ZEN AND THE ART OF MUTUAL FUND MAINTENANCE

JULY 2010

INTRODUCTION

'The test of the machine is the satisfaction it gives you. There isn't any other test. If the machine produces tranquillity it's right. If it disturbs you it's wrong until either the machine or your mind is changed.'
Zen and the Art of Motorcycle Maintenance (Robert Pirsig, 1974)

The funds industry periodically discusses how to better understand investors. With uncertainty still in plentiful supply despite bumper fund sales in 2009, such discussions have continued apace in 2010.

Asset managers' and financial intermediaries' efforts to meet and manage their clients' expectations are not new. But the see-sawing of fund sales over recent years provides a good opportunity to offer some different perspectives on where consumers have invested and the way that fund companies compete to increase such investment in their particular range of funds.

IN THIS REPORT, ANSWERS WILL BE SOUGHT TO FOUR KEY QUESTIONS:

- **How concentrated are sales?**
  The degree to which sales are concentrated in a small number of funds is examined by looking at ten of the most popular sectors and analysing the proportion of sales attributable to the most successful one, five and ten funds.

- **How much does performance affect sales?**
  In this section the performance of pan-European equity funds is compared to their net sales between 2002 and 2010. Sales are assessed each quarter through rolling performance periods of one year, three years and five years.

- **Land of Lilliput or Brobdingnag?**
  Closer scrutiny of the concentration of assets under management and sales flows for different fund companies provides insights into what sort of impact smaller players are likely to have in shaping the industry landscape.

- **Why hasn't competition lowered charges?**
  This is one of the most frequently asked questions about European fund fee levels. The answer reaches to the heart of both the way funds are distributed, and the way fee structures are determined.

AUTHORED BY:
ED MOISSON
HEAD OF CONSULTING, LIPPER FMI
ed.moisson@thomsonreuters.com

HOW CONCENTRATED ARE SALES?

First up is an examination of the degree to which sales flows are concentrated in a small number of funds. Such figures are crucial for asset managers considering whether to launch funds and take advantage of investor appetite for different product types. This leads to the question of whether companies are willing to risk accusations of launching a 'me too' fund — of adding little to the plethora of funds already crowding the market.

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Previous research[1] demonstrated the degree to which bank-owned asset managers rely on new fund launches to generate sales through proprietary channels, which contrasted with 'pure' asset managers selling through third parties (e.g. cross-border funds selling to professional fund buyers or UK fund managers selling to Independent Financial Advisers). As a result, and also reflecting where the bulk of recent European sales activity has taken place, this analysis will focus on cross-border funds. Specifically, ten of the most popular sectors in terms of net sales through 2009 were selected and the proportion of net sales then attributed to the most successful one, five and ten funds.

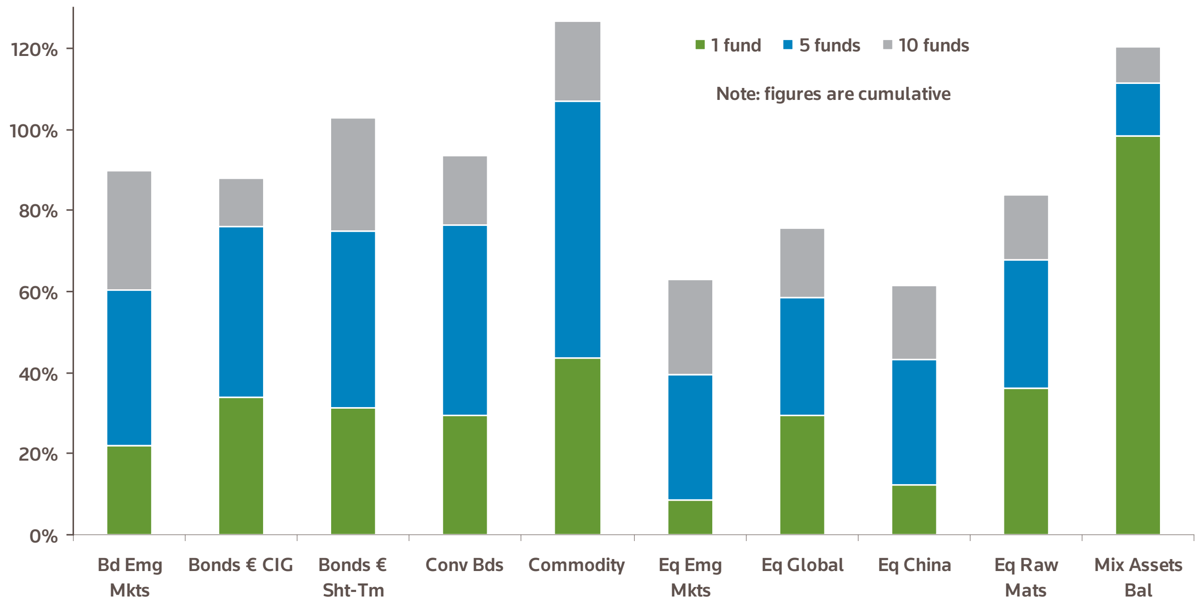
Taking last year's big success story — European corporate bond funds — as an example, the most successful fund in the sector achieved net sales of €7.1bn, which accounted for 34% of the flows into the sector. The next four most popular funds accounted for a further 42% of sector sales, and the following five funds added a further 12% to the sales total. So together, the ten funds enjoying the greatest net sales accounted for 88% of all sales into cross-border European corporate bond funds.

