by forgetting bad market news pretty rapidly.

Our central view is that the whole edifice of retail and institutional investment is so extensive that it is hard to see a massive shift in behaviour overnight, but that demand patterns will evolve, and, in true fruitfly fashion, evolve much more rapidly than history would suggest. We believe that core unhedged managed products will continue to lose share both to index exposure and to more advanced styles.

History repeats itself

Karl Marx is regarded as having said this, though actually he didn't. He said instead;

"Hegel remarks somewhere that all great world-historic facts and personages appear, so to speak, twice. He forgot to add: the first time as tragedy, the second time as farce.[2]*"*

From this, we learn that Marx could have used a sub-editor. In tracking down the precise quote, we have also encountered a couple of others which bear repetition, "History repeats itself. Historians repeat each other" from the British historian Philip Guedalla and "The History Channel repeats itself", courtesy of a comic strip "Mother Goose and Grimm".

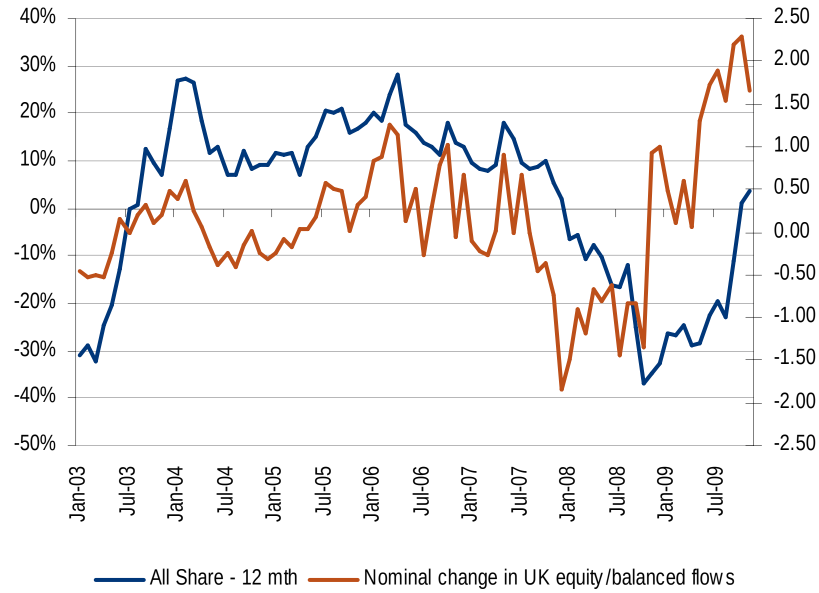
We digress. In asset management, the historical evidence strikes us as pretty clear. People typically invest in things which have performed well, and vice versa; this is the "rear view mirror" view of the world. To be more concrete, in the past retail flows into equities have been encouraged by strong equity markets and vice versa. Whilst flows do tend to subside after market disruptions, they bounce back again more strongly and rapidly than you might expect. Anecdotally, we remember investors announcing after the 1987 market falls that investors would never buy another equity fund, and saw prices of fund management companies taking a rare beating. As is often the case, the reports of the death of the industry were a great exaggeration. Data for events then is much less granular than we now have, and it certainly seems to be the case that net sales were dull in 1988; 1989, though, was a much better year before the dull 1990-93 conditions saw demand ebb away, with 1994 being a very good year[3].

For the era when we have more detailed data available, there is excellent data to suggest that flows are a function of recent performance. We have not attacked the relationship as econometricians (largely because we aren't) but the chart we have already shown in the section on flows above gives a petty strong indication that flows and 12 month market performance move in lockstep. The chart below looks at a slightly different cut of the data, and compares nominal 12 month change in equity and balanced flows with 12 month performance of UK equities. Again, the relationship looks strong (although there is no real correlation between the two series).

[2] This is the opening of his article "The Eighteenth Brumaire of Louis Bonaparte" (Marx, 1852). Don't get us started…

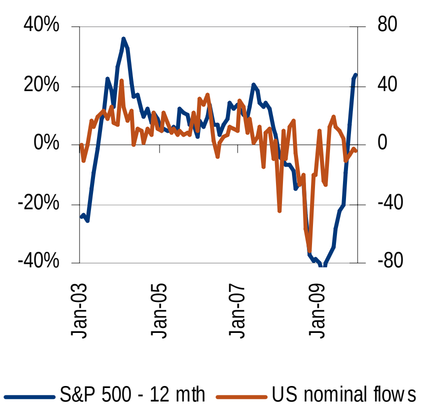
[3] See Chart 26 of the IMA's 2008 asset management survey for more details here

Chart 47: UK - equity and balanced flows against market



Source: IMA/DataStream/BofA Merrill Lynch research

Chart 48: U.S. - equity flows vs. market



Source: ICI/DataStream/BofA Merrill Lynch research

In the battle between “history repeats itself” and “this time it’s different”, it is pretty obvious which camp this chart falls into. The European equity flow chart we showed above is another.

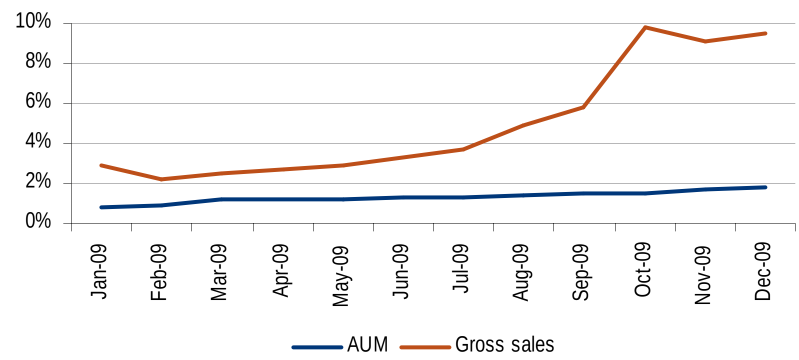
This time it’s different

The saying “The four most dangerous words in investing are ‘This time it’s different’” is consistently attributed to Sir John Templeton, although we haven’t been able to pin down the exact source.

