Sea of change on the horizon

US fund distribution 2014
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Executive summary

The complex symbiotic relationship between product manufacturing and distribution is fundamentally changing. Along with the entire financial services industry, distributors and client-facing advisors are looking to aggressively manage costs, protect margins and find new revenue opportunities where possible – and asset managers as manufacturers will feel the pinch.

Apart from no-load retail channels, asset managers have limited direct client relationships. To safeguard margins, grow their businesses and combat the threat of disintermediation, asset managers must focus – perhaps for the first time – on enhancing direct end-client relationships and building brand identity.

There are far too many investment management products chasing client dollars in the market. Most ostensibly, new products are merely repackaged products sold under a new name. Like it or not, the trend toward aggressive cost management and renewed focus on the bottom line will force asset managers to rationalize their product suites and reduce the number of funds they offer.

The passive exchange-traded fund (ETF) market is inexpensive, tax-efficient and set to grow at double-digit rates in terms of aggregate assets under management for the foreseeable future – at the direct expense of actively managed products. It is still too early to declare the demise of seeking alpha. Nonetheless, manufacturers and distributors of actively managed products must understand how to position themselves alongside – and compete against – both passive funds and index ETFs, as well as entrepreneurial ETF-savvy client advisors looking to move up the value chain and extract more revenues from their client relationships.
US asset managers and distributors have so far escaped the aggressive regulatory overhaul of fee-sharing arrangements that are creating change globally. By contrast, the UK’s regulatory overhaul of the decades-old system of fee-sharing is well underway with the implementation of the Retail Distribution Review. And in the EU as well as Switzerland, there are already initiatives to pass a ban on inducements by manufacturers to distributors. These initiatives may influence future changes in the US market. Further, passage of Dodd-Frank gave the Securities and Exchange Commission sweeping powers to potentially reshape the regulatory framework governing distribution. Regulations imposed on investment advisors, who are obliged to act under a fiduciary duty of care, and regulations governing broker/dealers, who fall under a different framework and a less onerous “suitability” obligation to “deal fairly” with clients, may be combined and unified to eventually create a single “Unified Fiduciary Standard” with implications for compensation, disclosure and fee-sharing across the distribution cycle.

Disclosure of more and more price-sensitive information is on the upswing, as a result of both regulatory change and a general demand by the investor for far greater standards of transparency. Already, the US Department of Labor’s Employee Benefits Security Administration (EBSA) has released final rules regarding disclosure of management fees and expenses charged to ERISA-governed retirement plans. The complex disclosure rules implemented by EBSA cover approximately 708,000 private pension plans with an estimated 72 million participants and nearly US$3t in assets. In short, with more and more disclosure and investor understanding of pricing, margins across the entire distribution life cycle will inevitably be scrutinized – and relentlessly squeezed.

Distribution is rapidly becoming an exercise in technology, as an increasingly large share of US personal spending is moving away from personal interaction and onto a virtual interface. In Europe, distribution through direct to consumer (D2C) online platforms may likely become the largest distribution channel within the next five years. In the US, the trend toward distribution via a technology-driven interface – with the implied disintermediation of the client-facing advisor – may not be far behind.
Introduction

Asset flows over the last year clearly signaled that the asset management industry was bouncing back. The equity business, in particularly, has come roaring back. For 2013, the US$452.5b of inflows into US equity funds were roughly the same as total equity inflows for the past four years combined. Investor enthusiasm for fixed income, coming off a historically unprecedented 30-year bull run, was considerably less with 2013 outflows of US$22.8b.

At the same time, the industry distribution model that has stood nearly unchanged for decades is currently in the process of being dismantled. In the aftermath of the financial crisis, key constituents along the value chain will seek to enhance margins, grow revenues and prepare for regulatory change. This ongoing reconfiguration of distribution will rewrite the list of winners and losers.

Those firms that aggressively seek new revenue opportunities, create innovative ways to promote and protect brand identity, and establish differentiation in what is rapidly becoming a highly commoditized industry will likely make it onto the list of winners. In contrast, those who continue to operate under pre-crisis paradigms and the old distribution models may find themselves on the outside looking in.

While the financial crisis is substantially in the past, and assets under management (AUM) growth has returned, the sector is by no means set to relive any bubble. But this rising tide will not lift all boats. The relationship between distributors and product manufacturers is changing mainly because the costs across the production life cycle are on the rise. Increasing costs will result in squeezed margins for the entire sector.
For example, over the last five years, more than one billion new flat-screen TVs have been purchased, with demand driven by rising consumer spending power, particularly in emerging markets; falling prices; and superior technology making old CRT-based TVs obsolete. At the same time, waves of retailers in the consumer electronics space have gone bankrupt. Despite continued growth in the flat-screen TV market, selling TVs is now considered a loss-leader for most retailers. In other words, even though a market may be growing, it does not at all guarantee that all firms will benefit from that growth.