Of course most reasonably sized cross-border fund companies will not launch a new product in isolation. Relations with distributors, the gatekeepers to investors, are crucial. There will certainly be cases where the largest fund companies will have little choice but to launch funds in order to meet distributors' expectations that they are able to offer a wide array of products that meet different investment needs at different times.

Before launching funds in successful sectors, fund companies have to take a view on different aspects, such as how long interest in that sector will last, whether the company has the relevant investment capabilities in-house, and whether their fund can be marketed differently from apparently similar products. This new analysis raises the question of whether new products in these popular sectors really have a chance of attracting reasonable sales.

[1] See Lipper FMI's report, *Profiting from Proliferation?*

FIGURE 1 CONCENTRATION OF FLOWS



The chart suggests an apparent difference between equity and bond funds, with a greater concentration of flows into fewer products for the latter. Not only are there more than twice as many cross-border equity funds as bond funds, but also with the European industry having been turned upside down over the past couple of years, perhaps the greater concentration for fixed income products could be expected: desperate search for income resulted in many piling in to previously lesser used products.

For equity funds, this might reflect an historical legacy with professional fund buyers well-used to picking over a huge array of equity funds and analysing fund managers' stock picking abilities. The lower concentration of sales seems to present sales opportunities for far more fund companies — on average ten funds in these equity sectors attracted 71% of sector flows, but 91% for bond sectors — so this data was dissected further. The same analysis for 'core' equity sectors of Europe and North America suggests a concentration of flows even more extreme than for bonds! This is not a simple asset class difference, but reflects issues specific to each sector and recent market conditions.

The chart also highlights another distinguishing feature of 2009, Carmignac Patrimoine's phenomenal success. This one fund drew in 98% of the Mixed Assets Balanced sector's €10.2bn in net sales in 2009. Certainly without Carmignac this sector would have passed by unnoticed. Even though there was speculation by BBVA in Spain as to whether this scale of inflows could be managed by one company, the continued pace of sales suggests that no one else shares such concerns.

Traditional mixed asset funds, whilst numerous, are far less likely to see a significant pick up in sales in the current environment and it seems unlikely that any redemptions from Patrimoine would flow into competing products. This view has not stopped others launching similar products, with more funds being launched recently than for any other sector [2] — 91 funds over the six months to the end of April.

[2] This excludes guaranteed funds as such funds are often launched automatically when previously launched guaranteed funds expire.

FIGURE 2 RECENT FUND LAUNCHES

SECTOR	FUNDS LAUNCHED OVER PAST 6 MONTHS	FUNDS LAUNCHED OVER PAST 3 MONTHS
Mixed Assets Balanced	91	48
Asset Allocation	77	39
Equities Global	68	30
Bonds EUR	52	27

While this 'Balanced' classification requires an investment policy that maintains a balance between equities and bonds, those mixed asset funds with no asset allocation restrictions and often with an objective of seeking absolute returns have also seen a recent boom in new launch activity — 77 funds over the six months to the end of April.

Having mentioned 'traditional' mixed asset funds, more recently in vogue have been 'multi-asset' funds, which have expanded their horizons beyond equities and bonds to invest in commodities, real estate, even making use of derivatives and greater use of cash in tougher market conditions. Such activity has boosted both of the sectors currently topping the league table of fund launches (depending on exactly how flexible a fund's asset allocation is).

'Asset allocation' funds are those with no restrictions on their asset allocation, potentially being fully invested in equities if markets are bullish, or swinging to 100% bond exposure if conditions change. They are usually absolute/total return funds. In a similar vein, asset allocation funds of funds (often styled as funds of absolute return funds) have also been a popular sector for launches over the past 6 months — adding a further 34 funds.