To argue “this time it’s different” on the asset management industry, which is what we want to do, you’d probably have to start with US equity flows. These have improved, but are far from brilliant. We have shown this chart already, so simply show it in the margin as an aide memoire. Since the end of December, flows have seen a good January and a dull start to February according to the ICI.

The next “this time it’s different” graph also comes from the UK. We show below the growth of the UK absolute return sector in 2009.

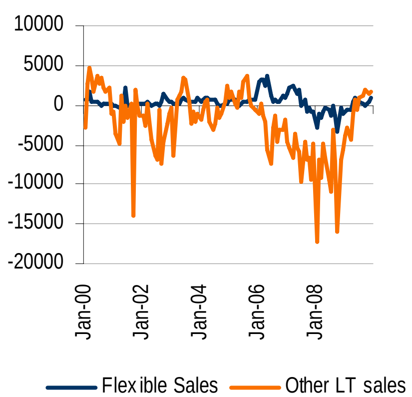
Chart 49: UK Absolute return - market share



Source: IMA/BofA Merrill Lynch research

There are two ways you can look at this. You could point to the rising share of gross flows, or the fact that he sector is still just less than 2% of the total market, hardly a massive amount. Clearly, both are true and inevitably, we would tend to foreground the first interpretation. Absolute return funds in UK retail, which has historically been very equity-oriented, have picked up significant share.

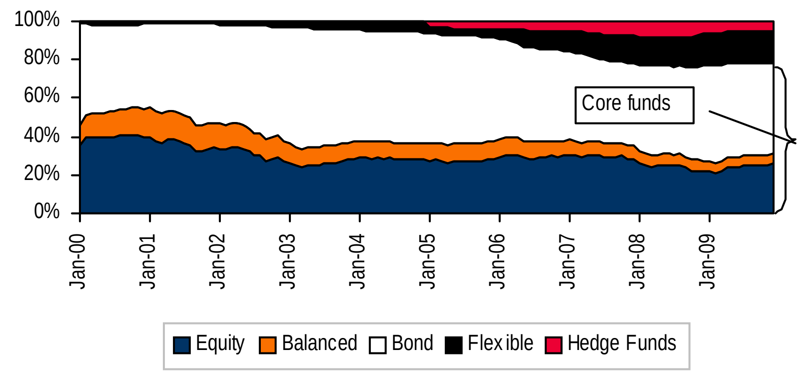
Chart 50: Flexible flows vs other long term



Source: Assogestioni/BofA Merrill Lynch research

A final modest anecdotal point. The Italian industry data is pretty granular, breaking AUM out between equity, bond, balanced (effectively, equity and bond funds in a relatively fixed proportion), flexible (do-what-you-want funds) and hedge funds. We show this breakdown below.

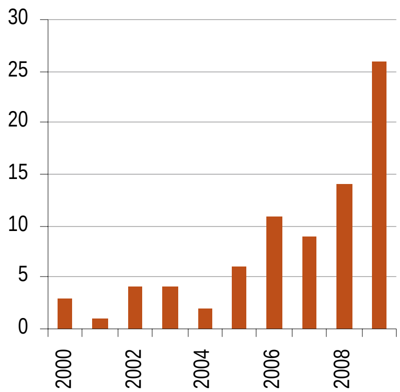
Chart 51: Italy - Mutual fund market by style



Source: Assogestioni/BofA Merrill Lynch research

If you take flexible and hedge funds to be non core funds, core lost market share persistently until late 2008. Since then, the hedge fund sector has shrunk (presumably reflecting the awful and in our view misjudged publicity it has received) but flexible has kept going. As a result, the non core funds hardly reclaimed any market share in the strong equity and bond market conditions of the latter part of 2008.

Chart 52: Number of long-short mutual fund launches



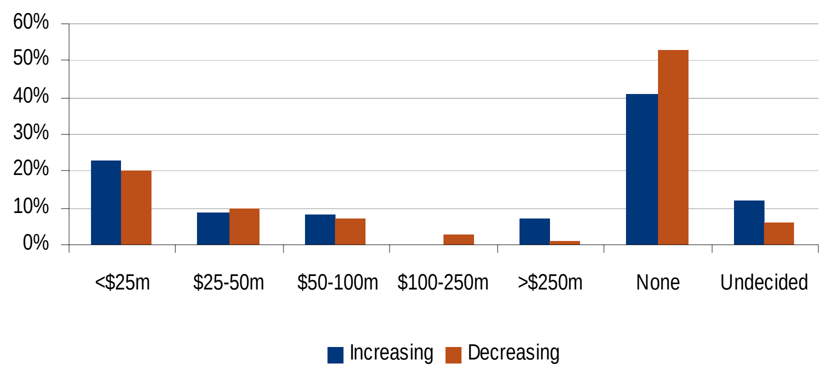
Source: Morningstar

There is some evidence that the same thing is happening in the US. We show in the margin the number of long-short mutual fund launches in the US. According to Morningstar, these funds saw inflows of $8.7bn of sales to the end of November 2009, against $4.6bn for 2008. These are so-called "40 Act" funds, which are regulated onshore. They are therefore somewhat analogous to our UCITS III funds.