Any ebullience about a cyclical upswing in asset management may soon be replaced with concerns about a secular downturn. Asset management is a mature industry: margins are being compressed across the board, commoditization of products is widespread and true innovation is increasingly rare. Everyone in the game is seeking new sources of revenues and new ways to win in the market.

As changing TV technology helped reshape the retailing of consumer electronics, the reconfiguration of the financial services sector is setting the stage for a paradigm shift in asset management distribution. With greater transparency than ever before – in no small part due to technology – distributors and end clients have access to vastly more information than in the past. In addition, the entire system is vulnerable to regulatory change in regard to payments and fee-sharing.

*Based on an analysis of publicly listed US asset management companies
Source: Standard & Poor’s Capital IQ
Distribution in the US today: the general landscape

In today’s market, asset management services are distributed to US-based investors primarily through five principal distribution channels: direct, professional advice, retirement plan, supermarket platforms and institutional.

1. Direct channel. This channel offers a direct commercial relationship between manufacturer and end client, representing full disintermediation of the traditional distributor. It includes ETFs, which have seen the strongest growth of any product class during the last decade and are likely to continue outperforming the growth rates of most other managed product classes. Although direct distribution is a highly profitable model for the manufacturer, usually only the largest bulge-bracket asset managers and those with brand “panache” are successful in this space. Fewer than 30% of households in the US that owned funds over the last decade owned funds purchased through the direct market channel. Fund managers distributing products through a direct channel typically have not provided investment advice, so investors must undertake their own research. However, fund companies selling directly to investors have been aggressively providing a variety of products and tools to assist in decision-making, such as research and investor education material. These firms often maintain robust, content-rich websites and telephone servicing centers that their direct customers may use. In terms of revenue share and total costs to the asset manager, direct channel distribution is, in theory, the holy grail of distribution models – all distribution activity is done in-house, and there is no costly external party (broker-deal, advisor) to pay. In reality, there are risks and considerable recurring costs involved in building brand identity, creating client-interface tools and maintaining a successful national sales functionality on effectively an online basis.
No-load funds have become extremely popular over the last 10 years

Total net assets of long-term mutual funds (US$)

2. Professional advice channel. In 2012, 53% of households owning investment products purchased them through the professional investment advice channel. This includes a very broad range of professionals operating under many different titles: financial advisors, private bankers, registered investment advisors, full-service brokers, independent financial planners, investment service representatives of banks and savings institutions, insurance agents and accountants. The most important feature of this channel is the provision of high value-added services to the end client, “high touch” personalization and ongoing customized assistance that may include retirement planning, insurance, lending and liquidity solutions, such as secured loans and jumbo mortgages, and even succession planning and tax advice. Most distribution through this channel will require a revenue-sharing agreement where the manager pays a portion of their management fees to the distributor – fees that effectively reduce the manager’s bottom line. While this channel may be the costliest route for asset managers, given that managers usually have limited, if any, direct client relationships, it is arguably the most viable channel for successful distribution, particularly for smaller firms that lack the resources to build a national sales network.
3. Retirement plan channel. This is the largest channel and includes primarily corporate 401(k) retirement plans in which beneficiaries choose from a menu of investment product options. With the decline of defined benefit plans in the US, 72% of American households own funds distributed through employer-sponsored retirement plans. Employers sponsoring defined contribution plans rely upon third parties to administer the plans and provide investment options to employees. Third-party administrators (TPAs) effectively act as the outsourced client interface for the fund manager and handle a wide variety of administrative services. As with the case of most distribution channels, because the TPA acts as the interface between client and manufacturer, the manufacturer here is left with limited to zero direct client relationship and limited brand identity.

