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Investment Management Review

DANGEROUS TIMES AHEAD FOR WEALTH MANAGERS

The top-down and bottom-up forces changing industry prospects (p3,6)

Plus

LEADING PENSION FUNDS CUT BACK ON ALTERNATIVES (p28)

Sea changes in hedge funds and private equity (p29)

VIRTUES OF INFRASTRUCTURE INVESTMENT QUESTIONED (p33)

Asset managers' limited interest in sector

FROM THE EDITOR:
UNFASHIONABLE SIDES OF KEY INVESTMENT DEBATES

Four different investment controversies have received much attention in recent months. In each case, the popularly accepted or fashionable view is not all there is to it, with opposing arguments that need to be seriously considered. Smart beta and closet indexing are two of the topics. The third postulates that individual fund managers should have 'skin in the game' by investing in their own funds. The fourth debate deals with the merits and demerits of promoting superstars, vis-a-vis a team approach.

Though smart beta and closet indexing are disparate concepts, both have a connection through passive investment. The words 'smart' and 'closet' reflect value judgments that dictate what the concepts stand for, resulting in smart beta having become all the rage and closet indexing being almost universally reviled. However, the actual practices that can give rise to the description closet indexing do not, at least in some cases, deserve the appellation. Some so-called 'closet indexing' is perfectly acceptable, although a lot of it is clearly bad. Similar considerations apply to smart beta. It can stand for genuine and much-needed alternative indices, but also for active portfolio managers, albeit of the quant type, masquerading as index providers and effectively misrepresenting their product, though not illegally.

What about 'skin in the game'? The idea is that if fund managers invest in their own funds, their interests are aligned with those of the underlying investors. This is an illusory concept, though intuitively appealing. This can only be the case if their risk profiles are similar. Considerations of unfairness also militate against 'skin in the game'. In many cases, the company can lose out by insisting on this.

In the case of the fourth debate, the promotion of superstars, the verdict tends to be more mixed in general. Currently, the industry is undergoing a phase when it is fashionable to decry the superstar culture, a fashion that has much to do with Bill Gross's ignominious departure from Pimco. Neil Woodford exiting from Investco Perpetual, with a large chunk of funds flowing out after him, added further grist to the mill of superstar detractors. The emotional swing against this culture was such that Larry Fink, the Head of BlackRock, felt that it was a good time to remind everybody that it had always had a team culture. Pimco also hastened undignifiedly to jump on the team bandwagon in several newpaper advertisements, ignoring the fact that its very roots and growth owed much to their erstwhile legend, and a more gracious approach might have come across better.

The fact is that, regardless of current fashions, whether or not a company should encourage the growth of superstars, or damp down individualism at the other extreme, is a matter of horses for courses. A lot depends on other factors, including the company's circumstances. Retaining the really talented is assisted by allowing them to develop a public profile.

A common thread runs through these four controversies. Just as in selecting securities, herd thinking is clearly prevalent in these matters of importance in the investment process. To be fair, looseness in the use of investment concepts such as smart beta leads to their corruption and marketing has much to answer for this. To an outsider, all this might be somewhat amusing, but in every case adoption of the wrong popular view could have serious consequences for the investing institution. Critical analysis of conventional wisdom pays.

Arjuna Sittampalam, Chartered MCSI
Editor

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REVIEW OF WHAT OTHERS HAVE SAID

It is impossible for busy people to read everything that is published about their industry. This section of the magazine includes reviews of some of the more interesting recent outputs from a wide variety of sources, together with editorial comments, as well as our own research. The items included have been selected for their potential long-term significance, in line with the ethos of this magazine.

In cases where the article is attributed to Sage & Hermes Research, the content includes our opinions, understanding and research, but we also draw upon other sources too numerous to be mentioned. We are indebted to a large number of publications in the industry, including the printed and the electronic media, for information.

DANGEROUS TIMES AHEAD FOR WEALTH MANAGERS

FTfm – 'HSBC chief rejects Barclays Wealth model', Madison Marriage, 11.8.14; 'Europe private banks struggle to regain traction', Steve Johnson, 3.11.14 and 'Swiss franc pressures private banks', Madison Marriage and Chris Newlands, 26.1.15

Financial Times – 'Reforms shake up 'mass affluent' industry', Harriet Agnew, 12.8.14; 'Online wealth managers invade private banks' territory', Emma Dunkley, 14.10.14 and "Robo advisers' arrive to pose tech challenge for investment managers', Pauline Skypala, 28.10.14

'Wires crossed?', Andrew Barber, Institutional Investor, September 2014

euromoney.com – 'Keeping it simple – the strategy for the world's wealth managers' and "Shared' family offices – the next competitor to private banks', Market Focus, September 2014 and 'Innovating the wealth management industry', Helen Avery, November 2014

'Family Office', FT Special Report, 26.11.14

'Losing the human touch', Deborah Fuhr, Financial News, 25.1.15

> *The young are particularly prone to shift advisers, being quite hard-headed about what they are looking for*

Growth statistics pertaining to the world's affluent remain beguiling for the wealth management industry. Beneath the surface, however, conditions are not all that good and it might get much worse. Structural forces are in play that might seriously squeeze private banks and other established players, from both the top-down and bottom-up directions. If these, as yet, incipient pressures gather steam, firms will have to adapt in radical ways to prosper, or even to survive over the medium term.

Even before the financial crisis, the private banking sector of asset management was one of its fastest growing sectors. There is no change here. Global private household wealth grew by the very impressive rate of nearly 15%, to $152trn, in 2013, according to the Boston Consulting Group. In addition to equity-market performance, which can of course reverse, increasing wealth in emerging market countries had a lot to do with this. The number of millionaire households worldwide increased from 13.7m in 2012 to 16.3m in 2013. At the top end of the scale, those with more than $100m are becoming wealthier at a near-20% annual rate. It is estimated by the consultants, McKinsey, that the total profit pool available to private banking will grow to $70bn within three years.

However, private banking has already been encountering problems. Profitability at the majority of these banks has yet to reach pre-crisis levels, affected by the costs of regulation and competitive pressures.

But they also have cause to be concerned about likely future developments. The most worrying theme which magnifies the effect of various disruptive changes underway concerns customer loyalty. The pace of change has already led to a tendency for clients to be much less loyal than before to their existing advisers. The young are particularly prone to shift advisers, being quite hard-headed about what they are looking for.

The younger among the wealthy are exercising more clout than previously, partly because of wealth being handed down and a higher prevalence of successful entrepreneurs below the age of 40.

The robo challenge

The threat to private bankers from the bottom end of the market comes from what are described as 'robo advisers'. This term refers to the automated selection of investment portfolios. This service comes in two modes: discretionary investment management and advice where the customer makes the decisions. The former in particular employs passive algorithmic strategies based on investors' risk profiles, and tends to use index-tracking vehicles, often exchange-traded funds (ETFs). The annual charges for this service, including the cost of dealing in ETFs, are typically about 0.5%, compared with the much higher 1.5% or so levied by the traditional advisers. The growth of this new sector has been phenomenal. The 11 leading robo advisers are estimated to have been managing $19bn at the end of 2014, a near-70% increase over the corresponding figure for just eight months earlier, according to the consultancy Corporate Insight. The sector's global assets are expected to reach about $250bn in the next five years, as found by a study issued last September by MyPrivateBanking Research, based in Switzerland. The move to digital has lowered entry barriers, given the availability of facilities such as cloud computing.

The biggest of these robo advisers that provide the service with little or no human intervention, Wealthfront, was launched in 2011. Having started 2014 with assets under management (AUM) of $500m, it had acquired $1.7bn by the end of the year. Much of the growth has been in the US, which has 83% of the assets managed by these new players. In Europe, the trend has yet to take off on the same scale. Among the few there, Nutmeg, Moneyfarm.com and Vaamo, in the UK, Italy and Germany respectively, stand out. According to Dan Egan of Betterment, which has $1.2bn in the US, European companies might find it difficult to achieve the scale required for sustained profitability.

The younger among the wealthy are exercising more clout than previously, partly because of wealth being handed down and a higher prevalence of successful entrepreneurs below the age of 40

Despite the popularity of these services, critics abound. For instance, Pauline Skypala, the *Financial Times* columnist and former Editor of the *FTfm* points out that in the US a balanced low-cost index fund can be bought direct, posing the question: "Why bother with the robos at all?" Samuel Lee, ETF strategist at Morningstar, the research house, is also dubious as to whether the new groups add anything to what Vanguard already offers in its portfolio service. This index-fund giant does have a human element in its advisory process and would not use the term robo. Given these objections, the long-term future of these new services is considered by some to be cloudy, especially bearing in mind that they are still making losses. In part recognition of these uncertainties, some of the newcomers are moving to compromise by adding a human element, and in some cases linking up with established companies. Fidelity, for instance, is making the wealth management platform of Betterment available to 3,000 financial advisers who use its Institutional Wealth Service Division, providing web tools and apps to entice the younger generation.

Some leading players are already adapting. These include Bank of America and Morgan Stanley in the US, and the UK's venerable private bank Coutts, which are establishing digital services and platforms. Another big threat is that fund management companies increasingly have the capability to bypass private banks and wealth managers through mobile telephones.

Overall, it does look as if the hybrid model, combining digital and human elements, might be the way to go on both sides of the digital fence. It is estimated by Scorpio Partnership, a leading wealth consultancy, that 92% of investors around the world, with an average of $3m of assets, are already using digital services extensively. This presents a dilemma to the incumbent houses while not affecting the upstarts who are not burdened by historic structures. The big houses might have to cannibalise some of their existing client base which provides them with higher fees in order to go with the flow.

Families going their own way

Among family offices, which are entities dedicated to managing the assets of wealthy families, it is the multi-family offices (MFOs) that pose a threat to private banks at the top end of the wealth spectrum. Whereas the single-family offices (SFOs) require a minimum of $50m of assets under management (AUM), and ideally $150m, MFOs combine the assets of several families to achieve similar scale and enhance accessibility to expertise and investment opportunities.

These expanding MFOs are the threat to the family-offices divisions of the private banks

Corruption in terminology is clouding analyses of these family offices. Many leading global private banks have rich families as their clients in divisions set aside for the purpose, which are then called family offices. In fact, in Bloomberg's list of the largest family offices, many of the top ones are the largest of these bank divisions, rather than genuine family offices.

MFOs are often open to other families joining them and even seek them out. The typical model currently involves the original founding family charging the newer entrants fees. These expanding MFOs are the threat to the family-offices divisions of the private banks, as an increasing number of rich families are becoming disillusioned with the stereotyped services provided by the banks.

There are several movements in this direction already. A new family office structure that has come into place is that mimicking the co-operative movement. An example is the Market Street Trust, which was originally founded by a single family, the Houghtons, who established Corning, the glass-maker. This family has opened its office to other families on a co-operative profit-sharing basis. At a more informal level, several family offices have begun to network and collaborate in finding new investments, such as those sought out by private equity and, even further afield, innovative sectors such as litigation funding. A common feature of all these developments is their disintermediation of the banks and other advisers, and the establishment of their own teams to spot investment opportunities. It is pointed out that it was rich families who originally backed the hedge-fund sector, before it was invaded by mainstream institutional investors.

The digital threat from below is probably the more dangerous than that of family-office departures at the top end of the scale

Going direct is not all that easy, and finding and managing the investments remains a challenge. In the UK, there are plenty of intermediary boutiques and advisers that can help with this process and are in demand globally.

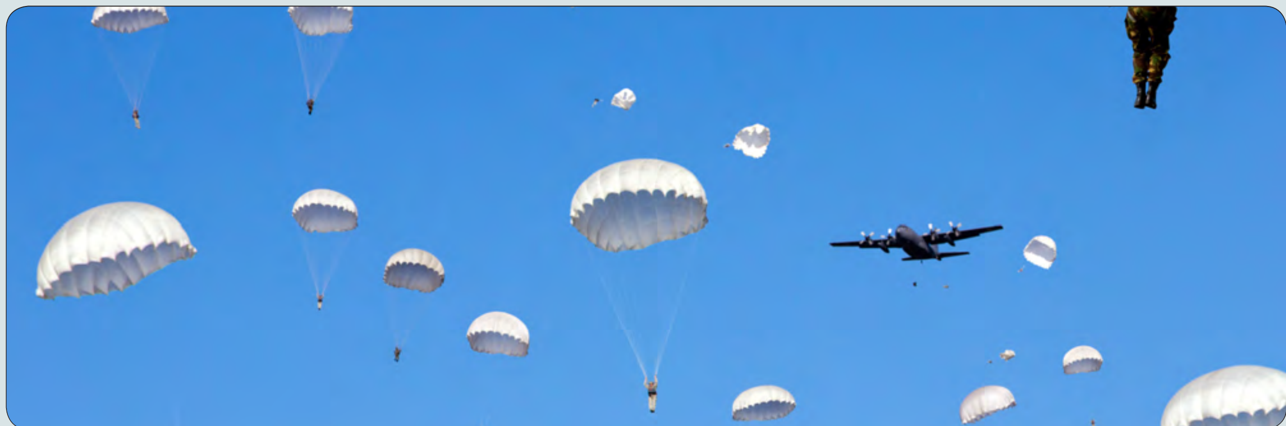
Editor's comment

The digital threat from below is probably the more dangerous than that of family-office departures at the top end of the scale. The automated portfolios are targeted towards the less affluent but there is evidence that many of the wealthier also see value for money here and are going for it. This is a serious peril. Offerings by the digital upstarts effectively become the new benchmark that the traditional sector has to beat, in terms of performance net of fees. If it fails to deliver on this basis, there is every prospect that the demand for automation might go upmarket on a much bigger scale.

Not only would market share be severely cut, but profitability could also be slashed – as in the UK retail supermarket sector, where the likes of Lidl and Aldi are running rings around Tesco and Sainsbury's. Even if the threat does not intensify, the capital cost of introducing automation and digital facilities cannot be recouped by higher fees, which are already at the top end of what the market can bear, given generally reduced returns. Against this background, a loss of assets to family offices doing their own thing could be another blow.

Furthermore, growth prospects in wealth management are luring new classes of competitors including insurance groups, fund management houses, hedge funds and financial advisers. McKinsey's prediction of a $70bn industry profit pool in 2017 might well materialise but 2022 might be another matter if the twin threats posed by digital and family offices intensify. What existing players can bank on now are strong relationships and customer loyalty, neither of which are reliable long-term propositions.

What family offices might do has wider implications on a bigger scale, for the asset management industry and, indirectly, global enterprise generally. There are many new types of businesses worldwide that are natural vehicles for long-term-orientated investment managers. These embrace sectors such as infrastructure, agricultural investments and space. On a much smaller scale, sector areas such as litigation funding, shipping and the like could attract family-office money, paralleling the latter's support of hedge funds in the '80s and '90s. The family office's abandonment of traditional private banks banking support could thus be the catalyst for the asset management industry supporting more genuine long-term investments.



VANGUARD INVADING THE FINANCIAL ADVISORY MARKET

'Vanguard turns its guns on financial advice', Stephen Foley, Financial Times, 9.12.14

It is unprecedented for a top independent fund management house to also take on the advisory role, but Vanguard is doing exactly this. The structure itself is not new. Banks and insurance companies have been doing it for ages. But Vanguard's prospective entry has some distinctive features that threaten to cause upheavals in the advisory sector.

The company is sweeping the board in terms of the funds it manages, but it is not resting on its laurels. Having enjoyed inflows into its funds in 2014, more than any other asset management group has done, the group intends to make a revolutionary impact in financial advice, paralleling its founder John Bogle's effect on the mutual fund industry in the '60s.

The company is aiming to devise a method of providing simple but effective advice to US savers, while charging just 0.3% of assets annually, a fraction of the 1% that the average financial adviser levies. Bill McNabb, Vanguard's Chief Executive, is confident of providing very good-quality advice cheaply on a very large scale, and,in the process, radically changing the advisory industry. It will mainly utilise online tools, including webcams for chats with advisers, and keep clear of the expensive overheads of existing advisory groups.

The group is a huge beneficiary of the move to passive worldwide, and passed the milestone of $3trn assets under managment (AUM) in the summer of 2014. Most of its funds are passive indexed funds and ETFs. Although it also manages about $1trn in low-cost active funds, outsourced to other groups, including Wellington Management, these active offerings now account for only a third of Vanguard's AUM. The company benefits from being owned by its funds in the US and, through these, ultimately by the investors in these funds. These provide it with the enormous advantage of not having to focus on profits and dividends and the like. Together with the move to passive, Vanguard's appeal is now unsurprisingly becoming global, with its non-US assets having doubled in the past six years.

The big question now is how the army of 225,000 US financial advisers will react to Vanguard's intention to make major inroads into their business

In earlier years, the group was held back by not paying commission to financial advisers, but the trend towards advisers charging fees rather than being paid commission by fund management groups has changed matters. Advisers on the fee-based model have become an important distribution channel for Vanguard. According to the fund research house Morningstar, these financial intermediaries have made a significant contribution to the growth in Vanguard's sales. The big question now is how the army of 225,000 US financial advisers will react to Vanguard's intention to make major inroads into their business. They are increasingly recommending to their clients' portfolios of index tracker funds, a business which Vanguard wants a slice of, with the intention of reducing the cost of investing.