US Institutional

We also have some useful proprietary survey data on US institutional intentions, initially published in a useful note "Second-half 2009 institutional survey" published on 12 Nov 09 and authored by John Haugh. We know that intentions do not always come to pass, but it would appear that this (large) subset of US institutions are minded to invest significantly in hedge funds over 2010. This ties in with anecdotal evidence that the US institutional market has been the quickest to recommit to hedge funds.

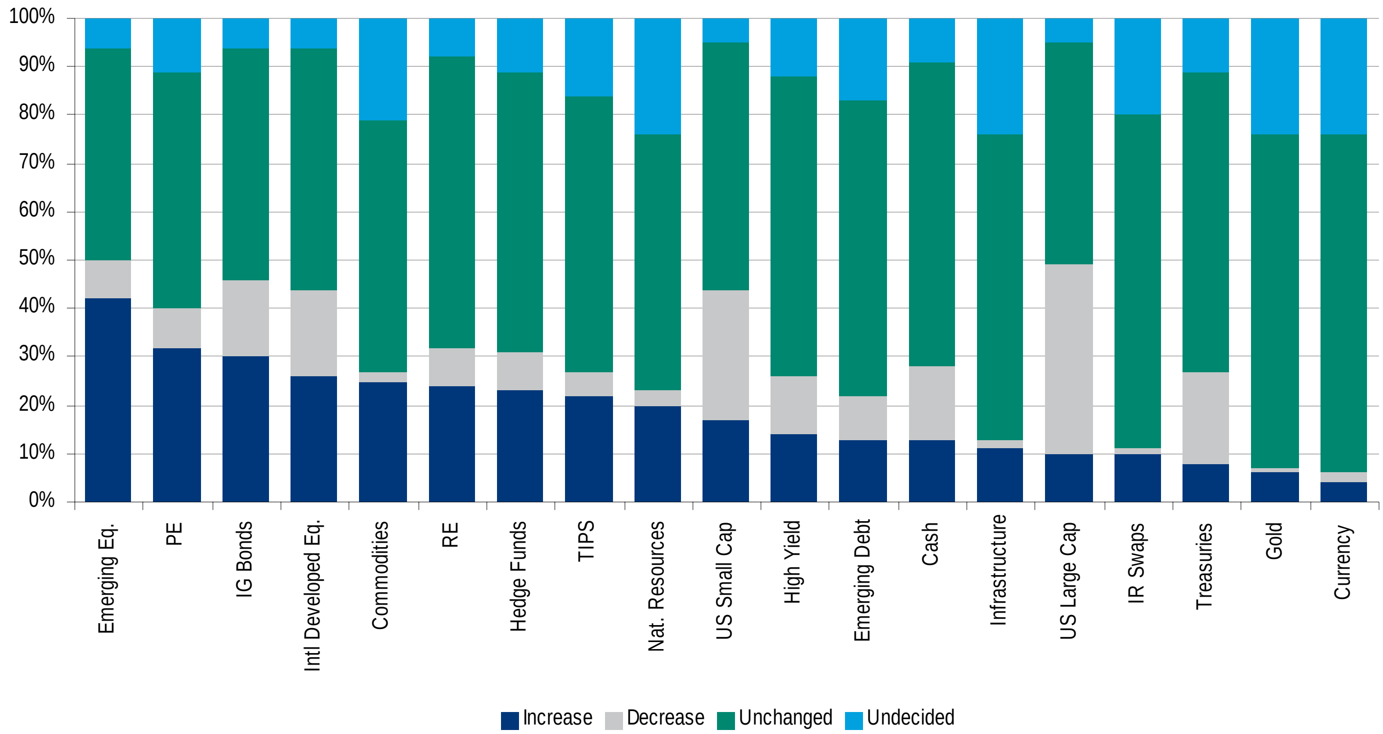
Chart 53: By how much do you anticipate increasing/decreasing your hedge fund investments over the next 12 months?



Source: BofA Merrill Lynch Global Research survey

The same survey contains an interesting chart of plans' investment intentions. We reproduce this below.

Chart 54: What changes do you anticipate to the asset classes below over the next 12 months?



Source: BofA Merrill Lynch Global Research survey

Understandably, John focuses on the shift this implies from domestic equities into international and especially emerging market stocks. However, there is another message here; a shift out of core products into diversifying assets. If you simply take the difference between those looking to increase and decrease exposure, the three biggest decreases are US large cap, Treasuries and US Small cap (followed at some distance by cash). Again, we know that this hardly captures the full richness of investors' intentions (which may never happen in any case) but it certainly suggests that directionally, US plans are looking to diversify. The same measure would suggest the three most popular asset classes are emerging equities, perhaps surprisingly private equity and commodities. Natural resources, TIPS, real estate and hedge funds are the next most popular. Granted, core assets are the dominant investment of these investors, so the shifts could be actioned, and yet remain undramatic, but the evidence suggests a desire on the part of US institutions to diversify.

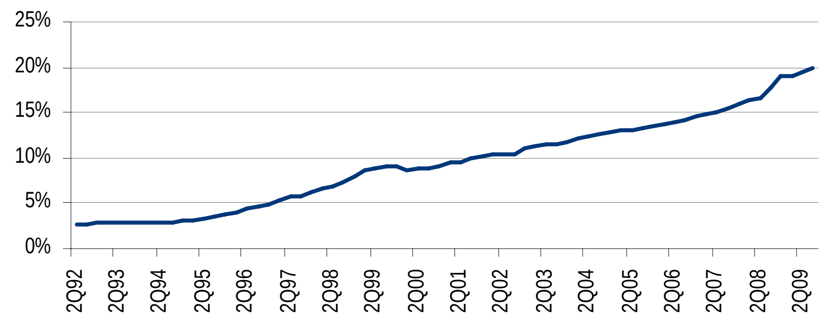
Our view

Our view is that the recent market volatility is likely to speed up changes which have been going on for some while. To recap, we have consistently argued that we will see increasing "alpha beta separation", where investors look to separate out index exposures, which are now available pretty cheaply in core areas, and mandates which are more skill-based. This is not obviously bad for industry revenues, but it is bad for the revenues of those who have historically based their businesses on charging alpha prices for beta.