4. Supermarket platform channel. The supermarket channel is made up of discount brokers that offer mutual funds from a large number of fund sponsors. This channel includes many no-advice discount brokers that operate almost exclusively online. The most important feature of a fund supermarket is its no-transaction-fee (NTF) program whereby an investor may purchase funds from a wide range of fund companies with no transaction fees. The NTF offerings from a discount broker often number in the thousands, providing an investor the convenience of purchasing no-load funds available from different manufacturers through a single, user-friendly platform. Although initially categorized as a low-margin, no-frills, bare-bones business model targeted at cost-conscious consumers, many of these supermarkets have beefed up their client services by offering comprehensive investor education material; a wide selection of financial research; and sophisticated, yet user-friendly, online and mobile tech applications. While the asset manager must pay fees to the distributor for a fund to be listed on a platform, given that most of these platforms operate under a high-volume, low-cost model, the fees are usually lower than the revenue-sharing agreements prevalent in the professional advice channel. However, the old adage “you get what you pay for” applies here: the product line from one manager will be thrown into a vast ocean of thousands of different products from dozens, if not hundreds, of other asset management firms – with no dedicated sales support.
5. Institutional channel. The previous four channels are geared almost exclusively toward retail or mass affluent investors with less than US$10m in net investable assets. In contrast, the institutional channel includes businesses, such as the treasury department of a corporation as well as insurance companies, endowments, private family offices, defined benefit pension plans, foundations and universities. The key driver to success in institutional distribution – apart from demonstrating proven performance results – is building solid relationships with the institutions’ designated investment consultants. Because they act as vigilant gate-keepers and decision-makers in allocating assets among different managers, it is essential to win their hearts and minds.

These general categories are by no means mutually exclusive as there is definite overlap among different channels. Further, large managers usually distribute through most channels. Nearly half of fund-owning households in the US held funds distributed through multiple channels. According to a study conducted in 2012 by the Investment Company Institute, 17% of fund-owning households held funds both within employer-sponsored retirement plans and through investment professionals, 5% owned mutual funds both within employer-sponsored retirement plans and through the direct market channel, and 10% held funds through investment professionals and the direct market channel. Thirteen percent of households owned funds through all three channels.

Nearly half of mutual fund-owning households held shares through multiple sources
Percentage of US households owning mutual funds, May 2013

Inside employer-sponsored retirement plan

Investment professionals

Fund companies, fund supermarkets, or discount brokers

1 Employer-sponsored retirement plans include DC plans (such as 401(k), 403(b), or 457 plans) and employer-sponsored IRAs (SEP IRAs, SAR-SEP IRAs, and SIMPLE IRAs).
2 Investment professionals include registered investment advisers, full-service brokers, independent financial planners, bank and savings institution representatives, insurance agents, and accountants.

Note: Figure does not add to 100% because 5% of households owning mutual funds outside of employer sponsored retirement plans did not indicate which source was used to purchase funds. Of this 5%, 3% owned funds both inside and outside employer-sponsored retirement plans and 2% owned funds only outside of employer sponsored retirement plans.

Building brand identity: who owns the client?

The chief executive officers of many bulge-bracket asset management firms occasionally opine in the financial media about the direction of equity indices or the shape of the yield curve. Yet, to many distributors, this is much like the CEO of General Motors discussing the usefulness of automobiles over public transportation. Asset managers, not unlike GM, usually have relatively few direct clients apart from institutions and only limited brand identification — they instead rely heavily on distributors. Investors, in turn, usually have limited direct relationships with asset managers and typically rely on the tail end of the distribution chain, whether consultants, private bankers or financial advisors, to assist them in their investment decision-making.

This complex, highly dependent and symbiotic relationship between asset managers and distributors has left all but the largest manufacturers in a vulnerable position. Manufacturers of asset management products are unique in regard to the characteristics of their products and distribution system in place. In an era when big box national chain stores and internet retailers regularly tweak their product line and reinvent their distribution models, asset managers have instead been manufacturing the same types of products and distributing them according to the same model, more or less unchanged, for the last few decades. This stagnation and lack of any meaningful change have left most asset managers with a homogenous product suite that is effectively at the mercy of an independent distribution system.
While asset managers have been bringing a steady supply of products to market in an attempt to grow AUM, the clear-cut bottleneck to growth is in finding clients with whom to place supply. In other words, the past distribution system has clearly left the balance of power firmly in the hands of the client-facing distributor. That distributor, whether it holds the title of wealth manager, broker, financial advisor, consultant or private banker, owns and controls the client relationship.

It is rare to find any sector where manufacturers nearly ignore their own brand identity, as is generally the case for most asset managers. In the nascent but rapidly growing craft brewing industry, for instance, brewers are legally prohibited from selling to clients and must rely entirely on local beer distributors. Seeing that distributors control retail shelf space and effectively run the entire market, beer manufacturers make huge efforts to build brand identity and loyal customers. Although they can’t sell directly to their client base, the more entrepreneurial craft brewers send representatives to visit grocery stores and bars to check on the placement and freshness of their products on display, chat with consumers to gain market intelligence and even hand out free samples to pique the interest of potential new beer drinkers. By contrast, most asset managers, short of the few actively pursuing AUM through the direct distribution channel, have usually operated as though they had only limited interest in either brand identity or direct client relationships.