Vanguard had already been an adviser on approximately $800m of client portfolios at the end of 2013, but this figure has multiplied more than five times to over $4bn at the end of September 2014. Even this figure is small by Vanguard's standards, but its planned drive in 2015 is intended to make a much bigger impact.

Vanguard's move coincides with huge changes in how brokers set about their business, establishing technology platforms. New companies have sprung up, such as Betterment, which has developed saving apps for Milennia.

Vanguard's plan is to build portfolios for its clients with a mix of its low-cost diversified stock and bond funds, in the process offering advice to less affluent savers who are unable to afford the fees charged by existing advisers. Some of the latter are severely critical and suggest that Vanguard might not exercise objectivity, instead recommending only its own funds. Peter Mallouk in Kansas City, for instance, intends to tell his clients that he can tailor exactly the right mix of products. Mallouk currently has over $4bn of client assets in Vanguard tracker funds, but he is considering switching out of some of them.

Editor's comment

The big problem, both in the US and the UK, has been the exclusion of the poorest from financial advice in the shift from commission-based to fee-based models. Vanguard's aim to provide a low-cost service will act as a boon here. It is not necessarily the case that the entire financial advisory industry will be hard-hit. Only those who do not offer value for money will be under pressure, and it behoves the best advisers to make sure they can justify the fees they charge in terms of the marginal extra returns, compared with their clients going with Vanguard and low-cost-technology-based producers in the US, and the likes of Nutmeg in the UK.

BIG HOLES IN MONITORING OF US FINANCIAL ADVISERS

Editor's introduction

Disturbing evidence has come to light that US regulators are not up to their job in protecting retail customers. How have they failed and what is being done about it?

Vanguard is posing a huge external threat to US financial advisers in order to help savers. But the latter have reason to worry about dangers within the advisory community. There are two separate problems.

In 2013, a mere 9% of these advisers were examined by the SEC, at which rate 11 years would pass before the entire group would be checked

Registered investment advisers not checked

'US advisers must pay to be regulated' Chris Flood, FTfm, 1.9.14

Registered investment advisers (RIAs) are expected to maintain higher standards of advice than the other class of US financial advisers, the brokers. Yet it is the RIAs who do not seem to be monitored adequately. The number of RIAs has increased by 40% over the past ten years to over 11,000, and their clients' portfolio assets have experienced more than a two-fold growth from $20trn to $55trn in this period. But the Securities and Exchange Commission (SEC) is struggling to catch up with the growth and to make sure that the RIAs are properly monitored.

Unfortunately it is hamstrung by lack of resources. In 2013, a mere 9% of these advisers were examined by the SEC, at which rate 11 years would pass before the entire group would be checked. Unsurprisingly, about two-fifths of the RIA population has never been examined.

It is suggested by an official at the SEC, Rick Fleming, that the RIAs should pay an annual fee, enabling more systematic review of their activities, to fend off a possible Madoff-style fraud. He heads the Office of the Investor Advocate, a new SEC division responsible for identifying problems investors might have with financial service firms.

Fleming accepts that there is likely to be resistance to the SEC increasing its budget, but pointed out that investors have a right to expect that their RIAs will be checked more frequently than every 11 years. A bill intended to impose new fees on RIAs is not progressing quickly through Congress – this has already thrown out a request by Mary Jo White, the SEC Chairwoman, for 250 more staff to examine the advisers.

It is suggested that third-party audits might be a better way of ensuring that all RIAs are examined annually, but Fleming feels that audits would be more expensive and introduce conflicts of interest if the auditor was selected and paid for by the adviser. The Financial Industry Regulatory Authority (FINRA), which already supervises broker-dealers who pay an annual fee, has been put forward as an alternative regulator, but David Tittsworth, recent President of the Investment Adviser Association, feels that SEC supervision would be the most effective and cheapest option.

Serious misses in monitoring of US broker-dealers

'Watchdog's records miss brokers' red flags', Jean Eaglesham and Rob Barry, The Wall Street Journal, 29.12.14

The maintenance of standards among broker-dealers, the responsibility of FINRA, has come under fire for not making available to investors the full histories of their broker-dealer advisers, including any past information that might give room for doubts about their reliability or integrity.

FINRA operates a BrokerCheck website and encourages investors to look at it for regulatory red flags about individual broker-dealers. These include complaints, regulatory incidents, terminations of employment for negative reasons and bankruptcies.

Frequently, the broker-dealer's employer carries out investigations in suspect cases and takes actions which might result in warnings, resignations or dismissals. Individual state records in many cases show this information but are available only if the state regulator is contacted.

In an examination of data held by the federal and state regulators, *The Wall Street Journal* revealed that a vast amount of information about brokers is available but not made public. At least 38,400 brokers have had a regulator wave a red flag, but in more than half of these cases the BrokerCheck records were completely clear.

It is believed that brokers that face internal reviews by their employers are statistically likely to have other problems, but the newspaper identified more than 4,000 brokers with one or more internal reviews that appear on state records but not on those of BrokerCheck.

There are many other types of information conveying warning signals about brokers that figure on state data but missing on BrokerCheck. These include more than 3,000 brokers with investment-related court cases.

State security regulators have demanded that FINRA should expand BrokerCheck to match the information that they show. The North American Securities Administrators Association points out that red flags such as bankruptcies of more than ten years previously, which are shown on state records, should also appear on BrokerCheck. FINRA has announced a review of what it discloses when brokers lose their jobs or a firm discovers regulatory misconduct by a departing employee.

Editor's comment

FINRA's review announcement seems to hint at merely responding to particular problems in a piecemeal approach rather than embarking on a comprehensive review aimed at plugging all possible holes in the system. For instance, its announcement does not seem to encompass court cases and warnings by employers rather than outright dismissals. This might be a reason for the SEC being preferred to FINRA in the review process of RIAs.

THE FINANCIAL TRANSACTION TAX REFUSES TO DIE

'Still kicking', Financial-transaction taxes, The Economist, 31.1.15

Financial News – 'One thing should be certain in life: the death of this tax', Talking Point, 28.9.14; 'EU still scratching heads over FTT', Tim Cave, 7.12.14; 'Hat-trick of delays on cards for FTT', Tim Cave, 14.12.14 and 'EU states give fresh backing to FTT', Tim Cave, 8.2.15

The implementation of the controversial Financial Transaction Tax (FTT), otherwise known as the Tobin tax, has already been postponed twice since the initial proposal in February 2013, provoking predictions that it will eventually be abandoned. However, notwithstanding continued failure to achieve agreement on several complex issues, some EU nations are attempting to push ahead. They are showing considerable tenacity in persisting with the tax, as demonstrated by a flurry of activity in the latter part of 2014. The impetus came from the Italian presidency of the European Council.

The tax had failed to gain the support of the entire EU, with countries such as the UK and Sweden refusing to go along with it. Luxembourg, though normally co-operative, has also opted out, for fear of losing its fund management business and its global financial centre status. Eleven countries – Austria, Belgium, Estonia, France, Germany, Greece, Italy, Portugal, Slovakia, Slovenia and Spain – remain in support, though Greece did not sign the joint statement issued by the financial ministers of the other ten countries around the end of the year.

This still left ten to continue driving the introduction of the measure, with only nine required under the principal of enhanced co-operation in the EU.

The proposals encompass a levy of 0.1% on share and bond transactions and 0.01% on derivatives transactions. It is believed that the actual effective tax could be a multiple of these figures, as the tax is levied at every stage in the chain, between seller and broker, broker and market maker, and so on. While those in favour of the tax claim that it will be a levy on banks, the culprits behind the financial crisis, the widely recognised reality is that it will be the end-investor who will pick up the tab, with the intermediary institutions passing on the cost.

The real sticking points preventing agreement among the 11 pro-FTT states lie elsewhere, and cover several complex issues. One is how derivatives are to be taxed, and another is the extra-territorial scope of the levy. How revenues are to be allocated, and designing a system to collect the tax, are also headaches.

On the derivatives front, two approaches are reportedly being considered. The first is to base the tax on derivative contracts' notional value, which is objected to by some states on the grounds that it would favour some derivatives and penalise others. The second approach is to link the tax in some way to the premium paid for the contract.

The question of extra-territorial coverage is governed by two principles. The first is 'issuance', where the entity issuing the contract is in one of the FTT states, and the other is 'residence',

which applies if one of the parties to the transaction is located in the FTT zone.

The failure to reach agreement apparently lies in the detail of how precisely the tax will fall and who will benefit. France, for instance, wants to exclude most derivatives, as its banks account for more than 25% of equity derivatives dealing in Europe, while Germany and Austria are keen on bringing a wider range of derivatives under the Tobin umbrella. Issues such as who gets the revenue are part of the complications. France and Italy have already introduced their own versions of the FTT in recent years.

France might have had a change of heart, but it might well turn again when actually confronted with implementation and the details are publicised

After an initial shock, trading volumes in France have not shown much change in the period since the tax was imposed in 2012. Italy, after bringing in the tax from March 2013, had a different experience, with trading volume falling by 12% in 2013, while other European markets were booming.

The above financial ministers' statement owed much to a change of heart by France, which agreed to a broad-based tax. Aided by Austria, the tax got a new lease of life, and an intended January 2016 implementation was reiterated. James Hughes, a director at the lobbying firm Cicero, and others remain sceptical as to whether the timetable is still feasible, given the several contentious issues that need ironing out.

Editor's comment

France might have had a change of heart, but it might well turn again when actually confronted with implementation and the details are publicised.

If agreement could not be reached after numerous attempts in the past several years, some of the obstacles might be insurmountable. The difficulties may not be just technical but also economic. The sceptics are justified in doubting the 2016 schedule.

BOUTIQUE HOTELS FOR STAR FUND MANAGERS

'Star attractions boost 'boutique hotels'', Mike Foster and Joe McGrath, Financial News, 2.11.14

Many high-performing fund managers would love to reap the rewards of their talent by setting up on their own, but the administrative and regulatory costs and burdens act as deterrents. The 'boutique hotel' concept offers a way out. These 'hotels' provide a platform for talented teams of fund managers to retain a strong share, amounting to as much as 30% of the operating revenue that they generate. RWC, 49% owned by Schroders, is a company that offers this hotel service. Its Chief Executive, Dan Mannix, points out that high-quality talent is scarce and needs nurturing.

Boutiques have grabbed market share from hedge funds and bigger firms in the past three years, with €66bn flowing to European boutiques in the eight months to August 2014, according to the research house Lipper.

Operating margins at these boutiques are high, with some exceeding 70%. Andy Brown's Cedar Rock Capital reportedly earned a 95% margin in the 12 months to October 2013.

Editor's comment

What is the difference between the hotels and the typical fund management firm owned by multi-boutiques? The latter, like the 'hotels', aspire to appoint talented managers but these managers tend not to have ultimate control though they are often granted substantial autonomy. The hotel concept can be new only if the ownership structure is different with the star fund managers owning and controlling their firm while ceding much of the revenue for the ancillary support. Alternatively the franchise model used in other industries might merit this novel name. The loose use of words is rife in asset management and only a close look at the ownership structure will reveal whether a new description is warranted.

BUFFETT'S BERKSHIRE HATHAWAY BECOMING A CONSUMER BRAND

'Buffett's reputation for acumen put to use in Berkshire Hathaway brand push.' Stephen Foley, Financial Times, 14.10.14

Warren Buffett's stellar reputation is being parlayed into a global consumer brand that is already established in parts of the US. Following his penchant for buying into top brands over the years, Buffett has evidently realised that his personal reputation is also a good basis for establishing a brand based on trust, stability and integrity.

Buffett has hitherto focused on a few key areas of management, but it is more than possible that he is now following in the footsteps of other conglomerate tycoons and over-reaching himself in areas where his experience does not stand out

In 2014, Berkshire Hathaway had rebranded utility groups, estate agents and a car dealership under its own name. HomeServices of America has become Berkshire Hathaway HomeServices, and it is suggested that its number of US estate agencies could expand to nearly 1,500 by the spring of 2015. The Van Tuyl car dealership chain, having been renamed as Berkshire Hathaway Automotive, plans to make further acquisitions.

Warren Buffett intends to license the Berkshire Hathaway name to estate agents in Europe, including the UK, and Asia, as well as the parts of the US, where it is relatively unrepresented.

What might happen after Buffett's eventual departure is again another matter

Editor's comment

Buffett's reputation for wisdom is beyond doubt, but there is no definitive way of predicting how long it will endure. Buffett has hitherto focused on a few key areas of management, but it is more than possible that he is now following in the footsteps of other conglomerate tycoons and over-reaching himself in areas where his experience does not stand out. Expanding the brand is all well and good, but there is a reputational downside as well. What might happen after Buffett's eventual departure is again another matter.

His real draw is in another direction, as one of the world's richest men

Buffett's aim of promoting his brand lends a fascinating slant to the issue of fund manager branding. Currently, brand consciousness enjoyed by even the top fund management houses is virtually nil worldwide. So, while Buffett's brand taking off in the US is understandable, what grounds does he have for thinking his name will catch on elsewhere? The chances are that most ordinary folk will be left cold by the idea of Buffett being the world's top fund manager, unfortunate from the fund industry's perspective. His real draw is in another direction, as one of the world's richest men, who has become so by using his brain. Everybody would relate to that story.

TRANSFORMATIONAL CHANGE IN CHINESE INVESTMENT LANDSCAPE

Sage & Hermes Research

In April 2014, the Chinese Government announced the Shanghai-Hong Kong Stock Connect Programme, linking the Hong Kong and Shanghai stock exchanges. This has been described as the biggest single event in Chinese capital markets for 15 years, as it is an important step forward towards integrating Chinese stock markets with the rest of the world. Though a minor beginning, it holds the promise of much bigger to come, a sea change in the country's capital control regime.

The measure will connect Shanghai, mainland China's largest exchange, with Hong Kong, which has hitherto acted as China's window to global capital markets. Stock Connect will allow all investors to buy shares on the Shanghai stock exchange and enable wealthy investors to buy equities listed in Hong Kong.

While the new link was met with wholehearted enthusiasm worldwide, some important barriers nevertheless inhibit an immediate take-off

Hitherto, access by global investors to China's $4trn onshore 'A-share' market has been strictly limited, mainly to foreign institutional investors such as pension funds, and even these only with special approval. Hedge funds have been eligible in theory, but in practice have never been approved. Every such institution has been limited to strict individual quotas, and has had trouble getting money out because of capital controls. Now, all types of investors are allowed.

In the reverse direction, Chinese individuals, albeit the wealthier ones, are now allowed to access Hong Kong listed shares. Previously, local Chinese could only invest overseas through Chinese fund managers who were allowed to sell to the former mutual funds invested in overseas securities. They were enabled to do so through the Qualified Domestic Institutional Investor Programme (QDII) launched in 2006. The link will increase global demand for Chinese shares and enable investors to go for domestic-orientated businesses in, for example, healthcare and retailing.

While the new link was met with wholehearted enthusiasm worldwide, some important barriers nevertheless inhibit an immediate take-off. There is uncertainty about capital gains taxation though the Government has announced a waiver of this tax for at least three years. There are also limits restricting the amount that can go through the new route. The flow of funds from Hong Kong to Shanghai is capped at $2.1bn per day and an overall maximum of $50bn. The limits apply to net flows (purchases less sales by foreign investors of Shanghai stocks), which softens the effect of the caps. In the reverse direction, Shanghai to Hong Kong, the corresponding limits are about three quarters of the flows going from south (Hong Kong) to north (Shanghai), and also require minimum investments of $80,000.

Furthermore, China does not recognise the true ownership underlying nominees' shares, which potentially allows creditors of the custodians to grab these shares in the event of the latter's liquidation. Another problem lies in a ban on short selling and the way it is implemented. In China, this means that a broker cannot execute an investor's sell order until the security is in its possession, which is a major obstacle if a quick sale is needed. Overall, Shanghai's oddities, dysfunctions, and heavy-handed administrative controls comprise hurdles that need to be overcome.

Unsurprisingly, most foreign institutions have not jumped in to invest, adopting a wait-and-see attitude instead. Around July 2014, a few months before the link came into play, the A-shares in Shanghai stood at an average 12% discount to the Hong Kong listing of the same shares. By November this gap had reversed, which has removed one possible incentive for institutions to jump in with both feet.

The problems bedevilling investment in Chinese shares have understandably been deterring foreign investors. Henny Sender of the *Financial Times* feels that Shanghai will take off only if there are better companies. Most shares in Shanghai are in privileged state-owned companies with profitability much less than in the private sector. Profits in state-owned companies were up only 6.3% in the year to July 2014 as opposed to 13.4% for private firms, according to Haibin Zhu, Chief China Economist of J.P. Morgan. The Chinese stock market peaked in 2007 and has consistently been one of the worst performers in Asia, now being nearly two thirds below the 2007 high.

Some statistics representing China's fund management prospects make compelling reading

The Shanghai-Hong Kong link has been met with enthusiasm, despite the clouded short-term outlook, because of the enormous long-term potential Chinese stock markets have to offer should this strong signal of reform eventually culminate in them becoming a fully paid up member of liberal capital markets globally. Some statistics representing China's fund management prospects make compelling reading. Only 3% of China's RMB145trn of financial assets is in mutual funds. China's asset management business is expected to grow six-fold to RMB24trn by 2020 from RMB4trn now, according to a report from the consultancy Oliver Wyman. If all goes well, it is suggested that there could be a similar link between Hong Kong and Shenzhen, where more Chinese start-ups are listed. Hong Kong, Shanghai and Shenzhen combined have the largest market capitalisation in the world bar the US stock market. The link is seen as a substantial step in Shanghai's progress towards international financial centre status.