One note worth making on the European bonds category is that many of these are exchange-traded funds (ETFs), reflecting the expansion of these products beyond their initial stock market offerings, particularly at a time when there are such wide — and rapid — variations in investor sentiment towards equities.

HOW MUCH DOES PERFORMANCE AFFECT SALES?

Reputations are made and lost on fund managers' ability to generate performance year in, year out. But how big an impact does performance have on the share of sales fund companies achieve?

In this section the performance of pan-European equity funds is compared to their net sales between 2002 and early 2010. As in the previous section, the universe is restricted to cross-border funds in order to create a more comparable universe of funds, particularly in terms of their distribution. Fund performance is assessed through rolling periods of 1-, 3- and 5-years each quarter. Funds are ranked by quartile for each rolling performance period: 25% of those funds in any given period that have the best performance are ranked first quartile, the next best 25% are ranked second quartile, and so on.

These peer rankings are compared to the net sales in each quarter succeeding a rolling performance period. For example, funds' performance over one year to the end of June 2005 is compared to their net sales in the quarter from the end of June 2005 to the end of September 2005.

FIGURE 3 1-YEAR PERFORMANCE V NET SALES (€M)

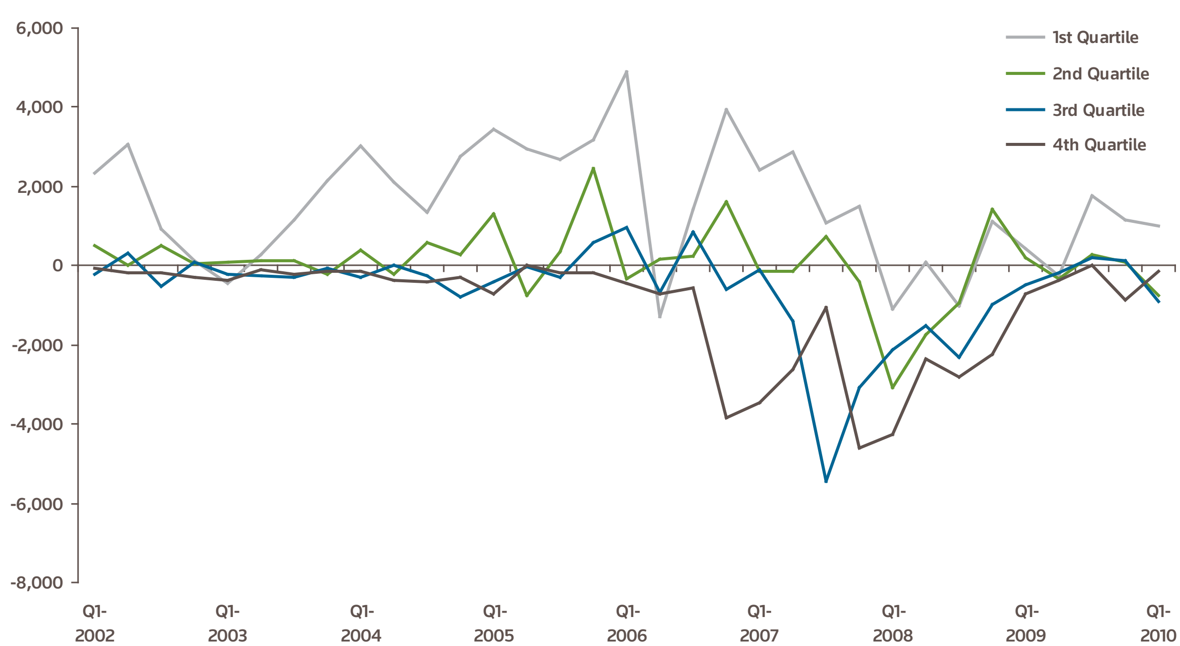


FIGURE 4 3-YEAR PERFORMANCE V NET SALES (€M)