Distributors, for their part, are becoming increasingly disillusioned by the manufacturing side of the equation, as they see very little product differentiation from one asset management firm to the next. Distributors simply want manufacturers to supply them with investment products that can meet or beat the respective benchmark — or can be customized in such a way to address their clients’ needs and expectations. For successful distributors, there is absolutely no shortage of products on the market. And typical of maturing, slower-growth industries, distributors are focusing more time and effort on growing their own top line by moving closer to the client and capturing an ever-larger proportion of the value chain. In short, the distributor more often than not owns the client relationship and, correspondingly, controls the balance of power. Like it or not, manufacturers will have to spring into action and start establishing brand identity and name awareness with investors.

The inherent conflicts between manufacturer and distributor and the growing specter of disintermediation have been seen to some extent throughout the entire industry — not to mention the perceived conflicts that may exist between distributor and clients’ interests. The most visible sign of change is in the growth of highly customizable “multi-asset/multi-manager” platforms now offered by asset managers. Taking this approach one step further, the most aggressive asset managers are encroaching on the territory once controlled by distributors.
Many of the larger manufacturers are traveling far down the road to full vertical integration by offering direct sales, financial advice, investor education material and a user-friendly interface directly to clients – such as in highly robust mobile tech applications – as well as investing heavily in building brand identity. In a further effort to increase their profitability, asset managers are pruning the number of distributors they partner with to sell funds.

However, even for the largest asset management firms, building brand identity and direct client relationships where little existed before is a considerable task. Following the financial crisis and the evaporation of a considerable proportion of personal wealth invested in financial markets, most Americans have lost their trust in asset managers as a group, as well as in other financial services sectors. A recent poll from the public relations firm Edelman shows just 44% of Americans trust the asset management sector, the same proportion of those who trust the overall financial services industry.

In short, building brand identity and establishing client relationships will be challenging tasks for manufacturers. But amid threats of commoditization, price-sensitive clients and aggressive distributors trying to leverage their ownership of the client and capture the bulk of revenues in the production-to-consumption life cycle, these tasks are essential. For manufacturers, the threat of disintermediation and marginalization looms large.
Spend money to make money: growth in AUM relative to marketing dollars spent by asset management firms (US$)

Source: Wickware Communications, Inc. – 2013 Investment Management Survey

<table>
<thead>
<tr>
<th>AUM</th>
<th>All firms</th>
<th>Retail firms</th>
<th>Institutional firms</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Marketing budget</td>
<td>AUM growth</td>
<td>AUM generated per $ marketing budget</td>
</tr>
<tr>
<td>All sizes</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>&lt;$5b</td>
<td>$363,000</td>
<td>$225m</td>
<td>$620</td>
</tr>
<tr>
<td>$5b-$10b</td>
<td>$266,364</td>
<td>$830m</td>
<td>$3,116</td>
</tr>
<tr>
<td>$20b-$99b</td>
<td>$1,051,429</td>
<td>$7,463m</td>
<td>$7,098</td>
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<tr>
<td>$100b+</td>
<td>$51,254,545</td>
<td>$101,484m</td>
<td>$1,980</td>
</tr>
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</table>

On average, total AUM (retail and institutional) increased by US$3,200 for every US$1 spent on marketing.
Financial advisors (FAs) spend their careers cultivating relationships and gathering assets. It can take years to win the trust of a major prospect and then build on its wallet share. Whether it’s an FA selling a fund product to a private individual or an investment consultant advising an institutional endowment on asset allocation, the client-facing advisor could readily protect margins and grow revenues simply by focusing more efforts and enhancing services targeted at the client side of the distribution cycle.

Challenging market conditions have led to re-examining new areas of fee generation. On a global scale, a continued abundance of liquidity suggests that capital markets may have entered a long-term era of low-to-zero real returns and that access to financial information and investor education is at an all-time high. The spend on regulatory compliance is eating into the sales and marketing budgets of all concerned. Clients are much more price-sensitive than they have ever been. These vastly more sophisticated, price-sensitive clients, combined with escalating regulatory costs, have translated into margin compression throughout the entire asset management industry. Everyone is seeking a closer relationship with the client and trying to exert tighter control on fee generation. Each player is looking to take part in as much of the value chain and stay as relevant as possible.
As a result, distributors are increasingly moving away from serving as merely a corner shop for products. To justify an ever-greater share of the client dollar, they will also seek more vertical integration. By moving up the value chain and rolling out such services as research, model portfolios manufactured through cost-effective ETFs, structuring customized solutions and financial planning, distributors can fully leverage their ownership of the client relationship. Wholesalers, for their part, are beginning to act more as “high touch” customer relationship managers and are adding more value to their service proposition, as opposed to simply pushing products to registered investment advisors.