Editor's comment

The argument that Shanghai can only take off with better Chinese companies hits the nail on the head. Stock Connect is just a means of going from A to B and back in share-dealing terms. It does not in itself do anything to entice investors. Reforms are needed on a much wider front, including corruption, the rule of law, corporate governance and liberalisation before the Chinese stock market takes its place among the world's best rather than just being one of the biggest.

P2P – SEEDS OF A SUB-PRIME TYPE CRISIS

'A loan in the dark', Feature: Peer-to-Peer Lending, Hedge Funds Review, November 2014

Peer-to-peer (P2P) lending has caused much excitement worldwide at the idea of the banks being supplanted by retail investors and borrowers bypassing them. The expectation is that more entrepreneurial individuals and small businesses will deal directly with each other, freezing out the big banks and other financial institutions. This may be the case in some countries, but in the US at least the process appears to have been hijacked to some extent, raising concerns about a repeat of the sub-prime crisis.

Then, the originators of the loans who actually dealt with the mortgages sold them off to the institutions and had no incentive to maintain tight standards in granting the mortgages. The rest is history. The chains of subsequent buyers and sellers had no real knowledge of the underlying risks they were taking on. It is feared that a similar process is underway in the P2P lending business.

Many financial institutions, including hedge funds, have cottoned on to the bargains available in lending to borrowers at P2P platforms. Lenders or investors there can receive interest of at least 6%, going up to even 35% on three to five-year P2P loans, which compares favourably with high-yield paper providing less than 5% and as low as 3%. Understandably there is a scramble by the bigger players.

The danger is that underwriting standards might be loosened, leading to a repeat of the sub-prime crisis… The underwriting standards are not orthodox in every case

The flood of institutional money has enabled P2P businesses to scale up and become rivals to banks and credit card companies. Two of the bigger players, Lending Club and Prosper, are expected to have originated about $6bn of loans during 2014, two and a half times the $2.4bn in 2013, itself nearly three times the $880m in 2012.

The institutions looking for high yield feel that P2P loans are not growing fast enough and could do with ten times the amount of lending, but such a jump in volume would cause too much pressure on the technological, operational and underwriting capabilities of the platforms.

The danger is that underwriting standards might be loosened, leading to a repeat of the sub-prime crisis. As happened then, the demand has led to an increase in number of P2P

securitisations. One particular hedge fund, Colchis Capital Management based in San Francisco, had about $660m of P2P loans, about 10% of the whole, provoking the comment that P2P lending has really become the "hedge fund to consumer lending".

The first deal to be publicly rated by one of the big three raters, Standard & Poor's (S&P), was in July 2014. The lender was SoFi, an online lender specialising in refinancing student debt. The senior tranches of the overall $250m deal were awarded an A rating. Some hedge funds are leveraging their large portfolios of P2Ps, to convert them into vehicles which potentially provide up to a 24% return. As the number of securitisations increases, the way seems to be clear for banks, insurers and pension funds to enter the game.

The P2P loans are typically for just three years, but the problems can accumulate towards the end as the stronger borrowers prepay and only the weakest are left, potentially causing the hedge fund massive problems.

The platforms acknowledge these risks, but Prosper points out that it is only a danger if all the investors are borrowing from the same banks. The platform also controls the amount of leverage. The underwriting standards are not orthodox in every case. P2P platforms use consumer credit risks scores, credit histories and debt-to-income ratios. They augment this with other data sources and analytics from social media and various websites. Closely guarded proprietary algorithms are used to assess borrowers' credit standing.

There is no evidence of underwriting standards having slipped over the past eighteen months, according to Peter Renton of Lend Academy Investments. Renton, however, admits that most investors have little idea of what might happen during a downturn, as they have no experience of a full business cycle. The platforms themselves are avoiding being too much at the mercy of the leveraged hedge funds. Prosper, for example, intends to develop an investor base that is split three ways equally among retail investors, wealth managers and institutions. It is working on tools and indexed products to make it easier for retail investors. Prosper considers itself a long-term institution, and is therefore keen on preserving lender diversity and controlling correlation of investors and leverage as it expands.

Editor's comment

There is a big difference at the moment between the largest P2P platforms and the individual advisers who sold mortgages before the sub-prime crisis broke. Large companies such as Prosper have an interest in their reputation and longevity, which is important, but it is not clear how hard they might be hit if hedge funds get into trouble in a possible chain reaction. Furthermore, there is a danger of lesser P2P platforms being more fly-by-night. Regulators need to look into it. Eventually, this might become a global issue. Firms of Prosper's standing might avoid the dangers, but less scrupulous firms encouraged by greedier hedge funds could sow the seeds of the next crisis, in yet another example of risks, rather than being eliminated, being shifted from traditional banks to other entities, which are less regulated for the most part.

FAST TRADERS' UNFAIR ACCESS TO SEC DATA

The Wall Street Journal – 'Fast Traders Get SEC Data Seconds Early', Ryan Tracy and Scott Patterson, 30.10.14, and 'SEC to Close Gap In Filings' Release', Scott Patterson, 29.12.14

Rapid-fire traders have been making money by gaining access to Securities and Exchange Commission (SEC) data earlier than other investors. Much to the SEC's embarrassment, the problem has arisen from its system for distributing the information filed by companies.

Research studies have found that there is a time lag between the moment paying subscribers receive a direct feed electronically and when the SEC puts the information on the website. This gap can range from about ten seconds to more than a minute, an interval more than enough for fast-reacting traders to make money. A trade in Balchem Corp, a chemical company, is an example of unfair profits thus made. On 9 November 2012, a corporate insider filed with the SEC a form disclosing a 6,000 share purchase of the company. Some direct-feed paying subscribers received the information at around 1.45pm but the same information was posted on the SEC's website only 25 seconds later. Within those 25 seconds, trading volumes shot up, as did the price of the stock from $31.90 to $32.13 per share. The original information became available on the website only after the price jumped.

The delay in information availability has been researched by two separate groups. A study by Jonathan Rogers of the University of Colorado, who co-authored with two University of Chicago Professors, examined Form 4 filings that

detail share transactions by corporate insiders, and found that in general trading volumes and stock prices reacted in the interval between paying subscribers getting the information and it appearing on the SEC website. Another research effort from Columbia University, due to be published soon, investigated filings in a broader way and came to the same conclusions.

The problem has not been specific to the SEC. There have been other cases of unfair early access by fast traders to market-moving price information

As highlighted by the researchers, the problems originated with the SEC's Electronic Data Gathering, Analysis and Retrieval system (Edgar), which was launched in the 1990s to disseminate information electronically. An SEC contractor runs the Edgar system and about 40 subscribers pay about $1,500 a month to this contractor to receive all the filings. The contractor is not to be faulted, as it forwards the information simultaneously to both the paying subscribers and the SEC website. The delay in public availability occurs on the website, effectively leading to a lack of a level playing field for all investors.

The problem has not been specific to the SEC. There have been other cases of unfair early access by fast traders to market-moving price information. In 2013, it transpired that market-sensitive University of Michigan data reached some investors before others. Business Wire, which distributes corporate news, was also reported to be supplying some information early. In both cases, the revelations in *The Wall Street Journal* led to a cessation of the practice.

After *The Wall Street Journal* highlighted the issue and quoted the studies in late October 2014, members of the US Congress followed it up with the SEC. On 19 December the SEC Chairwoman, Mary Jo White, stated in a letter to the Senate Banking Committee that the regulator was implementing a change to ensure that the information was not available on the website before it was made accessible to the paying subscribers, and that this process was expected to be completed in the first quarter of 2015.

Editor's comment

It is fascinating that the SEC, normally the gamekeeper not the poacher, is guilty, albeit inadvertently, of practices which would amount to malpractice if carried out by the private sector. It is possible that this sort of problem could be occurring on a wider scale in other organisations.

FUND MANAGERS FORCED TO PAY FOR RESEARCH?

Financial Times – 'Be careful with that commissions axe lest fees demand backfires', Paul Murphy, 1/2.11.14; 'Rules plan for equity research raises small-cap IPO concerns', Sam Fleming, 25.11.14; 'Sellside research: price for thought', Lex, 30.12.14 and 'EU push to split trading fees meets resistance', Philip Stafford, 6.2.15

'Unbundling would not bring about the apocalypse – but it is not a great idea', David Wighton, Financial News, 16.11.14

In the past couple of years or so, the UK's Financial Conduct Authority (FCA) has worried that the system of payments for investment research has not been operating properly, its concerns having been triggered partly by the corporate access issue. Since this issue came into its sights it has introduced guidelines forbidding the practice. The saga seems to have led the regulator to look at the whole question of research commission afresh. Reportedly it has developed an enthusiasm for complete unbundling, separating payments for research from those for execution in a clear-cut way. It is said to have influenced the European Securities and Markets Authority (ESMA) to consider this approach in its review of the MiFID II directive proposals that are scheduled to be implemented in 2017. MiFID is proposing a cleaner division between research and trading across all markets, not just equities. In reviewing implementation aspects,

ESMA is feared to be driving towards managers being required to pay for research out of their own funds.

The UK regulator introduced commission-sharing agreements (CSAs) more than ten years ago. This effectively separated execution and research to some extent, and it is believed that this is one of the reasons why the FCA and its predecessor, the Financial Services Authority, have avoided tinkering with the system. Nevertheless, CSA would be considered revolutionary in Europe, according to Robert Buller, Global Head of Account Management at Kepler Cheuvreux in Paris. This firm forecasts that smaller brokers in Europe could lose up to a third or a half of existing revenues with a fall in the number of brokers if CSA is introduced in Europe, similar to what happened in the UK.

Since unbundling proposals were mooted, cacophonies of protests have emerged throughout Europe. Four-fifths of fund managers in the UK, according to an Extel poll, feel that damage would occur in the form of a decrease in the number of analysts publishing research on small UK stocks.

Benoît de Juvigny, Secretary-General at France's Autorité des Marchés Financiers, asserted that research on small companies will entirely disappear

Tim Ward, Head of the UK's Quoted Companies Alliance that represents small- and medium-cap companies, worried that these companies' ability to raise money in capital markets would be seriously hit by reductions in liquidity and analyst coverage. His comments were echoed across Europe.

Benoît de Juvigny, Secretary-General at France's Autorité des Marchés Financiers, asserted that research on small companies will entirely disappear. Small and medium companies need capital markets to raise money but the research available is already limited. Unintended consequences will follow from the proposals. The Deutsches Aktieninstitut, which represents quoted companies in Germany, points out that the proposals go counter to political efforts to improve small and medium-sized companies' capital market access, and should be abandoned.

The sell-side fears a further loss of revenues and jobs if full unbundling is introduced. Such a loss has already happened. Frost Consulting estimates that global research spending is down to $4.8bn from a 2007 high of $8.2bn. The number of analysts has halved to 9,000 over this period, according to Edison Investment Research.

The Lex column of the *Financial Times* considers that such a development would not be bad. Banks do not have much clue about the profitability of their research, and the column pointed to Anthony Jenkins, Chief Executive of Barclays, focusing on cost management. Lex suggests that the large banks' ignorance of research might possibly be funding overcapacity. According to this column, if the new pricing transparency forces them to exit unprofitable niches, new boutiques could arise and the shareholders of the banks should be pleased.

It is suggested that the proposals should cover fixed income, commodities and currency markets, but payment for research in these areas is a strange concept. Commission is not paid. Brokers get their revenue totally through spreads which, it is suggested, could narrow.

On the other hand, Christian Krohn at the Association for Financial Markets in Europe opines that the proposed provisions are not framed in a way that is appropriate to the way non-cash equity markets function.

The Lex column of the Financial Times is misguided in its opinion on banks benefiting from cutting down unprofitable activities

Paul Murphy of the *Financial Times* warns that the proposals might backfire. He doubts very much whether fund managers or their investors would pay for research. The effect of unbundling could be to reduce spending on research and put up higher barriers to entry for new independent research houses.

The UK Treasury is reported to be sceptical about unbundling and the big investment houses are not demanding change either. The argument has been put forward that research costs are small in relation to investment returns, and that the regulators are making a mountain out of a molehill.

Suggesting that spreads in fixed income, commodity and currencies might narrow if research is paid for seem to be a fantasy

Editor's comment

The Lex column of the *Financial Times* is misguided in its opinion on banks benefiting from cutting down unprofitable activities. Many companies have loss leaders in areas that win them other business, and bank research possibly comes into this category.

Many big consultancies also make their research available without requiring payment. It is not the profitability of a particular activity that matters, but how significant it is to the whole of the institution as a proportion of total expenditure. If the *Financial Times*' logic applied generally, companies should eliminate advertising with its intangible, and often unmeasurable, payoffs.

Suggesting that spreads in fixed income, commodity and currencies might narrow if research is paid for seem to be a fantasy. Spreads in highly liquid markets are competition-driven. Here the research is a matter of overheads that might help to attract volume.

What about the impact on fund managers and investors? As Murphy puts it, the regulators with their proposals might be taking a huge risk, with massive unintended consequences. The more serious of these will become clearer if one imagines a world with much reduced research relative to the scale of the problem. The argument that research costs are small in relation to investment returns, particularly for big institutions with their large orders, has some validity. In general, the costs of dealing embrace spreads and commission. The latter tends to be small relative to the former in many cases.

That good research keeps capital markets efficient is true of all companies, and is particularly the case for small firms. Yet the good might be pruned along with the bad. The dangers of increased volatility in markets and misallocation of capital are potentially serious social ills that could dwarf the problem of who pays for research.

SMART BETA GATHERING MOMENTUM – BUT QUESTIONS REMAIN

'Proceed with caution', ETFs, funds-europe.com, March 2014

'Smart beta appproach plays to the crowd', Steve Johnson, Financial Times, 1.9.14

Institutional Investor Sponsored Report – 'Using Smart Beta to Outsmart the Market', Howard Moore and 'Be smart with your factors', ERI Scientific Beta, September 2014

'Smart beta is eating active managers' lunch', Sophia Grene, FTfm, 17.11.14

Financial News – 'Drilling down into smart beta', Sara Shores, 14.12.14 and 'Beware the bias inherent in smart beta', Deborah Fuhr, 25.1.15

The techniques widely grouped under the catchy title 'smart beta' are being adopted by investors at an accelerating pace. However, key questions remain as to exactly what the processes represent and what they achieve for investors.

The breathtaking rise in their popularity is revealed by the statistics (see box).

At the end of 2010, smart beta funds accounted for only $58bn and as of November 2014, exchange-traded funds (ETFs) tracking smart beta indices accounted for around $330bn. Though these statistics originate from different sources, and very likely use different definitions, the order of magnitude of the growth rate over the relevant period is incontrovertible.

The conceptual background underlying smart beta is drawn from two different ideas

The global ETF industry had assets under management (AUM) of $2.76trn. The smart beta proportion of more than 10% of these assets, most of it having come in over the past four years, provides another slant on the exploding demand.

Notwithstanding its popularity, there is no clear-cut or standardised definition of what smart beta actually is, and the category has attracted

Extract from 'Smart beta as equity benchmarks', Investment Management Review October 2013

In the past few years, the number of smart beta indices, alternatively referred to as advance beta or new beta, has proliferated. The assets allocated to these techniques have been experiencing rapid growth. Smart beta-based funds totalled $142bn at the end of the first quarter this year, compared with $58bn at the end of 2010. Inflows of $15bn from January to March inclusive this year were 45% higher than in the corresponding quarter in 2012, the strongest quarterly inflow for three years, according to an analysis by State Street Global Advisors (SSGA) of MorningStar data. Total inflows into smart beta funds in the past three years were $82bn. Most of the growth came through exchange-traded funds (ETFs), which accounted for $66bn over the period.

It is suggested by several commentators that smart beta strategies will represent one third of global institutional equity allocations by 2018. According to the leading consultancy, Cerulli Associates, global retirement assets are estimated to reach $41trn by 2017, with a 42% equity allocation. Thus, the one-third proportion that might be captured by smart beta strategies would increase the total investment in this category to nearly $6trn, which would make it a significant proportion of global assets variously estimated at between $50trn and $100trn, depending upon the definitions and calculation methodologies used.

According to Niall O'Leary, Head of Portfolio Strategy for EMEA at SSGA, interest in smart beta through ETFs, as estimated above, is just the tip of the iceberg and there are significantly more assets held by sophisticated investors in separately managed accounts. Reinhard Bellet, Head of Passive Asset Management at Deutsche Asset & Wealth Management (DeAWM), also said that many of the smart or advanced beta strategies marketed by ETF providers have been long available to institutional investors through bespoke index mandates. The consultancy Bfinance, founded in March 2012, found that a third of the 82 European institutional investors who took part in a survey planned to devote over 10% of their portfolio to smart beta in 2015.

many techniques not really belonging to it, to some extent justifying those critics who refer to the whole concept as just marketing hype.