Beta

There are a range of charts to suggest that indexation is growing. Below we show an old friend, the share of index products of the US mutual fund market. Bear in mind that the US is the longest standing home of the index fund.

Chart 55: Passive funds' market share of US equity funds

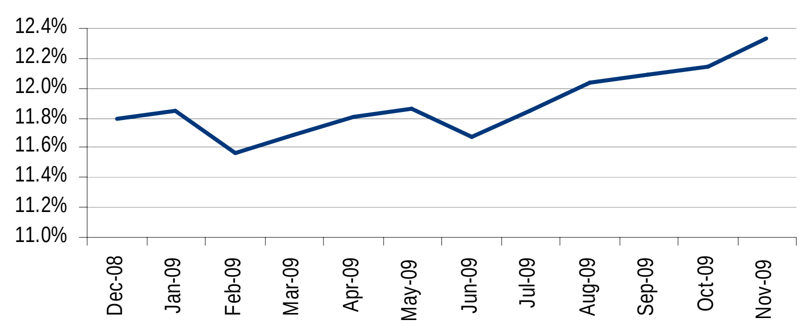


Source: Simfund, BofA Merrill Lynch securities

The chart above looks at equities; index funds have also made major inroads into taxable bond funds, although not for some reason muni bonds.

We have also seen some data to suggest growing indexation in Europe. We show below the percentage of the European universe identified by Lipper which is indexed. This has moved up steadily throughout 2009.

Chart 56: Index funds as percentage of Lipper European universe



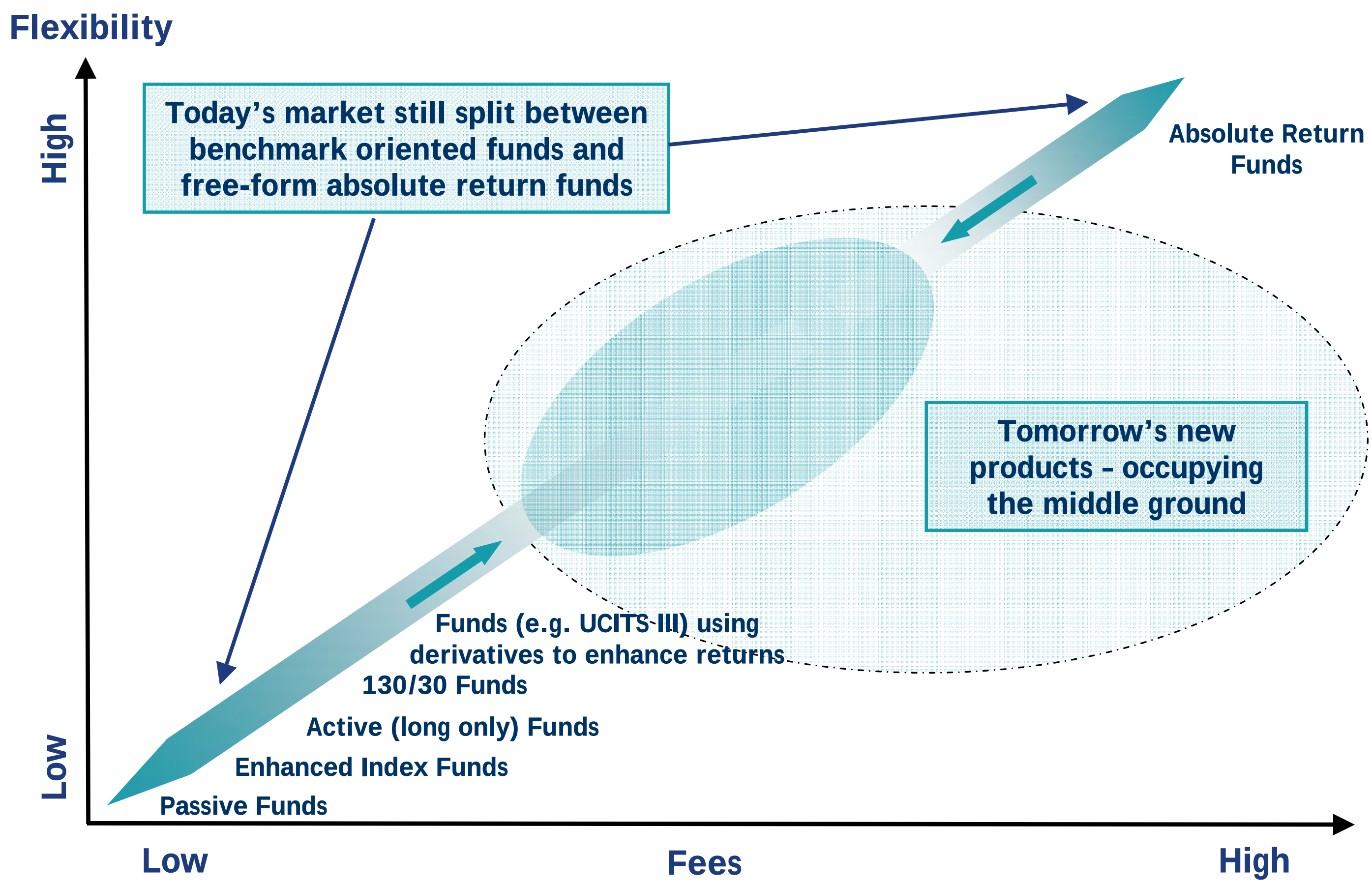
Source: Lipper Hindsight, BofA Merrill Lynch securities

Alpha

We believe there will be a continual shift away from core products into those which offer at least the prospect of alpha, risk control, diversification or all of the above. Some of this will be in the form of onshore hedge funds. However, we would also see this general move as encouraging flows in areas like commodities, possibly real estate (although often people are already exposed to this), private equity, multi asset funds, asset allocation products and products which use derivatives to alter the risk properties of the underlying asset class (call over-writing, hedging and so forth).

