Fees under fire

If the financial crisis has shown investors anything, it is that fees are certain and performance is merely unpredictable. While managing performance is a constant work in progress, fees are likely to change – whether asset managers like it or not

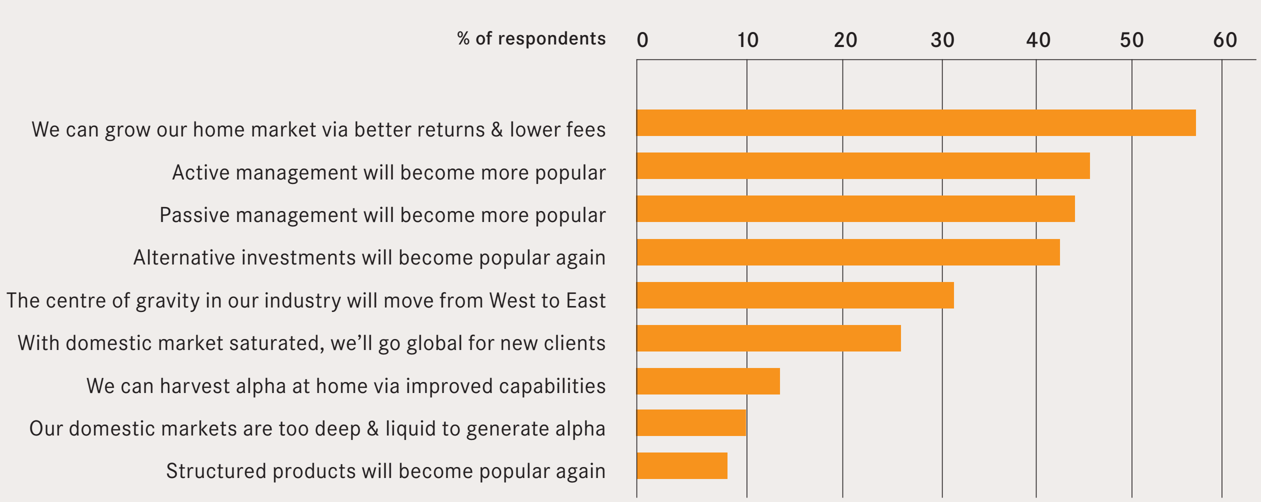
BY **CYRIL DEMARIA**

Asset management allocates savings to the most promising investment projects. These projects are measured through a risk and a potential return analysis, for which asset managers are usually paid through management and advisory fees. Their performance is rewarded as a percentage on the returns generated above a benchmark. This system aligns the interests of asset managers and investors to a point: if the performance does not fit expectations, the sanction of the asset manager is not financial.

The only option is to allocate the savings to another asset manager, which means that investors have to spend resources to find a better manager – assuming there is one. When a major crisis affects the whole industry, such as in 2007 - 2009, it is difficult to engage in such a process. According to the EFAMA (European Fund and Asset Management Association), in Europe the value of assets under management fell by 21% from EUR 13.6 trillion in 2007 to EUR 10.8 trillion at the end of 2008 (80% of GDP), and then recovered to EUR 12.8 trillion in 2009 (100% of GDP). The study "Exploiting Uncertainty in Investment Markets", developed by CREATE-Research and commissioned by Citi's Global Transaction Services and Principal Global Investors, states that in the US, the UK, the Netherlands and Switzerland, pension plans "funding levels averaged 115% (of pension payments) in 1999 and 78% in 2009. By 2007, they had recovered from the tech debacle (the internet investments bubble) of 2000-02, only to be savaged again."