The conceptual background underlying smart beta is drawn from two different ideas. One is that market capitalisation-weighted indices suffer from serious theoretical flaws. The second is derived from active quant techniques, where portfolios are managed purely quantitatively, with models tweaked and parameters changed over time.

Neither of these two ideas are new, having been around for many decades. But they have just been updated, benefiting from more sophisticated computers, data and investment techniques. A parallel can be seen with the motor car's basic elements, such as the internal combustion engine and braking systems that are very old but much more technologically advanced now.

Smart beta products reflect the above dichotomy in concepts. At one end of the spectrum, they are meant to be straightforward replacements of the much derided passive cap-weighted index, and at the other end they are just advanced active quant techniques, justifying their description as 'new wine in old bottles'. Even the smart beta substitutes as indices for the market-cap benchmarks cannot really be described as passive, though they are lumped under 'passive' investments. They need rebalancing, with the costs this entails. Liquidity can also be a problem if too many industry players adopt the same smart beta approach, such as an index based on high dividends. Then the prices can be bid up, and more than just rebalancing is then required.

In such situations, smart beta's basic advantage relative to the cap-weighted benchmark can be eroded.

In practice, the proliferation of smart beta techniques renders low the danger of excessive concentration in the near future, at least in highly liquid markets such as the US. It might be different, however, in emerging markets. According to the Swiss asset management company, Unigestion, an example is a Chilean water company, Inversiones Aguas Metropol, where the combination of low liquidity and the size of smart beta holdings can require nearly 240 trading days if a sale is needed.

Smart beta methods intended to replace capital-market weightings are soundly based in investment theory and practice. The primary element is based on factor risk, which identifies the tendency of securities exposed to particular risk factors, such as momentum, value and low volatility, to be correlated in their movements. Particular smart beta indices can be based on one or several factor risks. The second element comes in through efficient diversification of the securities actually chosen for the index to represent this factor risk.

This was articulated by Professor Noël Amenc, Director, Edhec Risk Institute, and CEO of ERI Scientific Beta: "You can be exposed to a very concentrated or very diversified factor index. And this diversification of the factor index is highly important in the returns from the allocation. For me, it is a two-fold definition: smart beta means, first, being exposed to well rewarded factors and the second being diversified in that exposure."

The funds at the other end of the spectrum can hardly merit the term 'smart beta' if it is interpreted as index substitutes. They are mainly quantitative trading techniques where the algorithm used is closely guarded, with others not being able to replicate it. A clear distinction must therefore be made between smart beta techniques that are designed to genuinely act as indices in place of the cap-weighted ones and other methods that are just portfolio management tools.

This bifurcation is reflected in a debate carried out at the EU and regulatory levels, as outlined in the below extract from *IMR*, October 2013.

It is anticipated that the smart beta concept might be extended to other asset classes, such as fixed income.

Editor's comment

In view of the rapid capture of market share by smart beta, the question could well be posed whether cap weighting is on the way out. This is unlikely (see box).

The often-made claim that smart beta might be a low-cost way of supplanting active management needs examination. Consistently beating the market as represented by the cap-weighted indices has been a Holy Grail for asset management ever since it became, to some extent at least, a profession. As widely known, very few have done this consistently, whether using fundamental research, technical analysis or a quant approach.

At the end of the day, smart beta also requires judgment involving returns and risks, albeit some may be based on longer time horizons than the typical active equity manager's, as opposed to the best ones, who tend to think long-term. As a risk management tool, smart beta has a lot to recommend it, but those who back it as a new-found way of outperforming are likely to be disappointed, except for a lucky small minority. Sustained successful investment judgment will remain a rare accomplishment irrespective of who attempts it, whether active managers, smart beta providers or full fledged quants operating openly as such.

Extract from 'Smart beta as equity benchmarks', Investment Management Review, October 2013

With the growing popularity of smart beta, are market cap-weighted indices doomed? Not so. First and foremost, the challenge to cap weighting is too fragmented among the vast array of choices available. In view of this, the investor or asset manager immediately faces a conundrum. It's easy enough to decide to ditch cap-weighting. But the next crucial step, selecting its replacement among the myriad choices, will be the challenge. It would be difficult for any person, team or organisation to justify incontrovertibly a particular option.

Furthermore, outperformance based on past data, as with all other economic and financial statistics, cannot be relied upon with certainty for the future. In particular, investment strategies, not excepting smart beta, have a potential self-destruct button – because, if too many investors believe in them, the effect will be to bid up the prices of the relevant security types, rendering the strategies much less attractive.

A natural reaction might well be to stay with the familiar cap-weighting. The risks of smart beta underperforming in the short to medium-term, and lack of resources for the selection process, could be additional disincentives for many.

EU AT ODDS WITH REGULATOR ON SMART BETA

Letter to Mr Roberto Gualtieri, Chair, Committee on Economic and Monetary Affairs European Parliament – from Noël Amenc, Director, EDHEC Risk Institute, 20.2.15

Ducoulombier, F. May/June 2013. 'Index Transparency – a European Perspective. Regulatory Developments and Investor Requirements'. Journal of Indexes Europe.

Amenc, N., and Ducoulombier, F. March 2014. 'Index Transparency – A Survey of European Investors' Perceptions, Needs and Expectations', EDHEC-Risk Publication.

The EU has taken a significant step forward in rejecting transparency in the index market, going against the recommendations of the top European regulator, the European Securities and Markets Authority (ESMA). The latter had recommended full transparency with respect to indices. Contrary to this recommendation, the European Parliament's ECON Committee was preparing to vote on 9 March, planning to remove all obligations of transparency on either index methodologies or their historical composition since the initial project to regulate indices.

This debate had been going on for some time (see box).

Extract from 'Smart beta at regulatory crossroads', Investment Management Review, July 2014

This letter was followed through by a press release from EDHEC in January 2014, outlining what is required and why on the topic of transparency. A key paragraph is as follows: "EDHEC-Risk Institute calls upon the Committee and the European Parliament to ensure that all benchmarks used in the European Union be required – on a complimentary basis and on fair and non-discriminatory terms – to provide both historical data (eg, index levels, components and weightings) and detailed methodology to permit independent historical index replication on a non-commercial basis. Such transparency would allow all interested parties to verify the integrity of track records and measure the extent of discretion exercised in the application of methodologies. More importantly, it would enable investors to assess benchmark suitability by analysing the benefits, risks and costs of indices in the context of their particular objectives and constraints as well as integrate indices into a modern risk and investment management framework."

Professor Noël Amenc of Edhec, in a letter to Roberto Gualtieri on 20 February 2015, wrote reiterating Edhec objections that had been previously made and covered in the financial media in early 2014. In this letter, he again drew attention to institutional investors' strong preference and need for transparency.

Editor's comment

Smart beta products that represent genuine indices need to be transparent, as the very nature of indices is that investors can identify the constituents and the methodology, for either mimicking or betting against them. Only those that have proprietary secret algorithms and portfolio techniques that cannot by any stretch be referred to as indices can object.

It will be a great pity if the EU fails to introduce clarity by supporting transparency. While the leading sophisticated investment institutions can look after themselves, many of their smaller counterparts and, more importantly, retail advisers, could be seriously misled.

If the EU persists on this route, it will be a massive step backwards in investor protection. Others in the industry need to join Edhec in their fight against ultimate adoption.

FIDELITY JOINS IN SPACE RACE

'Branson edges closer to final frontier for tourism', David Crow, Financial Times, 27.8.14

'Race to fund space start-ups resumes', Tim Bradshaw, Financial Times, 21.1.15

'Google to back SpaceX with $1bn', Ralfe Winkler, Evelyn Rusli and Andy Pasztor, The Wall Street Journal, 21.1.15

'Space, the final start-up', Kevin Maney, newsweek.com, 2.2.15

Two serious space accidents in November 2014 have led many to doubt the viability of commercial space activities. The fatal accident in Sir Richard Branson's venture has set back the course of space tourism quite a bit. However, there is far more to this than Branson's space tourism ambitions. So, what else is there to be excited about? The answer is plenty. Many other activities are in the pipeline. The beginnings of this final frontier being transformed into an investment asset class are underscored by the giant fund manager Fidelity tacking a stake in Space Exploration Technologies (SpaceX), which has been involved in space for some years.

An activity that holds the promise of massive changes worldwide involves satellite technology. The old image of these as huge objects is now very much outdated. Satellites can be as small as a loaf of bread, radically changing the economics. The ability to launch them much more cheaply is being achieved by SpaceX and Virgin Galactic. Moreover, smartphone technology, cloud computing and big data have contributed to advances in the space platform.

Reusability is the factor that makes the biggest difference to space becoming more commercially accessible

In January this year, Google and Fidelity announced an infusion of $1bn into SpaceX. The plan is to put 4,000 tiny satellites into low Earth orbit. Another 2,400 satellites are envisaged by OneWeb, which has Branson's Virgin group and the budget smartphone producer Qualcomm as backers. SpaceX's plans to launch thousands of satellites are expected to benefit two billion people, including those in remote areas and countries such as Iran, where the internet is not freely accessible because of the politics.

Another start-up in San Francisco, Planet Labs, is moving towards covering Earth with low-orbit cameras that can observe every crop on every farm, or count the cars at Walmart stores, and other similar data-gathering activities all over the world. The massive explosion in available data is expected to bring substantial value to the investment community, including hedge funds.

Underlying all these plans for new satellites is the idea of reusable spacecraft that can keep coming back for more loads. *Newsweek* magazine suggests that both SpaceX and Virgin, having worked on this for the past ten years, are close to success. This reusability is the factor that makes the biggest difference to space becoming more commercially accessible. But there is a challenge in some of these new ventures in the cost and effort of installing the required antennae and computer terminals. Another problem is how SpaceX plans to transmit internet signals to Earth, as it is believed that it does not have rights to the radio spectrum. These problems are not considered insurmountable but need to be resolved.

All this additional space activity is likely to provide massive opportunities for Silicon Valley-type start-ups. Already, the question of space debris has come up (see box).

Extract from 'Space – a budding investment class', Investment Management Review, April 2014

One of the most immediate problems is a question of space debris, which is even now beginning to threaten other man-made space objects in orbit. Currently this is under the control of governments, partly because of the fears of potential military use of clean-up operations. But the private sector has begun to be involved. Commercial companies are tightening up launch and design standards, in order to reduce the debris entering the lower earth orbits.

This can only get worse, leading to those who can clean up the debris becoming highly in demand.

Editor's comment

The catchphrase 'Space – the final frontier' now needs to be modified. It can no longer refer to the region up to 200 miles above the planet, and needs to be interpreted as the void beyond. The space immediately above Earth is no longer a frontier but subject to full commercial exploitation. The changes this might bring about could be far-reaching, affecting mankind in both predictable and unpredictable ways.

Google and Sir Richard Branson might be embarking on self-indulgent visions. But the same cannot be said of Fidelity. This hard-headed fund manager has strongly signalled the commercial potential of space. When visible results emerge, a huge amount of public-relations benefit will come Fidelity's way, no doubt persuading other asset managers to follow suit. It might even do something about most of the world not having a clue as to what fund management is about.

INVESTMENT SUPERSTARS – REWARDS AND PITFALLS

Financial Times – 'Star Investors are not really solo artists', John Gapper, 9.10.14 and 'Bill Gross at Janus: Manning or Balotelli?', Lex, 12.11.14

FTfm – 'Investors should follow their stars', Steve Johnson, 8.9.14 and 'Should wise investors follow a star?', Sophia Grene, 27.10.14

'BlackRock Message: We're no Pimco', Kirsten Grind, The Wall Street Journal, 16.10.14

One of the most contentious debates in the investment arena concerns investment superstars. Should investment management houses nurture and promote superstars, or emphasise a team approach?

There are two sides to the story, despite recent negative publicity about the dangers of a superstar culture. The corresponding underlying reality is the degree of responsibility accorded to a single individual in the management of a portfolio, as opposed to a collective decision-making approach.

The presence of stars confers benefits but also poses risks, both during the tenure of the talented managers and after they leave.

The advantages and dangers of focusing decision-making on a single individual is not confined to fund management. It is the age-old question of individual talent versus management by committee. The latter has a bias towards a safety-first approach, whereas the former can get it very right or badly wrong. In investment management terms, this translates into very talented individuals having the potential to produce superlative performance while a collective approach is more likely to lead to near middle-of-the-road results.

The presence of stars confers benefits but also poses risks, both during the tenure of the talented managers and after they leave

Which fork makes sense is not a universal truth but depends on the circumstances, status and type of fund management house. A well-established company with a large institutional client base would have a predilection towards the collective approach, as their institutional clients, often pension funds, would abhor the idea of 'speculating' with their members' money. On the other hand, an up-and-coming retail house that has still to make its mark in the fund management world has every reason to foster and encourage talented individuals. How else can it bring itself to the attention of end-investors and convince advisers?

One of the biggest risks is what happens should the superstar depart

A case in point is the origins of Pimco, which has been capturing the headlines recently. Its founder Bill Gross first made his name by a brilliant stroke of market timing in 1987, and the company has not looked back since. There are, however, downsides to reliance on and promotion of a star and allocating him too much power. It can have a negative effect on his ego, and indirectly affect his judgment, which Gross clearly suffered from in his final months at the giant bond house.

Even without the public relations disaster caused by Gross's internal and external behaviour, individual stars can pose massive risks. Bill Miller of Legg Mason was a darling of the US stock market, having achieved outstanding performance in the '90s and the early years of this century by relying on his value philosophy. But this very same philosophy brought him down about ten years ago, with abysmal performance triggering massive outflows from the group.

One of the biggest risks is what happens should the superstar depart. This has to be addressed from the perspective of

both the company and the end-investor. Has the company relied excessively on this star or does it have talented back-up managers in place? In either case, can it persuade its customers that it is business as usual, and keep hold of their money?

In two high-profile situations recently, this has not been the case. When Neil Woodford announced his departure from Invesco Perpetual, the company started haemorrhaging money and still was almost a year later. Pimco is suffering a similar fate, but Bill Gross was already underperforming before he left. When the legendary Anthony Bolton left Fidelity, there was not much sign of massive outflows; nor has this happened when Schroders has from time to time seen a highly esteemed star departing. In both the latter cases, perhaps the reputation of the company was even bigger than the star's, and/or the company had strength in depth which investors took for granted.

Stars departing pose the investors in their funds with critical decisions. Should they follow the individuals into their new company or stay put with the old? The connected questions are whether the individual manager can repeat his success in his new habitat and whether his successor at his old company can hope to repeat the outgoing star's achievements.

Stars departing pose the investors in their funds with critical decisions. Should they follow the individuals into their new company or stay put with the old?

The evidence is mixed and advisers are divided. Research carried out in July 2014 by Aegon UK revealed that nine out of 11 popular funds continued to meet their benchmarks after the star left, suggesting that investors should have remained. But a different conclusion emerges from a much bigger study by academics from the Cass Business School and the University of Nicosia. The research was based on 921 fund-manager changes between 1927 and 2011. It found that the top decile of all the relevant equity funds had typically outperformed their benchmarks in the three years prior to the departure but that the performance subsided to benchmark levels for three years following the change. Conversely, when funds replaced poorly performing managers, there was a marked improvement in performance.

Other conflicting evidence comes from Axa Wealth. Its study compared the situations 12 months before and after the departure of a fund manager. In seven out of ten examples, the new fund manager stepping into the shoes of the old outperformed the star relative to the peer group benchmark.

Another factor that is relevant is the question of size. Sometimes the departing manager had suffered from his very success, in that the fund had become too big to be agile, a problem he might well avoid in his next company. It also matters whether the fund manager departs alone or with his team.

The appearance of new stars and the associated birth of fledgling companies is key to the dynamism of the industry

The impact of stars for better or worse might be mixed, but there can be no doubt in the case of some 'immortal' investment legends. Benjamin Graham, the father of security analysis, produced 21% per annum over 20 years through his fund, the Graham Newman Corporation. Sir John Templeton extended the approach to global equities and his Templeton fund would have earned for its investors a 14.5% per annum return from launch in 1954 to his sale of the business in 1992. Peter Lynch, manager of the Fidelity Magellan Fund, from 1977 to 1990, came up with a mind-boggling 29% per annum return over the period, with his philosophy of investing in what you know, and was responsible for the famous phrase 'ten bagger', a stock that multiplies ten times from purchase to sale.

Editor's comment

If an individual is really talented and courageous, but not foolhardy, then he will tend to be better than a committee. His self-belief and courage in going against the crowd, even at the risk of looking bad in the short term, has a much better chance of good results in the long term.

The conflicting evidence in what happens when a star leaves indicates that there is no standard formula for deciding what to do in either following the star to the new company or staying with the old.

If an individual is really talented and courageous, but not foolhardy, then he will tend to be better than a committee

It is noteworthy that the likes of Benjamin Graham, Sir John Templeton, Peter Lynch and Warren Buffett all enjoyed a stable environment in their stint at the top. Who knows what might have happened if they had moved? Even a highly talented star could suffer a huge culture shock by shifting. They have to deal with a different team and support, possibly with less rapport. The discontinuity itself could be unsettling. The situation can go both ways. The incoming star might be admired and able to inspire the new team, or he might be resented, particularly if somebody else in the new stable had had hopes of getting the job and had his/her nose put out of joint.