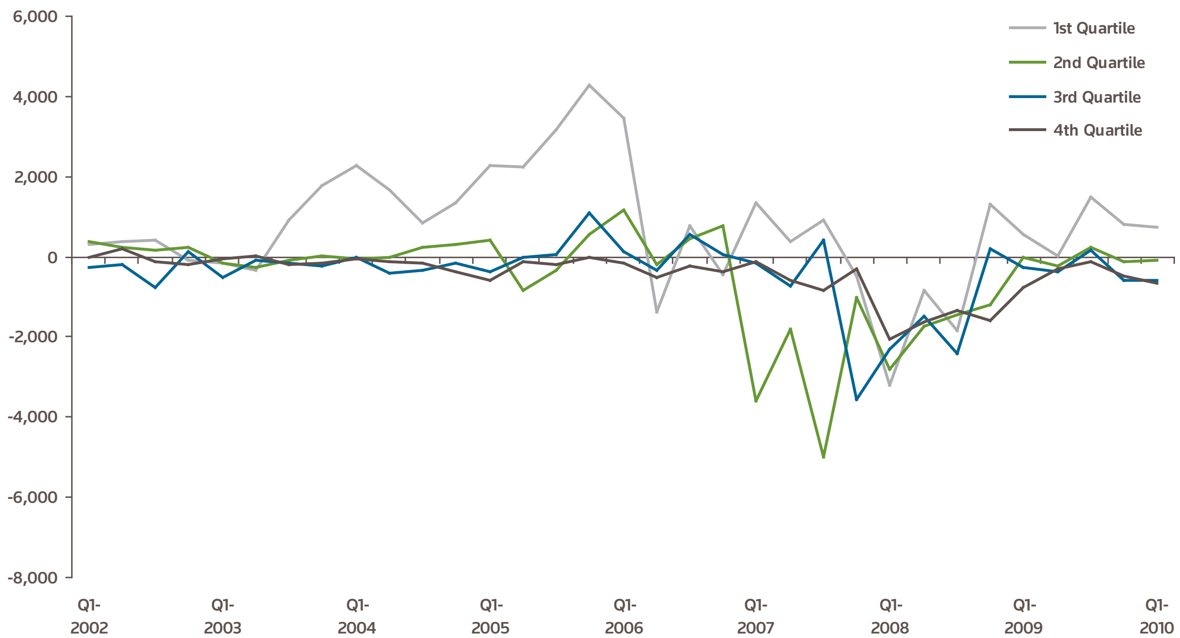
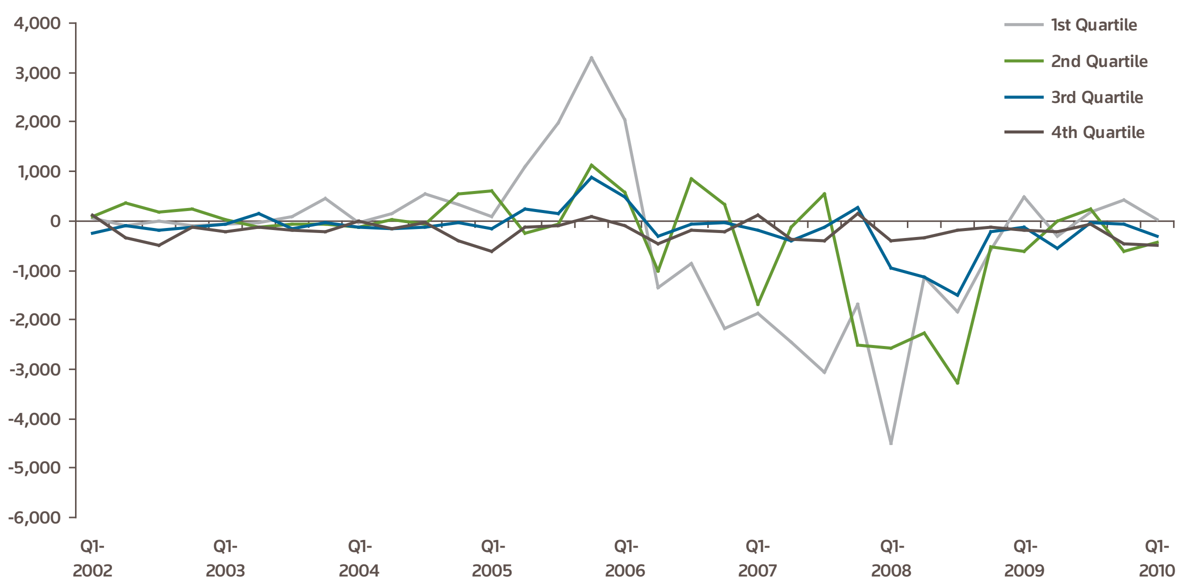


FIGURE 5 5-YEAR PERFORMANCE V NET SALES (€M)



The charts clearly illustrate the importance of achieving first quartile performance in order to attract a decent slice of the sales 'pie'. This is most pronounced when looking at 1-year performance, with 85% of the 33 periods assessed seeing first quartile funds achieve the greatest net sales. For 3-year performance, this relationship weakens slightly, with first quartile funds achieving the greatest net sales in 75% of periods. For 5-year performance this relationship virtually disappears altogether, with only 33% of periods seeing first quartile funds achieving the greatest sales.