We have a much-loved graphic (which originated with BofAML's head of derivatives research, Ben Bowler) which tries to capture this. The point of this (apart from allowing us to spend a lot of time fiddling around with PowerPoint whilst claiming to be working) is that there is a lot of space between the core/beta exposures which represent the vast bulk of current invested assets, and the 2&20 world of hedge and private equity funds. This middle ground strikes us as providing fertile soil for both mainstream and advanced managers looking to diversify their businesses.

Figure 1: Asset manager evolution



Source: BofA Merrill Lynch research

Azimut's flexible funds, for instance, strike us as sitting squarely in the middle ground. They do not claim to be hedged, but they are able to use derivatives to alter asset exposures as they see fit. Schroders' income maximiser range, and some of their commodity/agriculture funds, fall into this category as well. The onshore products being sold by Man arguably do not, as they are onshore variants of purer hedge fund styles. The same is true of the funds making up the UK absolute return segment shown earlier.

How quickly will demand move?

Part of us wants to argue “very quickly indeed”. In reality, we think the pace will have been speeded up by recent events, but will be slower than the ever-vigilant Martian watching the Earth financial services industry might predict.

It’s worth looking at what Marx says after the “history repeats itself” misquote:

“Men make their own history, but they do not make it as they please; they do not make it under self-selected circumstances, but under circumstances existing already, given and transmitted from the past. The tradition of all dead generations weighs like a nightmare on the brains of the living[4].”

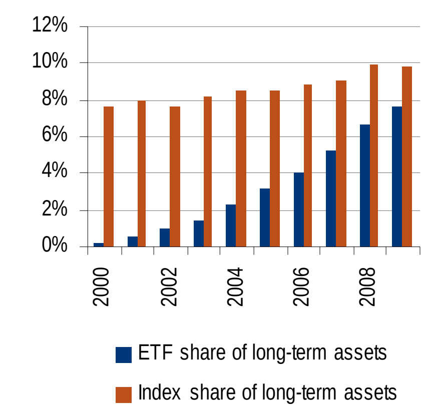
If you ignore the sexist language and florid writing style, this strikes us as on the money. Patterns of investor behaviour are probably not weighing like a nightmare on people’s brains, but they are still well ingrained. For example, there remains an instinctive view that hedge funds are in some indescribable sense “riskier” than equities, although clearly the quantitative evidence point totally in the opposite direction. We are also not convinced that overall the financial press is geared up to discuss the full range of assets which might ideally make up a more modern, balanced portfolio. The hedge fund stories which trip off the pen still seem to us to be either tales of lifestyle excess or of funds “blowing up”, which represent in our view two rare extremes, neither of which has much to say about what most funds actually do. Nor, by the way, are we convinced that indexation is likely to receive overmuch press coverage, if for no other reason than that nobody could describe it as exciting, or even vaguely interesting.

Our sense, and this is not something we can back up with hard data, is that the advisory channel is likely to lead the way in retail adoption of more advanced, diversifying styles, with the more sophisticated advisors leading the charge. This would fit in with anecdotes we have heard about demand for some of the UCITS hedge fund products which have been launched. We would expect that these early adopters will drive newsflow on retail adoption of more advanced styles, causing a ripple effect into other retail channels. We shall see.

Certainly, we believe that flows will continue to move towards providers of cheap beta and to those offering something which cannot straightforwardly be delivered as an index product. For active managers, to over-generalise this means that to protect revenues, they have to demonstrate the ability to move away from core mandates. It is bordering on the inconceivable to argue that people will not be able to make an excellent living managing active mandates in core asset classes for some decades to come. As a business model, though, this involves a willingness to fight to an increasing share of a decreasing pie.

[4] Ibid, second paragraph

Chart 57: ETF - market share of US long term assets



Source: Strategic Insight/BofA Merrill Lynch research

Prospects by segment

We recognise that our view that asset management is in the midst of significant convergence means that it is a bit misleading to break companies down into broad categories. That said, we do believe there are some general points which need making.

Index managers

Life is good if you are an index fund manager. You will have economies of scale, a competitive position which it will be hard for others to attack and products which people want. No wonder Blackrock bought the powerful BGI business, a deal which completed at the start of December 2009 (we have therefore shown the two firms separately in our section on AUM in 2008). Our view is that index managers will continue to win share in 2010. We would presume that their product development teams will be diligently finding new asset classes where they can provide beta products. Their efforts, of course, will continue to undermine those running large, index hugging mandates in asset classes which are relatively straightforward to index. The increasing acceptance of ETFs as a means of delivering beta is another "fruitfly" factor here, accelerating the trend still further. As the margin chart suggests, ETFs have been the major cause of the rise in US index assets recently. This format is also gaining popularity in Europe.

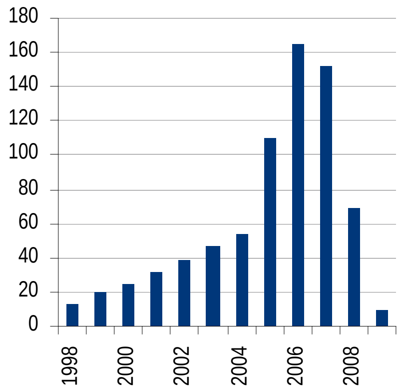
Mainstream mangers

Overall, we believe that mainstream managers need to continue to broaden their product sets, to move into the "middle ground" which we have described above.