Every company has to make its own decision as to whether to encourage a star culture or go for safety. The end-clients also need a judgment call as to whether or not to accompany the departing manager. Here, their advisers could play a crucial role in assessing the pros and cons.

From the perspective of the fund management industry as a whole, it will be a great pity if the star culture goes out of fashion. The appearance of new stars and the associated birth of fledgling companies is key to the dynamism of the industry. Hedge funds in their heyday owed their astronomic rise to the prevalence of superstars such as George Soros and Paul Tudor Jones. The industry needs stars as role models and for human interest. The regular appearance of outstanding superstars and investment legends inspires other potential achievers and helps to foster the image of asset management being a repository of talent and expertise rather than a commoditised conduit for going passive.

CLOSET INDEXING – THE DARK ART OF INVESTMENT

Sage & Hermes research

Very few people have anything good to say about the practice of closet indexing – hugging a portfolio close to its benchmark. It is referred to as the 'dark side', with the hint of nefarious activity even evoking images of Harry Potter books. But what exactly it is and why it is objectionable is not all that clear-cut.

The concept of hugging closely is easy to grasp even in investment management, but this can be a matter of degree, and objectors to closet indexing need to spell out what they mean quantitatively, with parameters identified and thresholds set.

As it turns out, one parameter alone cannot pinpoint closet indexing, but the concept of 'active share' (AS) has received much credibility as a primary measure and is fast gaining status as the key identifier. Two other variables that are considered along with this active share are tracking error and costs, but the active share is the easiest to measure, being the proportion of stocks in the portfolio that differ from constituents of the index. By this measure, 100% indicates fully active management and 0% as the other extreme indicates closet indexing or genuine passive management. Typically, an active share of more than 60% is taken to mean active management though this figure can be as low as 55%. A tracking error (the performance deviation of the portfolio from the index) of less than 4% is a negative indicator for active management, whereas an ongoing cost ratio of 0.4% or higher is seen as positive.

It is widely believed that active equity management does not deliver the goods, in that the majority of fund managers underperform their index. However, proponents of active management hold that genuinely active portfolios actually do outperform the benchmark, but that their impact is dragged down by the inclusion of closet indexers among the ranks of the active. Research has been produced by Simon Evan-Cook, Senior Investment Manager at Premier Multi-Asset Distribution Fund, showing that managers with an active share greater than 80 beat the FTSE share index by a significant margin over one, three, five and ten years in the UK. He distinguished between four groups, which had the following returns.

Active share and annual return over past ten years

Type of fund	AS	% return
Highly active funds	80 +	10.3
Active funds	60-80	5.9
Closet trackers	15-60	4.6
Genuine trackers	0-15	4.9

The original concept of active share was developed by Yale professors Martijn Cremers and Antti Petajisto in 2007. Their report had come to the same conclusion – funds with the highest active share significantly outperformed their benchmarks and had strong performance persistence. Other studies have shown that small or best ideas portfolios run by managers with real conviction also have a tendency to out-perform other funds.

However, a much larger study of the US equity market from 2004 to 2014 for Nomura, by Joseph Mezrich and Yasushi Ishikawa, came to a different conclusion. They looked at US equity funds with high active shares using

data from the Center for Research in Security Prices. The database from which this study was drawn was importantly free of survivor bias, whereas the same perhaps could not be said of some of the other studies. The study indicated that closet trackers outperformed the other groups, including those with higher active shares, in seven of the 11 years from 2004 to 2014. Their conclusion was that active share was not a reliable indicator of fund manager success, at least not over the past decade, and is perhaps over-rated as an investment tool.

In rebuttal, Evan-Cook pointed out that the Standard & Poor's 500 in the US is highly diversified and not easy to beat, whereas in the UK market the index constituents have high proportions in mining, oil and banks, and that active management could therefore bear fruit, in avoiding these sectors at appropriate times. The same is said of small and concentrated markets such as Sweden's.

Some comfort is extended to active managers by Mezrich, who had in previous research found a high correlation between the excess return generated by active managers and the ten-year treasury yield. This suggests that active managers have suffered from an adverse environment and that their skills could come into play in a period of rising interest rates. According to Mezrich, correlation in US stocks since 2003 has doubled, compared with that prevalent in the '90s, resulting in stocks moving closer together, thus it is more difficult to spot opportunities.

Proponents of active management hold that genuinely active portfolios actually do outperform the benchmark, but that their impact is dragged down by the inclusion of closet indexers... when regulators come in, a clear definition of closet indexing is needed

The Swedish Shareholders Association has filed a class action lawsuit against Sweden's second largest fund house, SwedbankRobur, alleging closet indexing in two of their funds and the charging of excessive fees on the pretext of active management. Hopes of winning the legal battle are not high, as the fund manager might justify the fees by pointing to the agreed mandate.

A solution that is widely advocated is for more transparency

There is more real hope of regulatory initiatives. The European Securities and Markets Authority (ESMA) and national regulators in UK, France and Scandinavia are all looking into the topic. It is currently just an information-gathering exercise, but critics of closet indexing hope that it will lead to actual regulation. ESMA is reported to be looking into the possibility of a co-ordinated pan-European policy. The problem is that, when regulators come in, a clear definition of closet indexing is needed.

Is it in terms of composition and weighting too close to the benchmark, or replicating the performance of an index too closely? Or funds whose tracking error is deemed too little, or which exhibit a turnover deemed too low, or display high correlations to market indices? Is it some or all of the above?

A credible regulatory definition needs a quantitative threshold, but the use of three parameters – AS, tracking error and cost ratio – as identifiers of closet indexing in determining the thresholds in any scientific way is an awesome, perhaps even impossible, task. Without quantitative measures however, regulators might end up with too much discretion, leading to regulatory uncertainty that inhibits new products and facilitates regulatory arbitrage.

A solution that is widely advocated is for more transparency, with managers of portfolios encouraged to publish the three figures relating to their portfolios, particularly the AS measure.

In pursuit of this objective, the Swedish Shareholders Association, representing more than 60,000 retail investors, has produced software designed to help investors to screen equity funds for closet indexing. This tool aims to classify funds in five categories: good value index funds, expensive index funds, genuine active funds, semi-active funds and false active funds. The last are considered to be closet index trackers. It is hoped that the software will be widely used in the major European fund markets, the UK, Luxembourg, France, Germany and Ireland.

Editor's comment

The conflicting results from the various studies indicate that active management can work some of the time but not all the time. When it does not, staying close to the index will be appropriate temporarily, but this process has developed such a bad image that very few people are likely to admit to it.

The word closet is justified only when the client is led to believe in more ambitious returns being targeted

Hugging the index is perfectly respectable under some circumstances, even on an ongoing basis, if institutions want low risk relative to the index. Consider a portfolio solely with index stocks, for example the FTSE 100 holdings, the portfolio having the same stocks but each of the weightings deviating plus or minus substantially from the index such as 200% or 25%. The active share could be small but if dynamically managed with weightings varied then the process represents active management. This would also be justified by the need to focus research attention on a stable widely covered universe that is easily understood by investors. The active share will be completely misleading. The tracking error also might be low and this process might be what the client wants.The word closet is derogatory and should not apply to the above example. But any measure of the portfolio will make it look like closet indexing. The word closet is justified only when the client is led to believe in more ambitious returns being targeted.

It is a matter of price and regulators getting involved could be a can of worms with institutional investors. With retail customers it might be a different matter where high management fees are charged and advertising material could promise very active management, implying strong stock selection.

EMPLOYEE OWNERSHIP PROMOTES PROSPERITY

'Power to the (working) people works' Steve Johnson, FTfm, 22.9.14

'Neuberger Berman focuses on international expansion', Asset Management, Sarah Krouse, Financial News, 8.2.15

John Lewis, an outstanding success story in retailing, also stands out for its employee ownership model. Does the same hold true for its counterparts in fund management that are majority-owned by their employees? Yes, according to research by the US asset management consultancy Casey Quirk.

Over the ten-year period from 2003, the assets of investment houses, in which the majority of shares were owned by employees, grew at a compound annual rate of 12.7%. Remarkably, even the growth rates for firms without majority employee ownership benefited from having more rather than less such ownership (see table).

Ben Phillips, a Casey Quirk partner, pointed out that this pattern is not by chance, suggesting that it is a question of attracting and retaining better talent. He feels that asset managers would prefer a share, even a notional one, in their own division, where they have a direct influence, as opposed to an actual stake in the larger parent.

Casey Quirk's findings were supported by other analyses and comments. Ian Smith, a partner in the financial services strategy group at the consultancy KPMG, stated that his research came to similar conclusions. He believes that there is more commitment at these independent firms.

There are several variants on the theme of employee ownership

Catherine Konicki, a partner at NEPC, a US consulting firm, agreed that it liked firms being owned by their employees, who thereby have greater control over the business. But she raised questions about the succession plan and whether employee ownership is concentrated among just a few.

The firm Neuberger Berman is owned by its employees and, in a likely reflection of this, enjoyed massive growth between May 2009 and the end of 2014, with global assets under management (AUM) increasing by about 60% to $250bn. The proportion of total assets coming from clients outside the US jumped from under 10% to 25% over this period, with European asset growth accounting for more than $20bn of the increase. This is attributed to the preponderance of bank and insurance company-owned assets in Europe, which are increasingly identified with indifferent management.

Compound annual growth rates of assets under management of listed firms

Types of firm	(%)
More than 50% owned by employees	12.7
Less than 50% owned by employees	10.8
With employees offered shares in asset management arm	9.5
Other firms	7.6

Jon Little, Chief Executive of Northill, which owns a majority stake in a number of asset management companies, ensures that the employees retain a significant holding in these subsidiaries.

According to the consultancy McKinsey, the independents are more profitable as well, with operating profits at about 20 basis points of AUM in 2013, the corresponding figures for bank- and insurance-owned managers being 16bp and 9bp respectively.

Of course, not all insurance companies do badly in fund management. Allianz and the Prudential succeeded by giving autonomy to Pimco and M&G, while Legal & General Investment Management and Standard Life have made their name in specific fields.

The effect of employee ownership on fund performance is not all clear-cut. Neuberger, for instance, had 78% of its funds beating their benchmark over ten years, but only 43% did so over three years and 42% over five years. However, this is just one company, which may not be representative.

Editor's comment

There are several variants on the theme of employee ownership. In the case of John Lewis for instance, all employees, both high- and low-earners, get shares and it is likely that when their employment ceases, the shares have to be given up in order to prevent a huge mass of legacy owners undermining the ownership model. In such a case, there may not be too much difference between a bonus paid based on the performance of the company and explicit share ownership, subject to the methodology underlying the grant of shares.

With fund management companies, the chances are that it is only some fund managers who own the shares in the company, though a wider class might qualify in a few firms. A distinction must be made between control and beneficial ownership, as the effects of share incentives differ. Furthermore, asserting that by virtue of share ownership fund managers have 'skin in the game' is not necessarily true. It depends on the size of their stake relative to their overall wealth. Casey Quirk's statistics might be impressive, but, unless the differences in ownership structure are shown to produce consistently better performance, the higher AUM growth rates will not persist.

'SKIN IN THE GAME' – A FLAWED CONCEPT?

'Why investors should pick managers with 'skin in the game'', Stephen Foley, Financial Times, 21.10.14

Backing fund managers who invest their own money in the funds they manage is put forward as a way of identifying those who are likely to perform consistently in the long run. This is seen as a solution to most fund managers underperforming the market and past success not being a predictor for the future.

The idea is that the interests of fund managers who have 'skin in the game' are more aligned with those of the investors in the funds. In the US, data relevant to this thesis comes from the Securities and Exchange Commission (SEC). It stipulates that every fund publish annually the amount of money its portfolio manager has in the fund. Mutual funds have to send these regulatory filings to their investors.

However, this information is not as detailed as it could be. The managers are required only to identify the bands in which their ownership falls: $1-10,000 and going up in various slabs to holdings above $1m. It is suggested that, if the SEC demanded more detailed data, it would benefit the active fund management industry.

'Skin in the game' has wider applicability outside fund management. It is suggested that equity investors prefer the chief executives of the companies they invest in to hold shares in these and, in fact, to receive shares as part of their compensation package. Insider dealings, whether buying or selling, are often seen as signals to do the same by outside shareholders. A hedge fund manager investing most of his wealth in his own fund is seen as positive by other investors in these funds in the belief that their interests are better lined with that of the manager.

Several studies support the idea of fund managers investing in their funds

The case for 'skin in the game' is not considered black and white, as most mutual fund managers who do well are rewarded for doing so and those who do badly can suffer in their career, irrespective of any ownership in the fund.

Several studies support the idea of fund managers investing in their funds. Last year, Capital Group ranked fund management firms according to the level of their managers' ownership in their funds. Ownership was defined as having at least $1m. The top quarter of the funds according to this measure have beaten their benchmark more than two-thirds of the time in the past 20 years, on rolling five-year and ten-year bases. A similar conclusion was arrived at by the research group Morningstar in a study earlier in 2014. Unfortunately, Capital Group and Morningstar did not analyse the data at individual fund level, but instead aggregated the information at company level. In other words, if a portfolio manager invested in a company fund not actually managed by him/her but still within the company, it counted. The justification for this was that the managers of high risk funds, such as frontier market vehicles, should not be expected to invest their personal net worth in their own funds. It is possible that if a fund manager had some ownership in a fund, other than his own, managed by his company then a strong corporate culture is in place that explains the overall better performance rather than the individual's ownership. This, however, undermines the principle of 'skin in the game'.

There is some fund-level research. Russel Kinnel looked at the 'Morningstar 500', a list of favoured funds established in 2006. He discovered that 67% of managers who had over $1m invested in the fund they managed had beaten the average over the past eight years. However 60% of the rest of this list of 500 funds had also outperformed. So the result says much more about Morningstar's process of selecting favoured funds than about 'skin in the game'. Overall, therefore, the available research is not conclusive.

Editor's comment

The author of the above article is right in saying that fund managers should not be expected to speculate on high-risk funds with a large chunk of their wealth. Actually, this argument goes much further. Why, for instance, should a fund manager living in and committed to the US, and having dollar liabilities in his personal life, be expected to take the currency risk entailed in investing in a German fund which he is managing?

Moreover, fund managers being required to invest in their own funds do not necessarily align their interests with

those of their underlying investors, who could have widely different risk profiles or utility functions in theoretical terms.

These are high risk vehicles. . . prudent investors would back these funds with only a fraction of their money knowing the high risk involved

However, the most telling argument against mandating or even pressurising 'skin in the game' concerns the personal circumstances of the asset manager. It is all well and good if this person has plenty of spare cash to risk, without having to set it aside for personal liabilities. But this is not likely to be true of the vast number of highly talented managers, who are typically in their late twenties or early to mid-thirties. They may still be trying to meet other commitments in their lives. The universe of talented fund managers with actual or potential good performance is not identical to the universe of those with sufficient spare wealth. The industry can lose heavily as a result, particularly because talented fund managers with the capability of producing scarce alpha are very thin on the ground.

True, hedge fund managers have lots of 'skin in the game' and the top ones have made huge personal fortunes. But these are high-risk vehicles. Investors and managers alike have similar risk appetites with respect to their investments in the fund. Prudent investors would back these funds with only a fraction of their money knowing the high risk involved.

Extending the principle to mainstream funds, an individual fund manager's personal risk preferences with respect to his own assets needs to match the fund's targeted risk profile in order for the desired alignment to occur so that he is not tempted to take more risk or be excessively cautious relative to what is expected.

'Skin in the game' is intuitively appealing, but it is a seriously flawed concept and could be counterproductive in some cases.

INVESTMENT MAESTRO STILL GOING STRONG AT 81

'No retirement for Loomis's 81-year-old ice cream fan', Chris Flood, Financial Times, 3.11.14

Bill Gross in his halcyon days at Pimco wore the crown of the undisputed king of bond markets. But he has since been put in the shade by another veteran with superior long-term performance figures.

The Loomis Sayles Bond Fund, the flagship of the Loomis Sayles company, managed by 81-year-old Dan Fuss, has generated a total return of 836% (10.5% per annum) since launch in 1991.

By contrast, Pimco's flagship Total Return bond fund produced a much lower, albeit still impressive, 438% (7.5%) over the same period. These figures perhaps justify the feelings of many that Fuss is the real king of the bond market.

These figures perhaps justify the feelings of many that Fuss is the real king of the bond market. It is not just his performance: Fuss belies his name by making no fuss, in contrast to Gross's histrionics

It is not just his performance: Fuss belies his name by making no fuss, in contrast to Gross's histrionics. Fuss is very much a team-player, giving full credit to his colleagues, credit that extends even to a member of the post-room staff who was recognised at the firm's annual awards ceremony.

On one count, however, Loomis Sayles cannot compare with Gross's achievement. The latter was largely instrumental in building a $2trn empire. Loomis, by comparison, has only a relatively tiny $22bn. Though Fuss has no hesitation in sharing the plaudits with the team, he continues to carry out a strong decision-making role. He says that it will be time to give up when he can no longer lead the morning meeting of up to 90 people.

Given his age and continuing prowess, it is not surprising that Fuss proselytises on the desirability of more workers remaining in employment after normal retirement age.