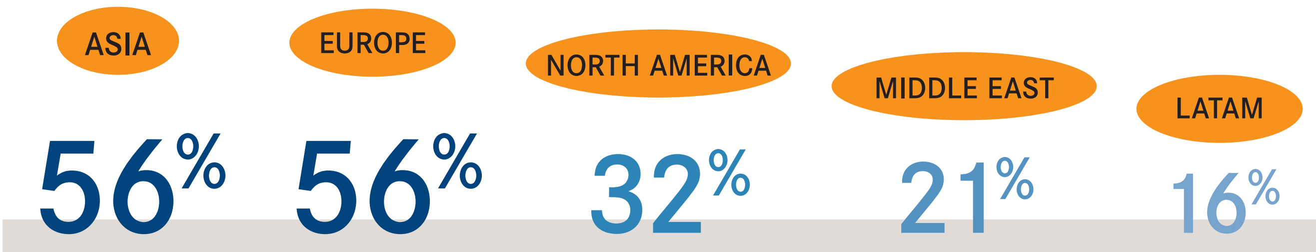
More than acting on the performance degradation itself, which can be merely a market phenomenon, investors have focused on fees. Thierry Zuppinger, CEO of the Zürich-based Quartal Financial Solution Services, a company providing commission

ASSET MANAGERS PERSPECTIVES (for the next 3 years)

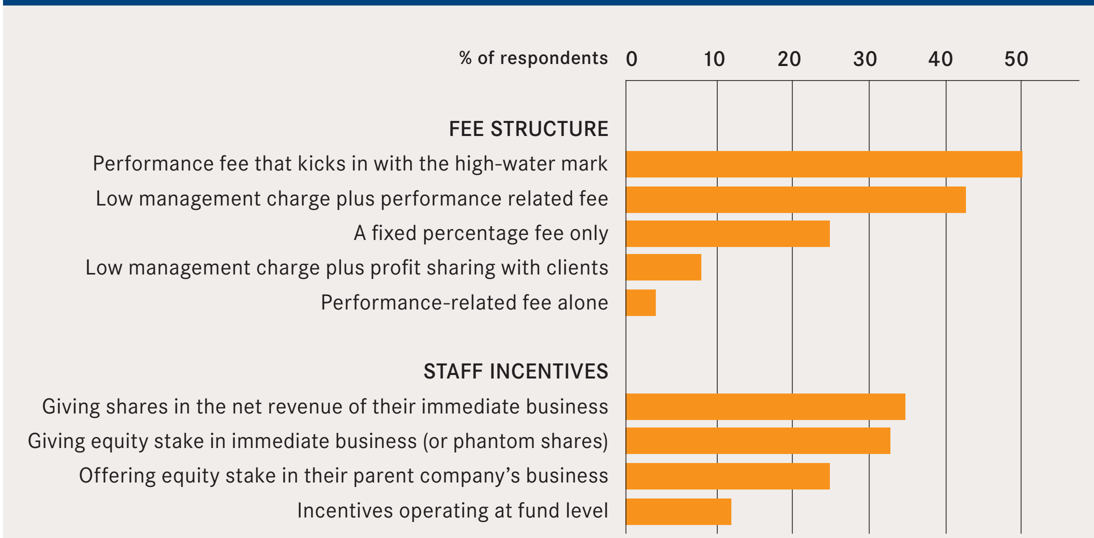


SOURCE: CITI, PRINCIPAL, CREATE SURVEY 2010

THE MAIN GEOGRAPHICAL SOURCES OF ASSETS (for the next 3 years)



TRENDS IN FEE STRUCTURE AND STAFF INCENTIVES (for the next 3 years)



SOURCE: CITI, PRINCIPAL, CREATE SURVEY 2010

and fee calculation solutions, confirms that "fee spreads are increasingly being reduced from the 0.5-5% to the 1-2% range. The concept of total expense ratio is also emerging as a central reference for investors." If asset managers cannot significantly absorb the market volatility, and reduce the risk, then fees have to be revised downwards. By reducing the fees paid to asset managers, investors should at least improve their net results. According to the Citi/CREATE Survey, "the latest bear market showed that some 80% of asset managers had been paying themselves too much. They failed to beat their benchmarks."

Beyond risk and return, liquidity has become one of the key aspects of the analysis. The evaluation is deemed to change and clients will be able to switch their assets more frequently. Not only should their due diligence be more thorough but also the service standards, as a consequence, more onerous – hence squeezing further the margins of asset managers.

In fact, as Asia is no longer perceived as the new *El Dorado* (only 31% of asset managers hold this view) to attract new money, the main target is to provide better returns and lower fees (57% of respondents to the Citi/CREATE Survey), hence propelling the passive management (55% of new asset should inflow by 2019). Europe is expected to provide at par with Asia most of the new clients going forward.