The better mainstream players have some key advantages in doing this. Most importantly, they have strong multi channel onshore distribution. This is, we think, the mainstream's key advantage over the alternative industry. They also unquestionably have scale, as well as talented professionals. The challenges here are firstly, gaping the nettle of moving beyond the traditional product set and secondly, convincing the market that they have the ability to manage more complex products.

The threats being faced by the mainstream are the growth of index management, as outlined above, and the arrival onshore of a range of hedge-like products managed by alternative managers. The risk for unwary mainstream mangers is that they face a pincer movement between index management and alternative managers. The risk has increased as the alternative industry has begun to encroach on the onshore preserve of the mainstream, a terrain where the index players have roamed for some time.

Chart 58: European LBO volumes (€bn)



Source: S&P LCD

Private Equity

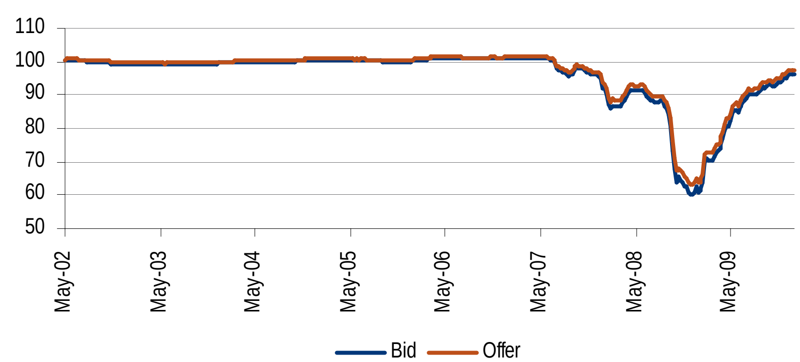
We are relatively upbeat about private equity. We would take it as a given that the industry will look very different to 2006; the good news, in our view, is that as 2010 develops, it will also look very different to 2009. 2009 was remarkable for its extremely low levels of investment. Whilst we do not expect 2010 will show a return to the "glory days", we do expect that volumes will increase significantly, admittedly from extreme levels, as the margin chart makes clear. "Buyout volumes will top 2009 levels" is hardly the bravest prediction we've made.

Pets at Home is an interesting deal, in our view. In it, KKR bought the company from another buyout shop (who had themselves bought it from a financial sponsor). According to S&P LCD, the deal size was £955m, with debt of £400-500m. In other words, the equity cheque was large (as you would expect from KKR) but the equity contribution was pretty high. The lessons from this seem to be:

- Debt is available, for sensible deals with restrained leverage.
- Equity is available; indeed, high equity contributions are actually a neat way of squaring the circle between the big buyout houses having significant "dry powder" and deal sizes being smaller

As well as relatively lowly levered buyouts, we share the consensus view that growth capital deals, which have always used relatively little leverage, should grow in importance. At the same time, Partners has made the interesting point that the style of private deal has largely evolved from distress to value. This is pretty evident, for instance, in the behaviour of the leveraged loan market.

Chart 59: S&P Flow name



Source:S&P LCD, Banc of America securities-Merrill Lynch research

The descent from par to 60 was, in our view, a truly remarkable episode in the credit crunch (the broader "ELLI" index sunk even further). Although no doubt some of this reflected distressed companies, the vast bulk of it clearly reflected distressed owners and vendors. From where we are now, on average, levered loan investors in the more liquid names are broadly back to where they thought they were all along, collecting coupons.

So, for private equity, 2010 will probably be a "back to basics" year, where assuming the economy doesn't collapse, good investments will be made, and some good realisations booked. The cyclical nature of the IPO market may be an issue here, but in our view people tend to over estimate the importance of IPOs for private equity sales. Secondary buyouts and trade sales have typically been favoured means of exit by the industry, as they offer greater certainty. Finally, we would expect to see some demand for new funds in the more promising-seeming areas.

Hedge funds

Saving the best to last, we strongly believed that the hedge fund industry should have a good 2010. This is simply because, as we have argued in the main body of this note, the industry provides what investors both need and, in our opinion, want. Need is pretty clear; hedge funds have led the way in aiming to manage risk as well as reward. Want is clearly more a matter of psychology than facts. Our belief, set out above, is that “this time it’s different”. If so, the clear winner will be the hedge fund industry.

We also believe that the recent upheavals may have had the perverse benefit of underlining to the industry that it ought to look to diversify its distribution. Following the crunch, managers have become much more open to ideas like managed accounts, onshore products and the like. This should, we think, speed up adoption of hedge-like strategies across the marketplace.