Editor's comment

Warren Buffett, his deputy Charlie Munger and Dan Fuss, all in their 80s, effectively demolish the idea that fund management is a young person's game. Fund managers who have passed or are near the century mark have come to light, though nowhere as famous as this trio. At least in fund management, age does not stand for withering but for much valued wisdom.

SHIPS QUALIFYING AS AN ASSET CLASS

'Shipping offers pension funds a flotilla of opportunities', Mike Foster, Financial News, 9.11.14

Shipping is being pushed as a suitable asset class for pension funds needing to match their inflation-linked liabilities with real assets.

Marine Capital, based in London, offers investors a return of 6% from container ships during a 15-year lease period, compared with just 2% on ten-year UK Government bonds.

According to Marine's Chief Executive Tony Foster, substantial shipping firms would act as counterparties to this proposed deal, with a return allowing for the $150m cost of building a ship. At the end of the period, the investors would be left with an asset with a residual value providing an overall internal rate of return of 12-14%.

Other asset managers have put forward shipping as an asset class before. However, shipping is at the sharp end of business cycles, reflecting world trade and periodic over-investment. The popularity of this sector is likely to be cyclical, and Marine Capital feels that backing shipping now is timely because the shipping cycle is at a low and ships are considered to be very cheap. In 2012, Marine came up with a $200m fund that invested in smaller carriers. The fund has so far produced a 20% return, and a second fund has been launched.

The total value of ships worldwide is about $2trn, while institutional investors, including private equity funds, account for a relatively miniscule $20bn. This offers ample scope for growth of the sector of the asset class

According to Foster, many ships are being de-commissioned partly because of the high prices being paid for scrap. The total value of ships worldwide is about $2trn, while institutional investors, including private equity funds, account for a relatively miniscule $20bn. This offers ample scope for growth of the sector of the asset class.

Shipping may provide an attractive opportunity, but sound management is still needed. Foster points out that Marine Capital has the requisite experience and maintains staff at shipyards to ensure that ships are built properly.

Editor's comment

The potential for this asset class cannot be denied. In addition to it being cheap from time to time, shipping is a good way of betting on the global economy. For the very biggest institutions, an overall size of $2trn would not be impressive, as much of it will remain in private hands. It may be more attractive for their smaller counterparts.

Shipping will always be a good way of betting on the business cycle

The main problem is the expertise and experience needed which is worth their while acquiring. Shipping will always be a good way of betting on the business cycle, in addition to the benefit of the illiquidity premium that this unquoted asset type has to offer. But, for the sector to take off, a few more Marine Capitals would be needed.

LEADING PENSION FUNDS CUT BACK ON ALTERNATIVES

Sage & Hermes Research

In September 2014, the second-largest US pension fund, with $300bn of funds as at March 2015, California Public Employees' Retirement System (Calpers) announced its selling out of its entire $4bn hedge fund holding. This move created substantial reverberations in the pension fund industry and among hedge funds. Europe's second-largest pension fund, the Dutch Healthcare Workers Scheme (PFZW) has also decided to axe its hedge fund allocation.

Calpers exercises massive influence among public pension funds, mainly due to its size and its record of being one of the initial movers into alternatives at the turn of the century. Therefore many pension funds might now feel obliged to justify continued backing of this sector.

Conflicting views have emerged as to how many of their peers will follow suit. Following Calpers' announcement, many US pension funds and two large UK funds, the BT pension scheme and the British Rail pension fund, were reviewing their allocation. Though State Street Research found in a survey that 77% of pension funds worldwide were expecting to increase their exposure in the next three years, the *Financial Times* felt that many will follow Calpers.

Calpers cited three factors in its decision that might create a watershed in the hedge fund sector: complexity, costs and lack of ability to scale. All three owed much to poor returns. The complexity of carrying out due diligence and monitoring the hedge fund holdings were regarded as too high relative to the size of the exposure. At the same time, fees (costs) were excessive in relation to returns – the same reason put forward by the Dutch pension fund PMT for abandoning the sector. Thirdly, Calpers' holdings in the hedge funds could not be scaled up, because of capacity limitations.

Calpers cited three factors in its decision that might create a watershed in the hedge fund sector

Ostensibly, the hedge funds are doing very well. According to Hedge Fund Research, total assets of $2.82trn in the third quarter of 2014 represented a ninth consecutive quarterly record. But the inflows are slowing, with the money coming in at $16bn in the third quarter, compared with nearly double that in the second quarter, and well below the $23bn of the third quarter of 2013. Eurekahedge produced even worse statistics, with the hedge funds experiencing their fourth consecutive net outflows in the third quarter, and the total for the year to December amounting to $55bn.

The main justification for hedge funds getting away with their high 2-plus-20% fees was the returns promised, but their historic lower volatility was also important. In fact, a Preqin survey suggests that 59% of institutional investors were mainly looking for reduced volatility, and only 7% for high returns.

Both planks of hedge fund attractions, returns and diversification, are now seen as shaky

Both planks of hedge fund attractions, returns and diversification, are now seen as shaky. According to the giant fund house Vanguard, hedge fund diversification is not better than that achieved by a classic 60:40 stock/bond split in a traditional portfolio. Hedge funds also underperformed the Standard & Poor's 500, which might have been acceptable but for poor diversification. Research suggests that, by and large, hedge funds are more correlated with equities.

Editor's comment

Pension funds in particular are slow to catch on to a new idea, and most still subscribe to the conventional wisdom of a few years ago. It is not clear whether Calpers' action is the start of a trend, and what other pension funds do in the next 12 months will be key.

Unless the alternative sector pulls a rabbit out of the hat in terms of better overall returns than achieved recently, a gradual and phased withdrawal by many pension funds, following Calpers, is more than likely.

The idea of institutions focusing on low volatility as an attraction on its own does not make too much sense. Lower volatility needs to go hand in hand with acceptable, though uncorrelated returns. Otherwise note that a constant negative return, for instance, has zero volatility.

SEA CHANGES IN HEDGE FUNDS AND PRIVATE EQUITY

Editor's introduction

Hedge funds and private equity funds were riding high before the financial crisis, but they have had their share of troubles during the downturn. In some ways, they appear to have come through, but their underlying health is not what it was and both groups of alternatives are having to face new realities, operate in a new environment, and are being forced to make changes.

Important developments

- Investment in hedge funds by California Public Employees' Retirement System (Calpers) might lead other pension funds in this direction. In anticipation of this, the hedge funds are turning back to their original supporters, the wealthy, who built up the industry and are now scrambling to get on investment banks' private wealth platforms. The sector could look dramatically different in ten years' time. *('Hedge funds confront the future', Amanda Cantrell, Institutional Investor, November 2014).*

- According to HFR and Preqin data as analysed by the *Financial Times*, in the six-and-a-half years from the beginning of 2008, pension funds invested about $450bn in hedge funds, assuming the average hedge fund return would have received about $95bn in gains, but hedge fund fees took a $68bn slice out of this, representing 72 cents in every dollar of investment gains. *('California calls time', Miles Johnson and Dan McCrum, Financial Times, 20.9/21.9.14).*

- Liquid mutual-fund alternatives imitating hedge fund strategies have seen their assets under management (AUM) grow by 40% per annum since 2008, according to a new survey from Deutsche Bank, with total AUM at $600bn in September 2014. *(Hedge Funds Review – 'Liquid alternatives surge by 40% year-on year', Kris Devasabai, 10.14 and 'Under Scrutiny' Nicolas Morgan and Antonella Puca, November 2014).*

Liquid mutual-fund alternatives imitating hedge fund strategies have seen their assets under management (AUM) grow by 40% per annum since 2008

Editor's comment

This total, though much smaller, is not negligible compared to the hedge fund sector of under $3trn and looks set to grab a bigger slice of the alternatives' pie. But a small blot on the horizon is that this fast-growing category is being scrutinised by US regulators for its illiquid security holdings.

- Investors are increasingly emphasising customisation and making co-investments. Investcorp, an alternatives firm, manages around $2.5bn in customised fund of hedge funds (FoHF) portfolios where clients specify the risk factor. Lionel Erdely, Chief Investment Officer at Investcorp, based in New York, anticipates that many institutional investors will dispense with the intermediaries and manage their hedge fund portfolios in house.

  Disintermediation is one of the big trends in the business. Many of these investors have their own hedge fund research teams, and Investcorp offers a co-investment approach through its platforms. According to Barclays and the Alternative Investment Management Association, 33% of investors have co-invested with hedge funds. *('Skin in the game', Kris Devasabai, Hedge Funds Review, October 2014).*

- The private equity sector's highly leveraged mega-buyouts are now being clearly seen for what they were: gigantic mistakes. The economic recession, together with massive borrowings, made many of the investments worthless, and the private equity firms concerned have been sued by shareholders of the companies that suffered.

They alleged that the buy-out firms colluded to depress the prices they paid for the companies. In August, some of the elite private equity firms settled, without admitting liability.

These huge deals are seen as no longer viable, mainly because the sector has changed quite dramatically from what it was before the financial crisis. Instead of paying heavily for public companies, they are now finding better pickings in minority holdings or divisions being disposed of by conglomerates. Some term themselves alternative investment managers, not just doing buy-outs but also playing in real estate credit and public markets. (*'Private equity', The Lex Column, Financial Times, 11.8.14*).

- Two of the biggest private equity groups, Blackstone and Carlyle, are making a major shift in their strategy. In looking for new ways to buy big global companies, they are co-investing with other major investors and departing from the usual formula of holding the investment for five years and targeting 20%-plus returns. They are focusing on large international companies with global brands that will offer lower returns and need to be held for longer to achieve this. This shift has been partly influenced by their largest clients. Some of the sovereign wealth funds (SWFs), such as Singapore's GIC and large Canadian pension plans, are now going down the direct investment route. A model that is admired is 2013's $23bn takeover of Heinz by 3G Capital and Warren Buffett's company Berkshire Hathaway. 3G did not use a fund to invest, and neither it nor Buffett have any pressure to sell within any particular timeframe. This approach is likely to be replicated widely as the big investors are disinclined to go through the buy-out firms' existing funds.

Buy-out companies entering the retail pensions market pose some danger

The new method is in line with the buy-out sector lowering its sights and extending its horizons generally. For instance, infrastructure deals tend to offer 8-12% and are still of interest to the buy-out group. Blackstone is currently developing a second version of its Tactical Opportunities Fund that is designed to hunt for the more unorthodox investments that are outside the traditional boundaries of private equity. In the first version of this fund, Blackstone dealt in non-performing loans, ground leases on Telecom Towers, TV stations and shipping investments. It also provided financing to liquefied-petroleum-gas container ships. The idea is that, if the investments are successful, Blackstone could convert its holding into a minority equity stake with a 20%-plus return, but will otherwise have a senior loan yielding good fixed income-type returns. (*'Top Buyout Firms Ponder New Strategy', Simon Clark, The Wall Street Journal, 7.10.14; 'Buyout firms look at longer time horizons', Simon Meads, Financial News, 8.2.15*).

Private equity foraging for retail pensions

Financial News – 'Access to private equity emerging for UK pensioners', Becky Pritchard, 21.9.14 and 'Firms aim to tap more funds from UK pension savers', Becky Pritchard, 26.10.14

Pantheon, the $30bn private equity funds of funds group and one of Europe's largest, is targeting access to UK's defined contribution (DC) pension plans. It has already initiated this process in the US, where Carlyle Group and Kohlberg Kravis Roberts (KKR) are also pushing for access to DC plans. Pantheon is closer to success in the US, and expects to do the same in UK and Continental Europe in the next few years.

Partners Group and HarbourVest are understood to be interested in UK's DC market as well. A prime motivation is the gradual demise of defined benefit (DB) schemes, hitherto a large client group of private equity firms. Furthermore the bigger DB plans that are surviving are increasingly going direct.

Time horizon could be an issue here. Private equity investors usually see their money locked away for ten years, which is not a problem for large investors but could affect small retail individuals, who might prefer to shift to some other asset within their pension plan within, say, three months after investing in private equity, causing problems for the illiquid private equity holdings.

Africa perhaps offers a better model as to how private equity can operate worldwide, in making huge contributions to society, including the very poor

For this reason, Pantheon is focusing on individuals in default DC schemes. Another problem lies in the requirement for daily valuations. Pantheon is hoping to do this in the US, based on market movements since the portfolio was last valued. Another huge obstacle lies in the 2% typically charged by private equity, compared with the 0.75% cap imposed by the UK Government. It is not clear how Pantheon intends to deal with this.

Editor's comment

Buy-out companies entering the retail pensions market pose some danger. Pantheon might be fine, given its stature. However once the doors are opened other private equity firms with lower standards could creep in. This might expose smaller pension funds and their relatively ignorant members to unacceptable risks. The authorities need to make sure that appropriate rules are in place.

Buy-out firms invading emerging markets

'Private equity fights for share of China hospitals', Patti Waldmeir, Financial Times, 14.8.14

The Economist –'Unblocking the pipes', and 'A sub-Saharan scramble', 24.1.15

Public markets in many emerging countries, being underdeveloped, offer classic opportunities for enterprising private equity firms in the West. This is an area where these firms can really add value and make a difference, socially speaking. In some instances, it can offer the extraordinary combination of impact investing and huge returns that might cause their peers back home to salivate.

In China, private equity is trying to grab a share of hospitals. Some of these are already private, but many others are still to be privatised or even to be built, representing green-field investments. Investment opportunities also extend

to dentists, rehabilitation centres and cosmetic surgery. Healthcare's percentage of Chinese GDP is at 5%, currently dwarfed by the US's 18%, according to McKinsey, offering massive growth opportunities.

One caveat, however, is that a time horizon of 20-40 years might be needed for a good pay-off in China, according to Alexander Ng of McKinsey. Even a seven-year time frame might be problematic, unless the opportunity is cheap, which is unlikely. Competition for deals will cause high prices at the outset that may need much longer time horizons for payback.

Many alternative firms are following several routes to acquire permanent capital, which will also reward them with a reliable flow of fees

Africa perhaps offers a better model as to how private equity can operate worldwide, in making huge contributions to society, including the very poor, as opposed to servicing China's rich in their healthcare needs. Many emerging African countries are hungry for capital in areas such as infrastructure and industries undergoing liberalisation. It is classic territory for enterprising buy-out firms.

But these firms cannot count on going in and getting out in just five to ten years, though some do, leaving their local partners disappointed. Deals of a size to interest western firms are thin on the ground. $100m upwards is ideal, but many deals fall below $10m.

Leveraging for extra returns is tough in Africa and one of the traditional exits into public markets is not available, given the state of local stock markets and the unwillingness to sell of their partners on the ground.

Private equity money goes into general industry as well as health clinics and universities. Even without actual control there is plenty of scope to advise and implement operational improvements. The most popular investments are in companies that are already home-market leaders and have the potential for making it regionally or globally. Carlyle, for instance, has committed nearly $700m to Africa and is taking a majority stake in South Africa's largest tyre retailer, Tiger. It plans to extend this company into neighbouring countries, in spite of the difficulties of diverse languages, culture and legal systems.

Editor's comment

Emerging markets are ideal terrain for private equity firms to create value for their investors, the local populations and for themselves given the underdeveloped state of the quoted equity markets.

Private equity aping the Warren Buffett model

'Perpetual cash machines', Henny Sender and Stephen Foley, Financial Times, 5.1.15

Hedge funds and private equity groups have to return capital back to their investors, and envy Warren Buffett with his stock of permanent capital and reliable flow of premiums from his insurance companies over the past 50 years. He has been free of the pressures of returning cash to investors.

Many alternative firms are following several routes to acquire permanent capital, which will also reward them with a reliable flow of fees. These include close-ended funds, both listed and unlisted, as well as listing the groups themselves, as Blackstone has done. Another route, unusual but growing in popularity, is through special purpose acquisition companies (shell companies).

Editor's comment

Hedge funds and private equity are facing a very different environment to what they enjoyed before the crisis. The signs are not at all good for a large number of hedge funds. The Calpers decision is bound to cause much reassessment and disappointing results will lead to gradual shrinkage of the sector. It is dubious whether hedge funds can turn back to the rich, their original backers in the '80s and '90s. Many of the super-rich are now much more sophisticated and not likely to back anybody without proven talents. They are also more adept now at finding suitable investments through their family offices.

The old model of financial engineering and operational enhancements is now increasingly difficult for private equity groups, and it is not surprising that many are heading for new pastures such as retail clients and emerging markets, and also changing their modus operandi in partnering other groups and in the type of investments they will consider. Investors who want to back these groups no longer have a fairly homogeneous sector, and have to be careful in the type they go for.

To some extent at least, the adoption of new practices signifies that the old models do not work well any more. Only time will tell whether the new approaches will deliver the goods.

CHINA POTENTIALLY POSING PROBLEMS FOR PASSIVE GLOBAL INVESTING

'Heavyweight Chinese will tilt balance of global indices', Jamie Perrett, Financial News, 21.9.14

Recent developments in the Chinese stock market may within five years present a serious conundrum for investors mimicking passive global equity indices.

Currently, the combined market capitalisation of Hong Kong, Shanghai, and Shenzhen, at about $4trn, makes China the world's second-largest equity market by value.

