

Ten Trends that will Reshape the Fund Industry

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For advisors scouring among thousands of mutual funds, bargains and inefficiencies will be harder to find in coming years. Intense competition among funds for shelf space will not translate to lower fees, and the new class of broad asset allocation funds is unlikely to live up to its marketing promises.



Those were among the surprising forecasts from Geoff Bobroff, with whom I met last week. Bobroff, whose consulting practice is based in Providence, RI, has been an advisor to mutual fund companies for the past 35 years and currently serves on a number of their Boards of Directors.

The biggest trend, according to Bobroff, is one that nearly the entire industry must confront: the secular decline of active large-cap management.

Over the last decade, according to Bobroff, large-cap active management shrank by half, from approximately 40% to 20% of industry assets. Money flowed into index funds, international funds and most recently into fixed income funds. Advisors have been less inclined to buy active large-cap funds, Bobroff said, because they have found it hard to justify layering their own fees on top of expense ratios. Instead, they have chosen to use passive large-cap strategies as a core and build other active strategies around that.

“Until we see a prolonged period of excess returns over the index, active large-cap it is not coming back,” Bobroff said. “And it has to be for at least a couple of years, because otherwise investors just won’t buy into it.”

Bobroff said that charging robust fees for large-cap funds is less likely today than it was in the 1990s, when everyone wanted that style. “This is the number one challenge for the industry,” he said.

Let’s look at the nine other trends in the fund industry Bobroff said await advisors.

Trend 2 –The rise of solution-based selling

In the past, fund firms could expect a clear path to success if they gained a spot on the approved list of wirehouses and intermediaries. It’s a different story now, Bobroff said, as brand loyalty plays a much smaller role in advisors’ and investors’ buying decisions.

Solution-based selling has become the dominant theme in fund selection. Bobroff said advisors and clients are building asset allocations and selecting funds based on risk



tolerance assessments. and individual fund characteristics now matter a lot more than the fund family.

The fund industry has not fully absorbed this changed dynamic, Bobroff said. Instead, it is still trying to deliver the same product mix that was successful in the past. No longer can a fund family expect to “throw a hundred funds on the wall and expect some portion of them to stick,” he said.

Trend 3 – The evolution of broad asset allocation funds

Following a poor experience with principal-protected funds from 2000 to 2002, the fund industry is now embracing a new breed a broad asset allocation funds, Bobroff said. These include Invesco’s balanced-risk products, AQR’s risk-parity strategies, and absolute-return funds now offered by Putnam and others.

Those funds have a mandate to “go anywhere and do anything,” Bobroff said, with the flexibility to invest across asset classes, including in commodities and derivatives. The goal is to provide the downside protection that investors seek without giving up too much upside.

Bobroff was skeptical as to whether they will succeed. “The risk is that we get a 1990s bull market and those funds are left in the dust,” he said. It will take a full market cycle of successful returns before Bobroff will be convinced these strategies can succeed. Their biggest challenge is that they have short-term benchmarks, such as exceeding inflation by 500 basis points each quarter. Such goals, he said, are “not doable.”

Trend 4 –Competitive pressure will not lower fees

Domestically, poor returns have increased the pressure for lower fees, Bobroff said. On the fixed-income side, fees are coming down because of waivers in the wake of low returns. “Nobody can earn their full fees,” he said, “except in global or emerging market debt or in high-yield.”

“When you’ve got the 10-year at 3.5%, you can’t take 100 basis points of expenses,” Bobroff said.

A separate subtext is at play, though, and it will keep fees from compressing. The distribution channels are demanding more revenue sharing, Bobroff said, and in the process they are compressing the earnings that managers make on their funds. “If you want access, you have to pay for it,” he said, and that means paying to be on wirehouse and custodian platforms.

The net, at least for equity funds, is that distribution channels may gain a greater share of fee revenue, but overall fees will not decrease.



One byproduct of the growing power of distribution channels is that Bobroff expects to see mergers, acquisitions and consolidation in the fund industry. Many of the smaller and mid-sized firms will be acquired, because they are too vulnerable to the vagaries of the market.

Trend 5 – Mary Schapiro will not last another year

Proposed changes to 12(b)1 fees will not move forward, Bobroff said. The financial community holds too much sway, he said, and will “rattle the cage” of Congress and SEC Chairperson Mary Schapiro.

Indeed, Bobroff said, he does not picture Schapiro retaining her position for another year.

Darrell Issa (R-CA), who is the Chairman of the House Committee on Oversight and Government Reform, will have Schapiro testifying “weekly,” he said, on everything from Dodd-Frank reform to the “simple question” of fiduciary reform.