The analysis also reveals that for funds with a 1-year performance track record, total quarterly sales averaged €1.6bn for first quartile performers, €73m for second quartile funds, redemptions of €617m for third quartile funds, and the worst performers suffered redemptions of €1.1bn.

The same figures for funds with 3-year performance only show a positive quarterly sales average for first quartile funds. Finally, for funds with 5-year performance, the quarterly sales averages show no clear pattern, except that all were in redemption. Total quarterly redemptions averaged €331m for first quartile performers, €325m for second quartile funds, €164m for third quartile funds, and €212m for fourth quartile funds.

The charts also highlight the differing impact of different market conditions. In the period of rising markets (between Q3-2003 and Q1-2006) first quartile funds (based on 1-year performance) on average attracted 88% of the net sales for those quartiles generating positive sales, with second quartile funds taking the remainder. For 3-year and 5-year performance, the equivalent figures are 95% and 76%.

When markets fell most recently (between Q2-2006 to Q1-2009), first quartile performance over one year made the difference between positive and negative net sales, while it minimised the scale of redemptions for first quartile performance over three years.

Does the winner take it all? Not all, perhaps. But a stellar 1-year performance record is clearly vital in securing a significant level of sales. This is all the more pronounced in rising markets and helps to minimise redemptions in falling markets. For all the discussion of the importance of sustained performance over longer time periods, 3-year and 5-year returns are simply not as important for securing the lion's share of sales.

LAND OF LILLIPUT OR BROBDINGNAG?[3]

IS THE EUROPEAN FUNDS INDUSTRY LORDED OVER BY GIANTS OR OVER-RUN BY LILLIPUTIANS?

2009 was marked by a net reduction in the number of funds available to investors, a rare occurrence in the European industry. But the fall in the number of funds was not as great as some expected, primarily because this closure and merger activity was accompanied by fund launches at levels not far off those seen in the more buoyant times of 2002 to 2004.

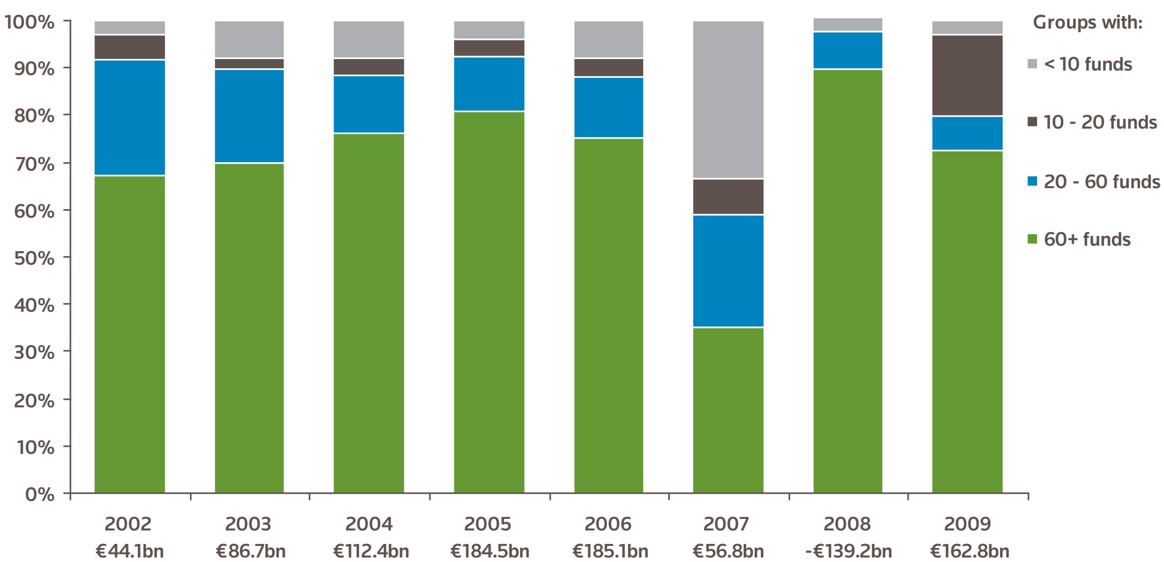
With such activity in mind, closer scrutiny of the concentration of assets under management and sales flows for different fund companies provides insights into what sort of impact smaller players are likely to have in shaping the industry landscape. This is also relevant when considering the relationship between funds' performance and their sales.