Hitherto, not many global investors were able to invest in the A-shares quoted in Shanghai, and the privileged few allowed to do so had to receive a special licence through specific schemes. Now, however, China is moving to make its shares more easily accessible for outsiders by reforming regulation and trading mechanisms. China's Stock Connect Scheme, linking Shanghai and Hong Kong, though just a small step in the right direction, is seen as a harbinger of more to come. The FTSE feels that within five years the consequence will be the inclusion of China in global equity benchmarks.

A proportion of the Chinese stock market is already included in the FTSE Global All Cap Index. This comprises the H-Shares that are Hong Kong-listed companies incorporated in mainland China, the P Chips that are privately owned Chinese companies incorporated outside mainland China, and the Red Chips that are also incorporated outside mainland China, but by entities linked to the government. There are 366 companies in these three groups collectively, which account for China's current weight of 1.9% in the FTSE Global All Cap Index.

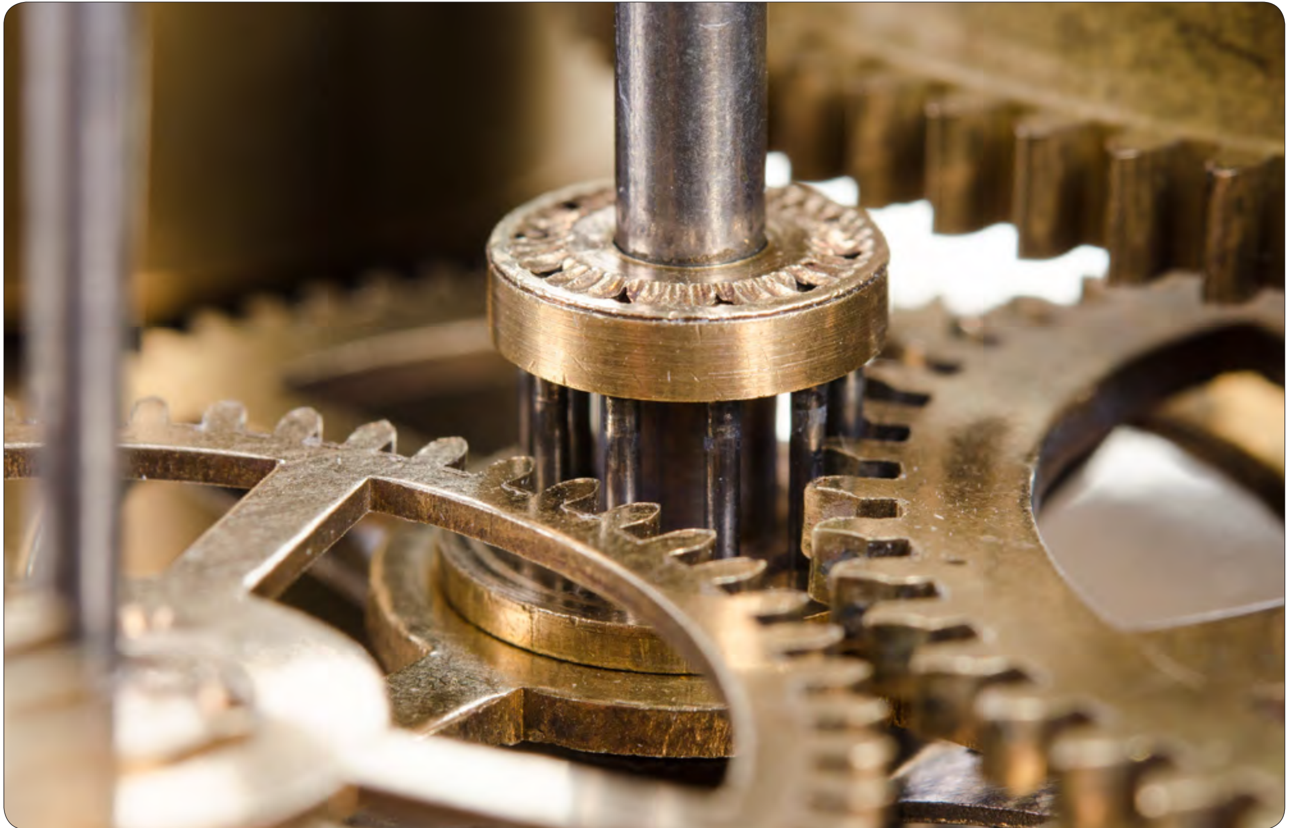
The FTSE feels that within five years the consequence will be the inclusion of China in global equity benchmarks... But what if corruption, deficiencies in the rule of law and poor corporate governance still persist?

If the A-shares were included on the basis of free-float-adjusted market cap, allowing for foreign ownership restrictions, this 1.9% figure would jump to 3.7%. There would be a corresponding increase in China's weighting in the FTSE Emerging index from 21.1% to 32.3%. This would affect ETF providers tracking the indices in question.

Large inflows into the A-shares could cause difficulties in the ability to replicate the index, especially given that many ETF providers may lack the expertise to trade in domestic Chinese equities. Given the scale of the change, the various benchmark providers, including the FTSE, are making considerable efforts to produce transitional indices that will provide market players some flexibility in the timing of their rebalancing.

Editor's comment

If China's capital markets become fully liberalised then the weighting change might need to become even bigger – for instance, if foreign ownership restrictions are removed, thereby perhaps justifying the inclusion of China's entire market cap in the indices. In the hypothetical situation of China having, at that time, become more liberal in its politics as well, there might not be an issue. But what if corruption, deficiencies in the rule of law and poor corporate governance still persist? Passive global investors would then have to choose between accepting all that this entails or becoming a bit less passive by not following the indices closely. The problem is not unique to China. The UK suffers from an imbalance of some sectors in the FTSE 100, but the difference is that the London stock markets are subject to higher standards than those prevalent in China.



VIRTUES OF INFRASTRUCTURE INVESTMENT QUESTIONED

Sage & Hermes research

Infrastructure has been long touted as the panacea for faltering economic growth. There are reasons to question whether investment in this sector is as beneficial as conventional wisdom would have it, and what potential it has to offer asset managers.

Infrastructure investment came to the attention of the mainstream investment management industry about eight to ten years ago, following decades of development by the likes of Australia's Macquarie, a pioneering investment bank with a leading reputation in the field. The sector was perceived as beneficial to the global economy, with President Obama stressing its potential from the inception of his presidency. Infrastructure also promised to be a huge honeypot for the investment management industry, with forecasts of it becoming a substantial asset class. An entire business cycle later, its potential is murkier, both for economies and for asset managers.

The Organisation for Economic Co-operation and Development (OECD) has projected the total global infrastructure expenditure required between now and 2030 to be $50trn. The consultancy McKinsey puts this at $57trn for the same period, while the rating agency Standard & Poor's (S&P) has come up with an annual financing requirement of $3.4trn from now till 2030, a forecast consistent in order of magnitude with the other two. Similarly, huge forecasts were made for 2015 nearly a decade ago, but they have proved to be 'pie in the sky'.

The prospects of the $50trn outlay actually occurring depend on a widely believed economic paradigm that holds that infrastructure investment is good for growth in both the short and the long term.

This paradigm is being challenged. In a polemical article in *The Wall Street Journal*, Holman Jenkins of its editorial board poured scorn on the idea of infrastructure spending being the panacea for the economy. He was dismissive of spanking new Chinese airports, bullet trains and similar projects and asserted that the supposedly crumbling infrastructure in the US provided good service, and that the US also came well ahead in terms of social infrastructure in areas such as education, health and welfare.

Some economists are also sceptical. They believe that the economic benefits of spending in this area cannot be assumed. Physical infrastructure can yield large and sustained benefits in the case of focused projects that are cost effective and achieve worthwhile purposes, such as relieving bottlenecks or exploiting vast new markets. Examples cited include the Marshall Plan that rescued the European economy in the aftermath of World War II, and the Erie Canal that provided the US Mid-West with a conduit to global trade.

However, many other projects offer less clear-cut benefits relative to costs, and quantifying them can be problematic. A case in point is the massive Thames River super-sewer project in the UK. Professor Chris Binnie, Chairman of the Committee that recommended it in 2005, has now reversed his position by asserting that it is a waste of money. According to Ralph Huenemann, Professor Emeritus at Canada's University of Victoria, who has evaluated proposals for the World Bank and Asian Development Bank, high-speed trains reaching Chinese rural areas are not of much use, with single-carriageway roads being of much more value to the villagers.

The prospects of the $50trn outlay actually occurring depend on a widely believed economic paradigm that holds that infrastructure investment is good for growth in both the short and the long term. This paradigm is being challenged

Andrew Warner, economist at the International Monetary Fund, came up with research supporting these negative conclusions. In an August 2014 paper, he found scarce evidence that infrastructure triggers economic booms. Many big projects are, in fact, put in place when the economy is strong, and tend to be the result rather than the cause of an upturn. South Korea and Taiwan have enjoyed decades of high growth without much of an infrastructure boost, while Bolivia and the Philippines have experienced the opposite, in spite of heavy infrastructure spending.

A look at some of the leading countries' experience to date is enlightening. In the US, notwithstanding Obama's inaugural hopes, infrastructure has failed to live up to its promise. Much of the blame is attributed to political fragmentation. Larry Fink, Head of BlackRock and arguably the most powerful asset management figure globally, decries this political paralysis in the face of the much-needed infrastructure that he staunchly advocates.

It has been estimated by the Institute of Civil Engineers that by 2020, lack of repairs to roads and bridges will cost US businesses $1.2trn per annum. Furthermore, much private sector involvement has hitherto been directed towards helping states and cities raise money to fund their budgets by privatising existing facilities, rather than by creating new projects. Even here, infrastructure investment has come up against political and regulatory issues. In Monsanto, for instance, the public authorities are suing Morgan Stanley in order to regain control of water systems. A gap in understanding had developed over what was agreed at the beginning.

These issues highlight a universal problem, not just in the US, that political and regulatory risks loom large in private sector decisions, whether or not to back the infrastructure sector.

In Germany, the problem is different. With a stable and prosperous economy, it has a shortage of suitable infrastructure projects available for the private sector. The cult of privatisation does not have a foothold. Though in principle, institutions would like to back the sector, they are deterred by regulatory uncertainties. The problem here is of worldwide relevance.

Typical infrastructure outlays involve high fixed investment at the outset and low operating costs with social benefits militating in favour of state monopolies. The latter, when privatised, remain exposed to regulatory and political change. The UK encapsulates these issues. Having been a pioneer in public-private partnerships, the country has since gone into slow mode, partly because of outcries that the private sector had got away with murder in terms of excessive profits.

China, and in fact much of the emerging market sector, pose different issues. There is often a surfeit of infrastructure of not much economic value. In India, for instance, bureaucracy, corruption and political problems are also inhibitions. In many countries, governments do not lack finance and thus do not really need the private sector, except for its expertise in some fields. This gap in knowledge is narrowing as middle classes in emerging countries expand, many educated in the West.

One of the attractions of infrastructure investment is its long-term nature, but this is being undercut by market developments

While the OECD may assert that $50trn of expenditure is needed by 2030, the world economy does not always get what it needs. Furthermore, as pointed out by Larry Summers, the Nobel Laureate Economist, and Holman Jenkins above, much of what is required, at least in the US, is repair and refurbishment of existing facilities and small-scale improvements, as opposed to large-scale ventures that are attractive to the private sector as investment assets. The $50trn figure needs to be regarded as a guesstimate with a potential large margin of error, depending on the in-built assumptions.

Standard & Poor's has projected that the gap between the above global infrastructure investment needs and available public sector funds will reach $500bn a year by 2030. The opposite side of the coin, according to the rating agency, is that investors' allocations to infrastructure worldwide could rise to an average 4% of total assets under management (AUM) in the next five years, more than twice the figure now. This could imply approximately $200bn per year of additional funding for the sector. Assuming that bank lending continues at about $300bn a year, S&P suggests that the funding cap of $500bn could be closed. However, these public sector funding needs and bank lending forecasts are subject to very large divergences in actual outcomes, given uncertainties in public sector finances, overall political will and bank finances over such a long term.

The critical question for the asset management industry is what it might be able to, or want to, provide and to what extent its potential outlays will impact on its overall exposure to infrastructure as a proportion of its total AUM. It is not at all clear that the asset management industry is in a position to come up with the money on the scale suggested.

Distinctions must be made between different types of infrastructure investment. The primary way of dividing this class is in terms of whether it entails green-field (new) ventures or brown-field ventures (infrastructure facilities already in place). A third dimension is the buying of shares in (both listed and unlisted) companies involved in the area. There is also the choice between infrastructure equity and debt.

One of the major attractions, especially for institutions, particularly pension funds, is the long-term inflation-linked nature of the asset class, although this pertains more to infrastructure equity than to debt. Macquarie stands out for offering inflation-linked debt instruments, because this is not generally true. A significant chunk of institutional investment is through debt funds, the number of which is increasing globally. According to Preqin, the alternatives data specialist, 30 such funds were looking to raise $20bn from investors in 2014, compared with just 20 raising $15bn in 2013.

Much of the equity-type financing by fund managers is going to companies already established in infrastructure, rather than to new developments. In late 2014, M&G Investments, the investment arm of UK giant insurer the Prudential Group, closed investment in its third infrastructure fund. The assets of this fund, including those of co-investments, amount to £1.3bn raised from the Pru and pension funds and insurance companies worldwide. The fund's investments include UK-based Affinity Water, Falbygdens Energi, a Swedish district heating and electricity distribution company, and Calvin Capital, a UK metering business, none of these classifying as green-field investments, or even brown-field, in terms of the above definitions.

Fund management companies and institutional investors are exhibiting severe risk aversion in terms of investing in green-field projects with their construction and cashflow risks, except possibly through guaranteed or insured debt instruments. When S&P refers to the funding gap, it is clearly talking about green-field money, precisely what the fund management industry is shying away from.

The institutional appetite for infrastructure is growing fast and is at its highest point at $282bn – nearly a three-fold increase since 2007, according to Preqin. In terms of funds available for investment, North America has the most with $137bn, Europe-focused funds have $87bn and Asia-focused funds have $31bn. Note that these figures are small relative to the forecast expenditures of $50trn needed in the next 15 years, particularly considering that the investment industry has been thinking about this as a class for more than ten years.

Overall, it is not surprising that the sector has lost much of its lustre, particularly in view of the huge political and regulatory risks involved

One of the attractions of infrastructure investment is its long-term nature, but this is being undercut by market developments. Before the sector came into the limelight around the middle of the 2000 decade, it was noted for offering a high and inflation-linked yield of a stable long-term nature. However, this key characteristic was whittled away by the sector becoming popular and being bid up to excessive price levels immediately before the crisis, only for these to subside during the subsequent crisis.

Before the crash, assets were often exchanged at 30 times earnings. That fell to 13-14 times earnings after the crisis broke. Now, once again, the heady price levels have returned, with recent infrastructure deals again reaching the 30 mark in p/e terms. Stakes in the Port of Newcastle and Queensland motorways in Australia recently changed hands at about 29 times earnings, and an earning before interest, tax deprecation (Ebitda) multiple of 17 times for the electricity network in Finland represented an 80% premium on a global regulators' valuation. The market has effectively introduced business cyclicality into a once stable long-term sector that can reduce returns when purchases are made at the wrong time. Similar considerations apply to investment through established companies. Overall, it is not surprising that the sector has lost much of its lustre, particularly in view of the huge political and regulatory risks involved.

From a social perspective, infrastructure was once considered to be the asset management industry's answer to doubts pertaining to its long-term social credentials, but its aversion to green-field investment has very much undermined this. If, at the outset, the industry undertakes to take over a project, once the construction risk ceases, it will be of benefit. However, such activity is not too much in evidence. In any significant size relative to massive expectations, the private sector looks like remaining reluctant to fund the infrastructure boom in any considerable way.

THE EU TAKES TO FINANCIAL ENGINEERING

Financial Times – 'The Juncker fund will not revive the eurozone', Wolfgang Munchau, 1.12.14; 'Juncker's plan needs companies to open up their healthy coffers', Sarah Gordon, 30.12.14

The Wall Street Journal – 'Juncker's Investment Plan Is No Magic Bullet', Simon Nixon, 1.12.14; 'EU Set to Unveil €300 Billion Fund', Matthew Dalton, 24.11.14

'Fiddling while Europe burns', The European Commission's investment plan, The Economist, 29.11.14

Leveraging and financial engineering are unusual activities for the European Union, entrusted as it is with the well-being and future of the European project and not expected to speculate with taxpayers' money. But this is precisely what it plans to do with the new fund unveiled on 26 November 2014 by the European Commission's new President, Jean-Claude Juncker.

The idea is to kick-start economic growth in the EU

The European Fund for Strategic Investment is targeted to invest €315bn with the EU through its development bank, the European Investment Bank (EIB), co-investing with the private sector. The idea is to kick-start economic growth in the EU with this investment impetus. While the plan is regarded as clever, widespread scepticism surrounds the chances of the EU achieving its stimulus aims. The €315bn outlay is expected to be spread over three years, about €100bn annually, which compares with Europe-wide investment already falling short of the pre-crisis level by €230bn per annum. There is hope at the EU level that some of the national governments might chip in with additional outlays, enlarging the stimulus impulse. But this is dubious, given that Germany is tight-fisted, the UK is fiercely resisting handing out further cash to Europe and the southern and eastern European states are in no mood to spend either.