He expects the fund industry to plow ahead assuming that 12(b)1 fees will remain unchanged.

Trend 6 – A proliferation of target-date funds

Clouds are on the horizon for target-date funds, Bobroff said, because of the interplay of demands from three constituencies – the SEC, the Department of Labor and Congress.

A key issue is whether funds will be labeled as providing a solution “to” a target retirement date, or “through” beyond the retirement date to the remainder of the investor’s lifetime. Bobroff expects the resolution to be a duplication of funds, with providers offering both “to” and “through” families of solutions.

Fee disclosure remains poor among target-date funds, and Bobroff said the burden of unraveling fees will fall upon plan sponsors. Much of the work Bobroff does as a fund director is to help validate the appropriateness of fund fees across the mix of share classes. In this context, Bobroff said fund companies face an important challenge justifying target-date fund fees.

Trend 7 – An uncertain future for actively-managed ETFs

Over the next year, Bobroff said there will be an interesting test of whether an opportunity exists for actively-managed ETFs. He doubts that market exists, despite new registrations from State Street and Eaton Vance.

Transparency requirements will be the downfall of actively-managed ETFs, he said, and managers will not want to see their investment knowledge diluted by the requirement to publish holdings on a daily basis.



These ETFs are more likely to work in the fixed-income markets, Bobroff explained, where holdings are not as easily to replace as in an equity portfolio.

“Everyone in the active world has this belief that they are missing something in the ETF world by not being there,” he said, adding that it will take at least a year to see whether active ETFs succeed.

Trend 8 – A shifting of risk to investors in variable annuities

Bobroff said insurance companies will package a “whole new genre” of mutual funds in their variable annuity products to provide riders such as guaranteed minimum withdrawal benefits. Those funds will be designed to be less volatile than traditional equity funds and will include offerings such as the AQR risk-parity strategy.

Bobroff said insurance companies will effectively shift the risk of the guarantee to the investor by forcing them to have less volatile sub-accounts. Fees for these types of variable annuities will not come down.

In the past, Bobroff said many insurance companies were too generous and mispriced the guarantees they offered, and this development is a reaction to those failures. They did not set aside enough reserves to cover the market decline in 2008.

“It will be an interesting question to watch to see whether or not they are successful,” he said. “We will know that by the end of this year as to which ones have had any success, and where the success has occurred.”

Trend 9 – The growing popularity of bank loans

With the fear of inflation growing, one product that is catching a lot of attention is bank loan funds. Domestic funds carry a variable interest rate that is 500 to 600 basis points over LIBOR, and non-US funds often pay an additional 100 basis points.

Those yields make them significantly more attractive than TIPS-based funds.

Bank loan funds are often backed by the senior debentures issued by private equity firms as part of takeovers, or they may be backed by loans in a bank’s inventory.

A big challenge in this market, he said, will be the availability of inventory to back these funds. As demand for the product grows, fund companies will inevitably be forced to use riskier collateral.



Right now these funds carry modest fees of 50 to 60 basis points, but Bobroff said newer offerings are coming to the market with fees of nearly 100 basis points. That, he said, is “awfully pricy” for a fixed-income offering.

Trend 10 – Funds will continue to dominate ETFs

The big question that the fund industry faces is whether ETFs will really gain significant market share over passively managed index funds.

Bobroff said that will happen, but ETFs will ultimately face limits to their growth. He forecast that ETFs will double their market share – from roughly 10% to 20% of assets managed – over the next decade.

One limit ETFs face is in the non-US markets, because the MSCI indices are too broadly defined for most investor’s tastes, particularly in Asia,. Bobroff said active management will still prevail in those markets, at least until indices are better defined.

It will also remain more convenient for brokers and financial intermediaries to deal with index funds versus ETFs in the 401(k) market. For retirement plan record-keepers, Bobroff said the technological challenge of consolidating ETFs into the statement preparation process is too great.

“I am sure technology will improve,” he said, “but I don’t see it improving to the extent that ETFs are going to become the product of choice.”

Overall, Bobroff said that the fund industry is “deluded” if it believes that it will make the same margins as in the 1990s. “We can’t,” he said, because of the increased competition and the demands from wirehouses and custodians for a greater share of fees.

“We have to see more consolidation across the industry,” he said.

Funds and fund companies that deliver performance will keep and grow assets, and those that fail to deliver will quickly disappear. “That is a business model that this industry has never had to incur,” Bobroff said, “but that is what we are living with today.”

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