Long-term cross-border funds' (i.e. excluding money market funds) annual sales can be divided between the size of each company. Here 'giants' are those companies with 60 or more mutual funds, with the remaining companies split between those managing 20 to 59 funds, those managing 10 to 19 funds, and the smallest players managing fewer than ten funds. Interestingly, an immediate guide to the fragmented nature of the industry is revealed, with 44 companies qualifying as 'giants', 48 and 61 companies feature in the two intermediate categories, but around 400 groups are in the smallest category, i.e. more than 70% of all cross-border groups[4].

Turning to the net sales for these groups, the largest groups attracted an average 71% share each year. However, this total varied between 35% in 2007 (many of the largest groups had already begun to suffer redemptions) to 81% in the boom year of 2005. Indeed as markets rose from 2002 through 2005 the largest players increased their overall market share.

Many of the smaller players were able to gain real traction in 2007, with their share of sales totalling 65%, just over half of this (33%) coming from those groups with fewer than ten funds. Meanwhile 2009 was the year when cross-border groups with 10 to 20 funds made headway, taking their share of fund sales to 17%.

FIGURE 6 GIANTS AND BOUTIQUES



[3] See Jonathan Swift, *Gulliver's Travels* (1726).

[4] The exact numbers of companies varies each year, so while the smallest grouping in any given year is around 400, throughout this period some 579 groups featured.

With the largest groups controlling such a high proportion of sales activity, perhaps the others are just fighting over the scraps. But do not forget that the universe of funds examined here average annual net sales of just under €100bn — fighting for even a small slice of the remaining 30% of these sales (i.e. after excluding the giants) must be worth it.

This also poses questions as to just how far fund buyers look down the list of fund groups to dig out some of the nuggets among the smaller players. Of course, on the assumption that fund buyers do take on the considerable task of investigating other companies beyond the largest players, this data could suggest that too many of the smaller players are simply unable to distinguish themselves from the rest of the chasing pack.

This analysis also links to the previous section; if the biggest players control the largest proportion of sales, they are also likely to be benefitting most from having first quartile performing funds. (As well as suffering the largest redemptions when their funds fail to perform.)

One other aspect to highlight from this analysis is that the largest groups actually saw 90% of the industry's sales-related activity in 2008, but this was not something to shout about too loudly — this was a share of net redemptions, not inflows.

ACROSS THE ATLANTIC

While the European industry seems quite fragmented (especially when considering the analysis above solely covers the cross-border players) some context can be provided by a comparison with the US. That the US has around 8,000 funds, while Europe has nearer to 30,000, is well established, as is the fact that the latter has a much lower average fund size. But it is worth digging a little deeper to see if a fuller picture can be painted.

In both Europe (here including both cross-border and domestic activity) and the US, 5% of groups manage 80% of industry assets under management. In Europe this relates to 72 fund groups, while in the US — with fewer fund companies overall — this relates to just 29 groups.

At the other end of the scale, 63% of European groups manage five funds or fewer (960 groups in total) while in the US the same figure is 67% of groups (420 groups in total). Although just serving one market, the US industry still has a high proportion of small players. Having said this, these same groups (with five funds or fewer) on average manage assets of €120m in Europe, but a healthier €650m in the US.

In an area examined more closely in the next section, in Europe many of the smaller companies are running a completely different business model from the big players. Those small companies with a handful of funds are likely to have a tiny investor base and limited distribution, they tend to pass on fund costs to investors (rather than capping Total Expense Ratios), and they rely on performance or niche investing strategies to attract clients. The ability for the industry to have developed in this way reflects the low barriers to entry.

With such dynamics at work, if European funds are really to change their attitudes to issues such as fee levels or the size of a product range then it will have to be a change brought about by the titans of the industry — the largest fund companies and their distribution partners.

WHY HASN'T COMPETITION LOWERED CHARGES?

One of the most frequently asked questions about fund charges is 'When there are so many funds in Europe, why does this competition not drive down fees?' The answer to this question reaches to the heart of both the way funds are distributed, and the way fee structures are determined for many, many funds in Europe.

The assumption that competition leads to lower prices (or lower fees borne by mutual funds) is based on the economic model of supply and demand. This can be taken as the idea that in a competitive market, price will act to equalise the quantity of a product demanded by consumers and the quantity supplied by producers, resulting in a balance of price and quantity.