Service providers

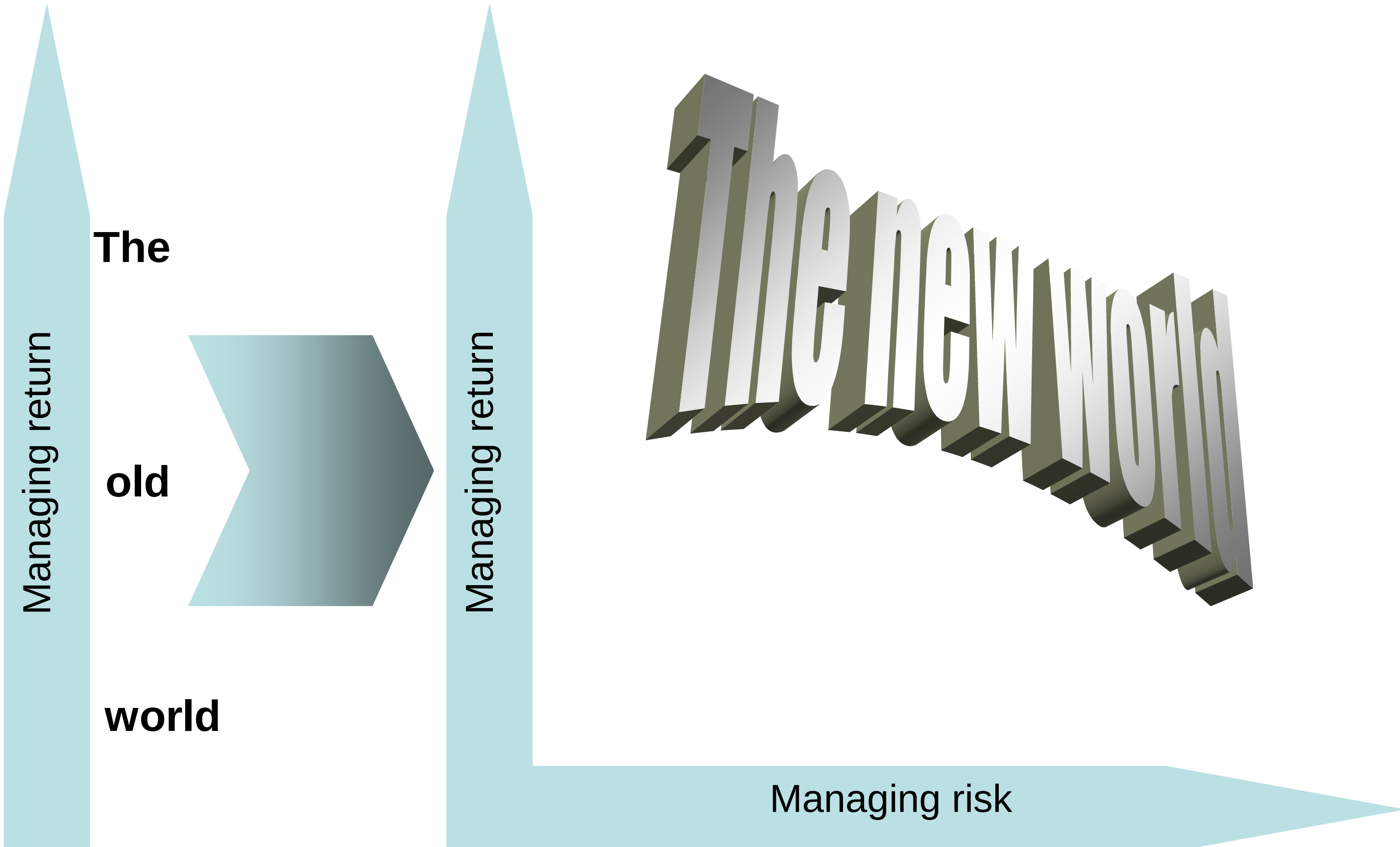
We continue to believe that the increased implementation of risk controlled investment approaches is good for investors. It is also good for those who make a living selling these products to managers – banks, exchanges, IDBs and so on. It is also good for technology providers and other outsourced businesses like GlobeOp. The “selling picks and shovels to the miners” businesses can only benefit, we think, from a proliferation of miners, which is what we are seeing now.

Overall

New times call for a new graphic. We summarise below the thesis which we have argued for most of this note.

Mainstream asset management is moving from 1D to 2D, on both sides of the Atlantic.

Exhibit 2: Mainstream asset management – from 1D to 2D



Source: BofA Merrill Lynch research

We simply fail to see why investors should act as if it is better to have assets managed using old technology when new technology is available. We remember vinyl records with some affection (contrary to rumours, we have no particular views on 78s), on the basis that you got nice covers with them, but we have no wish at all to go back to that era, simply because digital technology is so much better. We also have childhood memories of the household car not starting due to damp spark plugs, defective widgets and the like. We remember our first colour TV set, which certainly enhanced the snooker-watching experience. We have no wish to revert to these; nor do we believe investors should opt wholesale for unhedged active equity mandates. There is a place for active long only equity as a source of alpha; there is a place for equity beta; we see no reason why the former style should be so dominant, though.

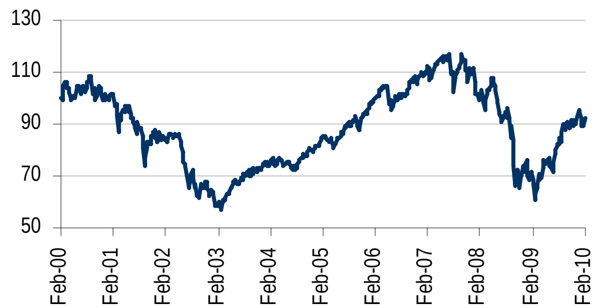
This is not to say that full equity long/short is the way to go. This works for some people, but others could quite reasonably opt to avoid idiosyncratic shorting, which can be a treacherous occupation. Our middle ground chart shown earlier, though, demonstrates that there is a wide range of styles which lie between active core equity and full hedge.

Our key message, though, is clear; we will not return to the way we were; this time it is different. Demand post crunch will evolve rapidly away from core beta-like offerings to more risk managed products.

Appendix - Background charts

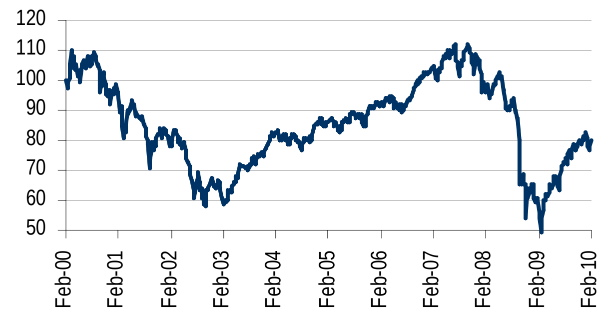
We show below the performance of some key local markets. All are in local currency aside from Asia, which is in US$.