The fees jungle

That should change dramatically the situation of the 2,500 asset management companies registered in Europe. Institutional investors, providing 66% of assets under management in Europe, face a daunting task. In fact, the structure of fees is quite complex and difficult to navigate. There are two channels to deploy the assets: investment funds (representing EUR 5,328 billion as of end of 2008) and discretionary mandates (EUR 5,388 billion), meaning that the fee structure differs and needs to be assessed carefully.

Jean-Charles Spanelis, (Managing Director of Quartal France and founder of Finelis Group), describes a rich typology of fees: "aside from the entry fees which are paid to distributors for their administrative and fund selection work, there are commissions on movements and management fees paid to cover the investment process and monitoring. Sometimes, a retrocession of management fees is paid by the asset manager to the distributor. Finally, there is a performance fee which is paid to the asset manager if an out-performance is generated compared to the benchmark." Additionally, administrative fees are paid to custodians, fund administrators, transfer agents and auditors. ▶

According to the consulting firm McKinsey, distributors get the lion's share of fees with an average 62% of the total paid by the client. This is under fire, as clients are increasingly switching from a "product" to a "solution" approach. Fund platforms are increasingly popular, hence lowering the cost to gain access to the products. Distributors will have to increase their service quality, as well as their technical collaboration with the clients.

New measures will include the setting up of high-water marks (performance fees are paid only when a fund exceeds the highest previous value reached by its cumulative returns). Fifty percent of asset managers are expected to implement them. Rolling multi-year performance fees which discourage excessive risk taking are also projected, to which is connected the staff incentive scheme. "However, progress will be gradual. Guarding the existing revenue streams remains a top priority after a 40% drop in gross revenue (of asset managers) in 2008", according to the Citi/CREATE Survey.

Value-for-money fees

In fact, the fee structure has been evolving already, notably under the pressure of regulators. For example, "in the UK, according to the new regulations, the IFA (Individual Financial Advisors) will have to apply hourly-related fixed fees and cannot calculate the fees as a percentage of assets", explains Jean-Charles Spanelis. This has sent shock waves through the asset management world, notably because other regulators are looking into the British legal experiment. The pressure also comes from Europe, as an easier comparison of funds is possible due to UCITS (Undertakings for Collective Investments in Transferable Securities) regulations.

Regulations have two consequences. First, they set high barriers to entry for newcomers to the asset management world. In that respect, if "open architecture for funds distribution is a good thing for final investors as it increases the choices, small distributors will be put at a disadvantage", states Jean-Charles Spanelis. Additionally, "more accountability has meant risk aversion; common distribution has meant endless disputes in revenue sharing; separation of manufacturing and distribution has meant no focal point for innovation", according to the Citi/CREATE Survey.

As for pressure on fees, the likely outcome will be a restructuring of asset managers, notably through outsourcing of non-core activities which are expected to be sub-contracted. "Around 50% of asset managers have no obvious competitive advantage except a physical presence in the market place. Too often, performance projections are presented with such authority and conviction, when they are nothing more than wishful thinking", states the Citi/CREATE Survey. Middle office will hence play an increasing role to manage these new forms of alliances between different companies while maintaining the checks and balances necessary to avoid the scandals witnessed over the course of the last crisis.

Distribution will then switch from uniform sales pitches from distant vendors to close fiduciaries. This is confirmed by Jean-Charles Spanelis, who thinks that as outsourcing will make further progress, so will be the complexity of fee calculations and revenue sharing. "Fees are also targeted by the business process outsourcing trend, as is fee invoicing and calculation", says Thierry Zuppinger. Flexibility of IT solutions will be critical to follow the reshuffling of activities related to the new model of "virtual asset managers" likely to emerge according to Citi/CREATE.

Increasingly, "all-in-fees which cover all the costs related to the funds" are gaining ground, according to Thierry Zuppinger. Hence, asset managers will have to do more with less. However, as fees will be lowered, conflicts of interest are likelier to emerge. Unless a clear identification of core competencies and compensation of each segment of the asset management value chain is achieved, then fees will disappear on one side to be recouped somewhere else. Alongside fee structure, ethics and business practices have to evolve. Otherwise, the movement will go into reverse when the market accelerates again.