Of relevance to the funds industry is, first, whether investors are motivated by price and, second, the degree of direct influence that end-consumers have in determining price. On the first issue, no evidence has come to light in Europe that a significant proportion of retail investors are motivated by annual fee levels. (Here 'significant' really means 'big enough to influence the level of fees fund companies charge'.) However institutional investors are much more likely to push for better terms and the size of their investments obviously gives them greater clout to achieve this. These differing attitudes can be seen in historical changes to fee levels, generally rising for retail investors but falling for institutions (see figure 7).

On the second issue, the fact that the funds industry is an intermediated market cannot be overlooked. Be it most commonly through Independent Financial Advisers (IFAs) in the UK, private banks in Switzerland, or retail banks in Germany and Spain, the vast majority of retail investors do not invest directly with fund companies. As a result it is these intermediaries that can bend the ear of fund companies on fee levels and product offerings.

In assessing the fee levels that mutual funds charge, the importance of the cost of distribution is critical, not just in the way it impacts investors, but also for fund companies trying to ensure that their opportunities for sales are maximised. This then presents two competing pressures. On the one hand, there is downward

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FIGURE 7 **FEE EVOLUTION**

	RETAIL CLASSES		INSTITUTIONAL CLASSES	
	Total operating expenses	Management fees	Total operating expenses	Management fees
Latest	1.93%	1.58%	1.07%	0.85%
End-2004	1.87%	1.51%	1.16%	0.87%
End-1999	1.75%	1.38%	1.29%	0.99%

Note: Asset-weighted averages for cross-border actively managed equity funds.

pressure from cost-sensitive investors. On the other hand, there is upward pressure from distributors coupled with natural resistance from fund companies to cut into their revenues. This turns in a circle as fund groups take a view on what degree they can take a hit on revenues, depending on the degree to which investors are motivated by price (as discussed above).

Returning to retail investors, it is reasonable to assume that most cost-sensitive self-directed investors will most likely invest in passively managed products, be they index-tracking funds or ETFs. Specifically in the UK such an attitude may well be accompanied by a more favourable view of closed-ended funds (known as investment trusts), which generally do not pay annual fees to distributors, and on average have lower total annual operating expenses than their open-ended cousins. If this assumption is correct, then even among cost-sensitive investors, most open-ended fund providers will not feel greater pressure to lower their fees on actively managed funds — although they may see the benefit of having at least one index-tracking product in their arsenal.

Such a benefit is much more likely to become a necessity in the UK in light of the FSA's Retail Distribution Review (RDR), which aims to split clearly costs relating to a product from costs relating to advice. It can be anticipated that many actively managed funds will set up share classes for retail investors that do not include annual distribution fees (known as trail commission in the UK), while most passive funds are already 'trail free'.

Some complaints about the proposed changes (notably that those investors who currently pay product-related commissions will later be unwilling to pay advice-related fees) lead one to pose the question as to whether commission-paying investors fully understand that they are paying to invest and that these commissions affect their returns.

ARE FUNDS LIKE FOOD?

These dynamics help to explain the fee levels generally found in Europe, particularly among those funds sold cross-border into multiple countries. In trying to find parallels with other industries to explain this phenomenon, supermarkets/food stores are a useful analogy. Here consumers are often cost-conscious and, as a result, supermarkets — the food industry's intermediaries or distributors — are proactive in trying to minimise the costs involved in stocking their shelves, i.e. by squeezing farmers.

In this way some of the largest supermarket chains have built their businesses by competing on price, such as Lidl across Europe, or Wal-mart in the US, or the latter's UK subsidiary Asda. At the other end of the scale, Waitrose (UK) and Whole Foods Market (US) stand out for marketing themselves based on the quality of their food, rather than their low prices. It is interesting that these latter 'high quality' supermarkets are much rarer to find. Much more likely is to find a supermarket that generally emphasises its competitive pricing, while combining this with niche ranges of higher quality food (and higher price tags to match).

The funds industry contrasts sharply with supermarkets when it comes to marketing in this way to the extent that non-price competition dominates[5]. It is hard to think of any European fund company that targets less affluent investors because the primary cost to such investors is not the fees or commissions they pay, but the initial investment (€5,000 or €10,000, say). Instead many fund companies argue that investors have to pay more in order to get more in return — however limited this approach is in reality[6].

For the food industry, this gives great power to supermarkets, while for the funds industry it gives power to distributors and professional fund buyers.