How do financial engineering and leverage come into the equation? The plan is to start off with €8bn drawn from existing budgets. This sum is to be set aside as collateral for a guarantee of double the amount, €16bn. The logic is that all the projects that might be mooted will not fail at the same time, enabling the classic leveraging technique of actual cash backing a multiple in terms of investment. The EIB expects to add another €5bn to the pot, making €21bn in all. This €21bn is then to be used as a second layer in the leveraging pyramid, to raise €60bn through the issue of bonds. The EU will absorb most or all of any initial losses in the partnership with the private sector. The intention is to reduce the risk of such losses, thereby attracting more private capital. Effectively, some of the losses will be socialised while the profits are privatised. This will attract some criticism, but the project is justified on the basis that the potential stimulus to the European economy will more than offset the financial risk taken on by the EU.

The Economist magazine is particularly dismissive, calling the plan laughably inadequate and pointing out that the guarantee of Europe's €16bn is derived from recycled money from unspent amounts in other sections of the budget. Overall the initial reception is lukewarm.

Not all comment is negative. It is suggested that the question is not how much money the EU puts up, but whether it can remove bottlenecks to private sector investment. Hitherto the emphasis has been on providing grants, but this plan involves the introduction of investment focusing on commercially viable projects. The biggest problem, of course, is to find a sufficient number of such projects. Some of the investments suggested are of a cross-border nature, such as electricity transmission lines connecting the national grids of different countries.

There is a fear that the EU might merely issue a guarantee instead of laying out upfront cash. Without such an infusion of cash, this could lead to several problems:

- Investors might be reluctant to come in, doubting the guarantee's effect, and uncertainties might arise due to possible political interference. The advantage of cash upfront means that it would automatically be available for meeting losses, as opposed to a guarantee having to be invoked.
- Secondly, capital, in general, not only covers risk but provides liquidity, and for the latter actual cash is important.
- A related problem is that it will not be certain how much of the new investment would have taken place anyway.

Though the plan is criticised for making very little new money available, with much of this being pinched from other budgets, the real problem is different. The credit rating agency Moody's estimates that the nearly 650 corporates that it rates in Europe, the Middle East and Africa hold a total of over $1trn in cash. Large chunks of this in Europe are concentrated in the energy, automotive, telecoms and utility sectors, accounting for nearly three quarters of this total, with about one quarter held by just nine companies. These companies have difficulty in identifying suitable opportunities. It is considered that the Juncker plan could work if the new fund's resources are directed towards companies that are likely to take on the greatest number of staff as they expand.

Editor's comment

At least some of the evidence points to lack of cash not being the obstacle to Europe's growth. Risk aversion and shortage of confidence perhaps are much more to be blamed. The consequences are that the riskier, smaller and medium-sized companies are starved of cash and those who do have it, including the big corporates, are scared to part with their money. Against this background Juncker's investment plan seems to be woefully inadequate.

EUROPEAN LONG-TERM INVESTMENT FUNDS – MIRAGE OR REALITY?

'Eltifs: grand goals for a humble fund structure', Steve Johnson, FTfm, 15.12.14

While the Juncker plan grabbed much of the headlines, it is felt that another aspect of the EU's growth strategy through investment offers better prospects for the longer term.

The EU has come up with the concept of 'European long-term investment funds' (Eltifs). These differ from the conventional UCITS vehicles, which have achieved world status as globally accepted investment mutual funds safeguarded by the EU's regulatory umbrella. The problem with UCITS funds is that they have to promise liquidity to investors, thus inhibiting long-term investments of the illiquid type. UCITS need to offer investors the opportunity to redeem their units at least twice a month. Examples of illiquid assets that satisfy the long-term criteria are infrastructure investments and loans to small companies. Both these areas are considered ripe for absorbing money that will promote growth in the stagnant European economies.

The details are still unclear. At the end of November 2014, the various European institutions arrived at a compromise that is believed to be enhancing the prospects for this fund type. Eligible assets include aircraft, intellectual property, social infrastructure and unlisted equities. Even listed equities are allowable if their market cap is less than €500m. The compromise also covered potential liquidity issues that might arise at the end of the stipulated redemption period, referred to in more detail in Wolfgang Mansfeld's Regulatory Spotlight article, which follows this.

The compromise also covered potential liquidity issues that might arise at the end of the stipulated redemption period

While funds must be domiciled in the EU and managed by an EU company, there is now freedom under the latest proposals to invest more elsewhere than implied by the minimum 60% that the European Parliament previously stipulated should be invested in EU states. Moreover, a fixed redemption period was an early bone of contention, but now both extensions and early redemptions are allowed under certain conditions.

It is envisaged that Eltifs can be listed, providing liquidity through secondary markets, but this has provoked criticism that Eltifs are no different from the investment trust sector, a longstanding feature of the UK stock market.

Several asset managers are adopting a wait-and-see attitude

Julie Patterson, Head of Investment Management Regulatory Change at KPMG, points to two differences between Eltifs and investment trusts. Eltifs require a minimum investment of at least €100,000, whereas investment trusts in the UK impose no such restriction, a negative aspect of Eltifs in her view.

The advantage of Eltifs, on the other hand, lies in the investment trusts being classified by the EU as alternative investment funds, whereas Eltifs will be available to top-end retail investors.

Patterson believes that the wealthy and the more affluent retail investors will be attracted to these funds, but several asset managers are adopting a wait-and-see attitude. According to Patterson, even investors in Asia are attracted.

Editor's comment

Wolfgang Mansfeld, as referred to above, highlights the difficulties and fund managers' less than enthusiastic attitudes in going for these long-term investments. Only a small number of fund managers so far seem to have expressed an interest. It would be a great pity if the industry does not take this opportunity to add value.

CONTRIBUTIONS FROM INDUSTRY EXPERTS

The previous pages of this magazine comprise reviews of and commentaries on the best in other recent publications. The following pages include articles on key topics written by external industry experts.

REGULATORY SPOTLIGHT:

IN TIMES OF TIGHTER REGULATION, THE INCEPTION OF LONG-TERM FUNDS OFFERS AN OPPORTUNITY

Dr Wolfgang Mansfeld

The year 2008 marked a tidal shift in fund regulation. Since then, stricter rules have been imposed on almost all areas of the fund business. Regulators have imposed rules on largely unregulated products (such as hedge funds), enhanced the standards of business conduct and improved investor protection.

Meanwhile, the fund industry has some hope that this era may come to an end. One argument is that important pieces of post-crisis regulation have been finalised. The EU Directive on alternative investment funds and fund managers (AIFM Directive), approved in 2011, has been completed and largely implemented. In the area of UCITS, the EU regulated retail funds, the post-2008 revision of the directive – leading to the latest release labelled 'UCITS V' – was approved a year ago. The focus is now on two provisions that should make UCITS (even) safer, taking into account lessons of the crisis. The one is to tighten the functions and liabilities of the depository, which proved to be insufficient in the aftermath of the Madoff fraud. The other provision concerns remuneration policies and practices, in order not to encourage inconsistent risk taking by fund managers. Last but not least is MiFID, the financial markets directive.

I suspect the true reason is that the fund industry is not very familiar with the handling of long-term assets

A further reason to hope for less new regulation is that the political climate may have changed. In Europe, the incoming EU Commissioner for the internal market, Jonathan Hill, is assumed to have a better understanding of the needs of the financial industry than his predecessor. In the US, the Republican majority in the Congress is regarded as more business-friendly. Regulators obviously try to shorten the list of pending regulatory proposals and focus on key projects. In this respect, some optimism seems to be justified.

I remain convinced, however, that financial stability and shadow banking will stay at the top of the agenda, with an increasing focus on the fund industry. The reform of money market funds – in particular those funds offering a stable NAV – is the most urgent issue in this area. In the US, in autumn 2014, the Securities and Exchange Commission (SEC) issued new rules requiring institutional money market funds to operate with a variable net asset value. Money market funds will be allowed to impose restrictions on redemptions under certain conditions. Also, in Europe, stable value money market funds shall be subject to additional provisions, the concrete shape of which is still being discussed.

Beyond money market funds, further issues have already been put on the agenda: herding and liquidity risk. Regrettably the active contribution of the fund industry to this discussion has so far been very limited. A commendable exemption is the recent proposals of BlackRock calling for international rules that would allow the imposition of redemption fees, in order for some kinds of funds to mitigate 'run risks'.

Excerpt from 'Regulatory Spotlight', Investment Management Review, July 2014

Herding as a source of systemic risk.

Herding – correlated and pro-cyclical investing – has been identified as a source of systemic risk. Background is in particular the growth of the fund industry combined with the rising share of ETF and other passive strategies (including so called 'closet indexing' by active managers). Passive strategies, in particular if based on market-weighted indices, have an embedded element of momentum investing. In addition, ETFs offer a fast and liquid opportunity for momentum investing by unitholders.

Liquidity transformation and liquidity risk. Industry growth and herding are accompanied by structural changes in capital markets, leading to liquidity risk concerns. Due to changes in banking regulation, the market-making capacity in fixed-income markets has declined. The SEC estimates that current primary dealer capacity in the US market may stand at the level of 2001, whereas fixed- income assets of mutual funds and ETFs have quadrupled over the same time period.

So all in all, the tightening of the regulatory framework will certainly not cease completely. There is one project, however, that offers interesting new perspectives for the industry: the forthcoming inception of the European long-term investment fund (Eltif).[1]

Financial stability and shadow banking will stay at the top of the agenda, with an increasing focus on the fund industry

The immediate motivation of the Commission in introducing Eltifs is certainly not to do the fund industry a favour. Eltifs should boost investments in Europe's real economy. Commissioner Jonathan Hill has made Eltif a clear priority for his term in office, as part of the broader Capital Markets Union initiative. Nevertheless, Eltifs are a big chance for the industry, as we can expect a strong demand for long-term finance. At the same time, it appears unavoidable that the private household sector has to bear the risks and rewards of such investments more directly, which makes the investment fund the ideal vehicle for the intermediation.

Excerpt from 'Regulatory Spotlight', Investment Management Review, July 2012

For the fund industry a long-term UCI could be a business opportunity. Of course it would require investments in special management expertise, but on the other hand the potential demand is significant. Beyond, the fund industry could play a significant role to support the 'real' economy. It could even change the investment philosophy of asset managers – less short-term relative performance, more long-term absolute performance; less momentum trading, more engagement with portfolio assets.. . . the fund industry would thus have the chance to boost its profile and standing with politicians, regulators and society.

In recent months, the project has made significant progress. At end 2014, the EU Parliament and EU Council found a compromise on the Commission's proposals and paved the way for a formal approval of the Eltif regulation in mid-2015. The provisions of this agreement contain some remarkable improvements, compared with the first proposal of the Commission.

We can expect a strong demand for long-term finance; at the same time, it appears unavoidable that the private household sector has to bear the risks and rewards of such investments more directly

First of all, the compromise text extends the range of eligible assets, which will certainly be helpful. But the most important improvement concerns liquidity. According to the original Commission text, Eltifs should be strictly closed-ended vehicles with a defined end of life and no redemptions before that point of time. This obligation would lock investors in for a longer term; moreover, it would have made it difficult to manage the investment portfolio, as Eltifs will be required to hold a number of different assets in order to have some portfolio diversification. The compromise text gives the fund manager "the right to temporarily extend the life of the Eltif"; furthermore, redemptions before the end of life of the Eltif may be permitted under certain conditions.

These new provisions are important steps in the right direction, but leave many details open. Therefore, the European Securities and Markets Authority (ESMA) will be commissioned to develop draft regulatory standards regarding the relation between life of the Eltif and life-cycle of individual assets.

The reception of Eltifs by the fund industry has so far been all but enthusiastic. The industry is certainly right to point to open issues and potential impediments. But I suspect the true reason is that the fund industry is not very familiar with the handling of long-term assets. Long-term assets tend to be less liquid. They can't be traded with a push of a button; they require 'individual' handling from acquisition until exit. Liquidity and redemption management will be extremely challenging too.

I served five years as Chairman of Germany's biggest provider of open-ended real estate funds, which have a number of features in common with Eltif. Matching long-term assets and redemption rights is without doubt challenging, but according to my experience these challenges can be met, and the result can be satisfying for both investors and fund managers.

Dr Wolfgang Mansfeld was a member, until June 2011, of the Executive Board of Union Asset Management Holding, the holding company of Union Investment Group, Frankfurt am Main. From 2007 to 2010, Dr Mansfeld was President of the German fund industry association BVI. Since 2004, he has been a member of the European Securities and Markets Authority (ESMA) Consultative Working Group on Investment Management. From 2002 to 2005, he was President of the European Fund and Asset Management Association (EFAMA).

[1]. *See 'Long-term funds offer an opportunity for the industry', Regulatory Spotlight, July 2012*

INDUSTRY PERSPECTIVES IN FIGURES

The following tables provide a statistical perspective on the key trends in important sectors of the asset management industry.

Global-managed assets

In isolation, it is difficult to interpret what amounts and growth rates mean. Figures in billions and trillions are bandied around and it is useful to assess how the numbers for each sector relate to the whole.

	Assets ($trn) year end 2013	2014
Mutual funds and exchange-traded funds	31.8	33.4
Hedge funds	2.0	2.1
Private equity	3.5	3.8
Pension funds	24.7	26.2
Insurance assets	9.1	30.9
Sovereign wealth funds	6.1	7.1
Total	**97.2**	**103.5**

Sources: IMR estimation, ICI, EFAMA, BlackRock, Eurekahedge, OECD, TheCityUK, Preqin, TowersWatson, SWF Institute

Estimated global managed assets at end-2014 exceeded the threshold of $100trn for the first time. They amounted to $103.5trn, representing a increase of 6.5% from the corresponding end-2013 figure.

Although hedge funds, ETFs and private equity are much talked about and receive prolific coverage in the media, it is interesting that they are all (still) small in total relative to mutual funds. The other big asset pools include pension funds, insurance and sovereign wealth funds.

Mutual funds

	Net flows ($bn)		Assets ($bn) end of period	
	2013	**Q1-Q3 2014**	**2013**	**Q3 2014**
Global industry	**888**	**962**	**30,030**	**31,315**
Regions				
USA	356	129	15,018	15,558
Europe	299	547	9,375	9,716
Asia-Pacific	100	189	3,356	3,636
Fund categories				
Equity	411	223	13,269	13,790
Bond	176	355	7,084	7,497
Money market	67	50	4,760	4,429
Balanced	301	304	3,706	3,999

Mutual funds maintained a significant level of inflows of $662bn globally in the first three quarters of 2014. Bond funds and balanced funds received the strongest inflows. Mutual fund assets were $31.3trn at the end of September 2014, exceeding the end-2013 level by 4.3%.

Exchange-traded products (ETPs)

	Net flows ($bn)		Assets ($bn) end of period	
	2013	**2014**	**2013**	**2014**
Global industry	**236**	**331**	**2,401**	**2,778**
Regions				
USA	191	246	1,701	2,007
Europe	18	61	420	457
Asia - Pacific	22	16	168	201

Source: BlackRock

In 2014, the growth of the ETP industry remained strong, with net inflows into ETPs of $331bn, about 40% more than in 2013. Total assets increased to $2.8trn.

Pension and insurance assets

Assets ($trn) year end	2013	2014
Pension funds	24.7	26.2
Insurance	29.1	30.9

Assets of pension funds grew in 2014 to $26.2trn. Assets of insurance undertakings exceeded those of pensions funds, with $30.9trn in total.

Alternative funds

	Net flows ($bn)		Assets ($trn) end of period	
	2013	2014	2013	2014
Hedge funds				
Global industry	**23**	-1	2.0	2.1
Private equity				
Global				
fundraising	532	600 (estimate)	3.5*	3.8*

** as at end June*

Growth of the global hedge fund industry, which has slowed since 2012, was also weak in 2014 due to poor inflows and moderate performance. Fund assets increased to $2.1trn at the end of 2013, according to Eurekahedge Research.

Private equity fundraising was remarkably strong in 2014, with more than $600bn of capital raised and assets reaching $3.8trn mid 2014, according to Preqin research.

Top ten asset managers

Rank	Manager	Total assets end 2013 $trn
1	BlackRock	4.1
2	Vanguard Asset Management	2.6
3	State Street Global Investors	2.2
4	Fidelity Investments	1.9
5	BNY Mellon Asset Management	1.5
6	J.P. Morgan Asset Management	1.5
7	Pimco	1.5
8	Deutsche Asset & Wealth	1.2
9	Capital Group	1.2
10	Pramerica Investment Management	1.1

Notes

IMR calculated the statistical figures based on publications of the following institutions: ICI, EFAMA, BlackRock International, Eurekahedge, IPE, OECD, Preqin, Statista and TowersWatson.

Regular, systematic and authoritative statistics across all sectors are difficult to come by in the fund management industry. Given that the statistics are from different sources, there may be some incompatibility in the definitions and assumptions underlying the figures.

Because of this incompatibility, the figures reported should be treated as approximate and designed only to give a feel for relative orders of magnitude.

Investment Management Review (*IMR*) cannot accept responsibility for the accuracy of the figures cited, as they are not based on our primary research and are meant to help our readers to identify the broad trends in the industry across different sectors and their relative importance to the whole.

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