Chart 60: FTSE All Share



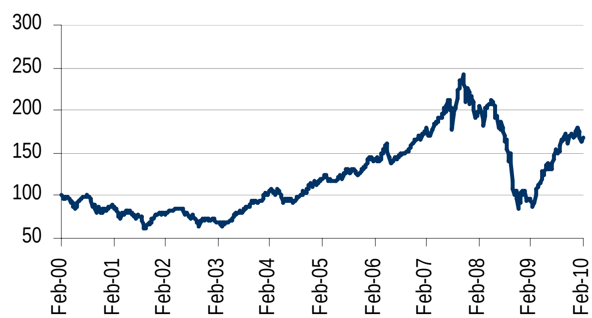
Source: DataStream/Banc of America Securities-Merrill Lynch

Chart 61: S&P Composite



Source: DataStream/Banc of America Securities-Merrill Lynch

Chart 62: FT World Asia Pac ex Japan

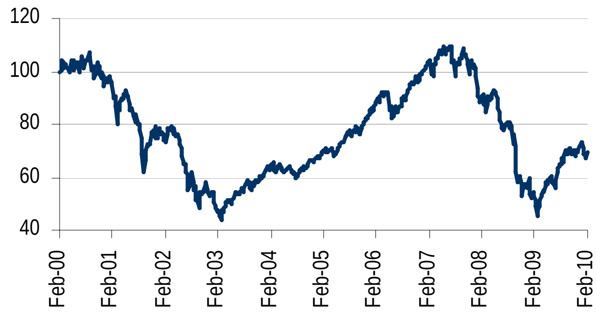


Source: DataStream/Banc of America Securities-Merrill Lynch

Chart 63: Nikkei 225

Source: DataStream/Banc of America Securities-Merrill Lynch

Chart 64: FT World Europe ex UK

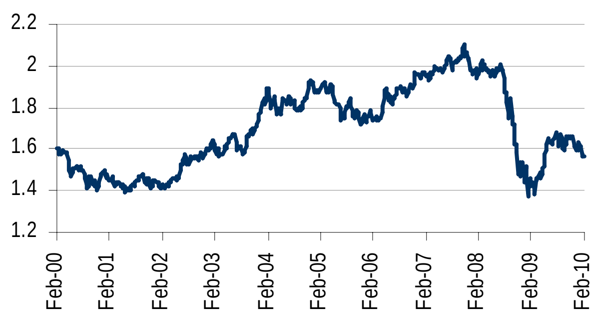


Source: DataStream/Banc of America Securities-Merrill Lynch

Currencies

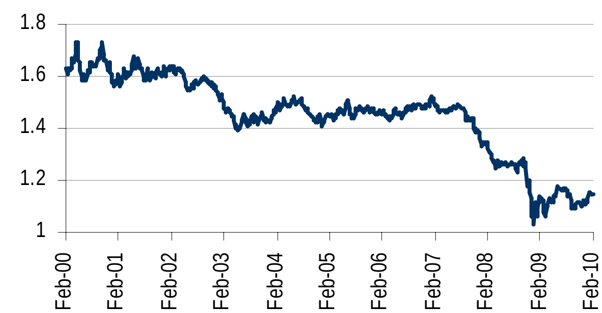
Below, we show the Sterling exchange rates with the US$ and the Euro.

Chart 65: $/£



Source: DataStream/Banc of America Securities-Merrill Lynch

Chart 66: £/€

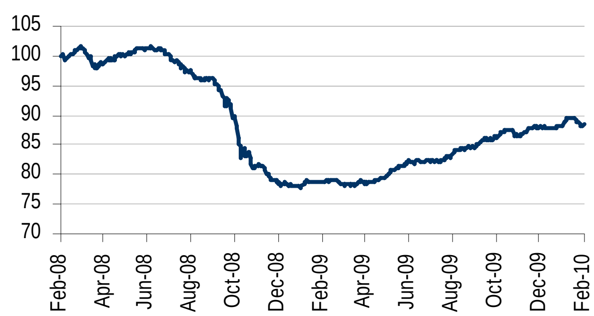


Source: DataStream/Banc of America Securities-Merrill Lynch

Hedge Funds

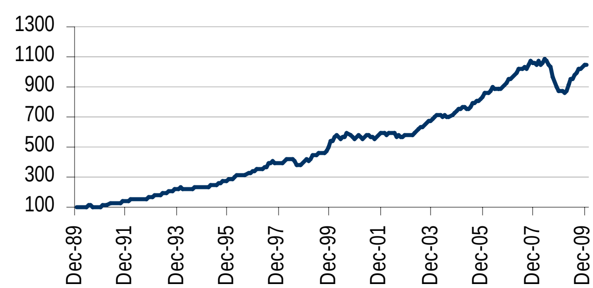
Finally, below we show the HFRX, the HRF daily investible index, and the HFRI.

Chart 67: HFRX



Source: HFR/Banc of America Securities-Merrill Lynch research

Chart 68: HFRI Composite



Source: HFR, BofA Merrill Lynch research

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Investment rating	Total return expectation (within 12-month period of date of initial rating)	Ratings dispersion guidelines for coverage cluster*
Buy	≥ 10%	≤ 70%
Neutral	≥ 0%	≤ 30%
Underperform	N/A	≥ 20%

* Ratings dispersions may vary from time to time where BofAML Research believes it better reflects the investment prospects of stocks in a Coverage Cluster.

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