Of course the pricing pressure that supermarkets are able to place on farmers often reflects the types of products that are being sold. While a dairy farmer might produce different types of milk (for example, with varying cream content) ultimately there are still similar products, so the ability to negotiate on price is limited. The price that the consumer pays for a litre of milk at any one time may vary, but this will largely reflect the pricing/profitability strategy of the distribution channel (national supermarket, small chain of stores, or corner shop) and to a lesser extent the cost of milk production.

[5] On this general concept, see S.Brue, C.McConnell, *Economics – Principles, Problems and Policies* (McGraw-Hill)

[6] See also Lipper's report *Fee Fi Fo Fum*

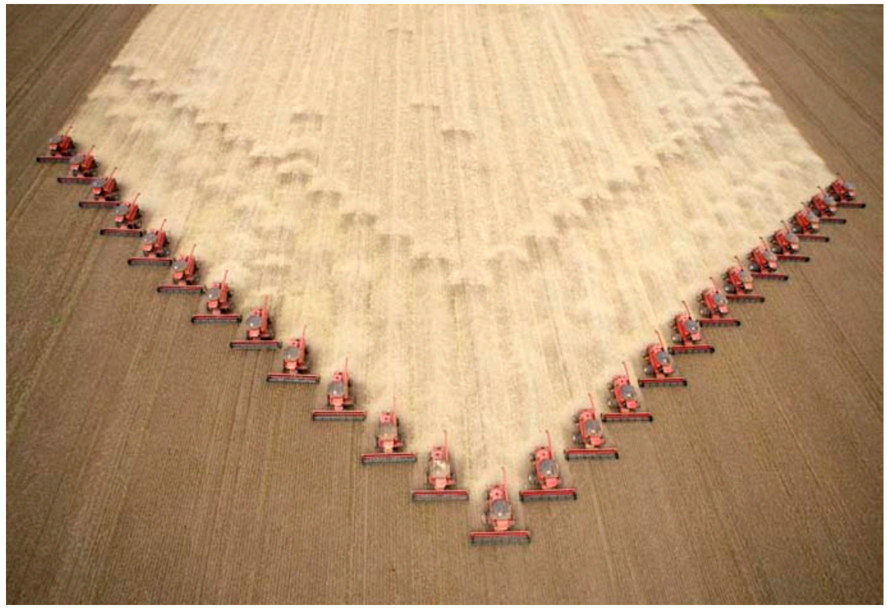
In the funds industry, the barriers to entry are low and the higher costs involved for smaller funds from small companies can often be passed on to investors. As a result, product providers proliferate. Actively managed funds cannot be commoditised in a way that milk is, not least because fund investors are buying an expectation of future performance, or 'hope', in the words of PIMCO's Bill Gross, and 'hope has a legitimate price'[7].

This is where the threat posed by passive funds comes in: getting closer to the commoditisation of mutual funds. ETFs and index-tracking funds reduce costs by not paying distribution fees and by reducing the cost of fund management, thus reducing the drag on fund returns. The active fund manager is effectively removed from the equation; fund performance is reliant on the market.

[7] See PIMCO Investment Outlook, *Investment Potions* (August 2009)

FINAL COMMENTS

By analysing fund sales activity in different ways, insights into the relationship between asset management companies, distributors and investors have been revealed.



REUTERS/PAULO WHITAKER

The findings on the concentration of sales activity for the most popular sectors — with over one third of sales on average moving into a single fund — sound a note of caution for asset managers considering new product launches, as well as highlighting the apparent herd instincts of distributors recently.

Apart from the initial sales activity when a fund is launched, then a stellar 1-year performance record is virtually essential in order to generate significant inflows. In 85% of the periods assessed, first quartile funds achieved the greatest net sales based on 1-year performance. However this proportion fell to 75% for 3-year performance and virtually disappeared for 5-year performance, with only 33% of periods seeing first quartile funds achieving the greatest sales.

With the ongoing pressure to increase assets under management — a pressure that is not likely to let up as more and more fund managers promote their ability to achieve absolute returns in all market conditions — then it is difficult to see how larger fund companies, particularly the cross-border players, can reduce the size of their fund ranges while still maximising opportunities to build relationships with different distributors in different markets.

This has a knock-on effect for fee levels and the need for asset managers to maintain good relationships with distributors (and for distributors to view product providers' funds as financially viable for them). Mutual funds have not been 'commoditised' (90% of European assets in long-term mutual funds are actively managed) and investors pay for a fund manager's skill and for the hope or expectation of future good performance. It is in this environment that annual fee levels for cross-border funds continue to rise for retail investors, but are falling for institutions.

It will take seismic shifts in the European landscape for these dynamics to change.