As a case in point, institutional consultants are increasingly offering services that are highly overlapping and similar to asset managers; many consultants now offer customized solutions to their clients by constructing a tailored portfolio comprising not only alternative allocations from specialized hedge funds, but also low-cost ETFs. Given the sketchy track record of alpha generation among many active managers, an increasing proportion of the market is more than willing to buy into a low-cost, passive ETF investment strategy that can be custom-made, hand-delivered and professionally monitored and rebalanced by consultants. In the pre-crisis bubble era, institutional consultants were a key ally,
partner and major distribution channel for manufacturers. Now, many of those same consultants are aggressively redoubling their efforts, offering access to a full range of alternative and traditional allocations and thereby often squeezing out and competing directly against manufacturers.

In a distribution-driven business, fine-tuning distribution and putting into place a winning sales and marketing strategy can actually trump investment performance. This is especially true, given that the track record among manufacturers for legitimate alpha generation has come under severe scrutiny in recent years. Most active fund products that ostensibly sought to generate alpha have failed to meet expectations, leaving clients dissatisfied and looking for answers. Increasingly, clients are asking what real differences exist among the multitudes of investment products in the market and are realizing that portfolio management is becoming commoditized. Essentially, the actual sales and marketing of investment products as well as the entire client interface experience have become as important a driver for top-line AUM growth as investment performance – if not more so.

<table>
<thead>
<tr>
<th>Fund category</th>
<th>Benchmark index</th>
<th>No. of funds at start</th>
<th>After 1 year</th>
<th>After 3 years</th>
<th>After 5 years</th>
</tr>
</thead>
<tbody>
<tr>
<td>All domestic equity funds</td>
<td>S&amp;P Composite 1500</td>
<td>2,810</td>
<td>46.05%</td>
<td>77.53%</td>
<td>60.93%</td>
</tr>
<tr>
<td>All large-cap funds</td>
<td>S&amp;P 500</td>
<td>1,052</td>
<td>55.80%</td>
<td>79.95%</td>
<td>72.72%</td>
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<tr>
<td>All mid-cap funds</td>
<td>S&amp;P Mid Cap 400</td>
<td>390</td>
<td>38.97%</td>
<td>74.00%</td>
<td>77.71%</td>
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<tr>
<td>All small-cap funds</td>
<td>S&amp;P Small Cap 600</td>
<td>611</td>
<td>68.09%</td>
<td>87.32%</td>
<td>66.77%</td>
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<tr>
<td>All multi-cap funds</td>
<td>S&amp;P Composite 1500</td>
<td>757</td>
<td>52.84%</td>
<td>80.38%</td>
<td>71.74%</td>
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</table>

*Underperformance is based upon equal weighted fund counts. All index returns used are total returns.

Understanding full well their tight control of the client, the larger distributors, particularly major wire houses, have become increasingly aggressive in managing revenue share arrangements and up-front fees to have products put on their proprietary platforms. The top five distribution firms control some 55% of US household assets. Beyond that top five, asset managers increasingly depend on a small group of middle-tier intermediaries to sell their funds and support their brands. When dealing with manufacturers, successful distributors are demanding greater fees to include products on their platforms – fees that cut directly into the bottom line of manufacturers. If the largest distributors all continue to follow the same aggressive pricing path, asset managers will have little choice but to pay up and see a further squeeze on margins.

Direct-to-investor sales can enable manufacturers to capture the lion’s share of total fees paid by the investor. Nonetheless, manufacturers are for the most part substantially dependent on distributors and hold little, if any, independent pricing power. Aggressive pricing by distributors is all part of an inevitable squeeze throughout the entire industry, and it accompanies an ongoing search for greater sources of new revenues – again, the classic sign of a mature industry in what is perhaps a long-term secular downswing. Distributors also are tightening their demands in terms of support services, investor education initiatives, standards of risk management, governance and transparency. In the post-Madoff “trust but verify” era, asset managers, particularly small- and mid-sized firms, that seek to expand their distribution channels have their work cut out for them. Client advisors have substantially raised the bar in their due diligence requirements and are as skeptical as ever about buying into new products from new manufacturers.

With the search for new revenues, an all-out effort to enhance margins in an era of rising costs and a flat outlook for capital market returns, it is no surprise that the client-facing advisors which own these relationships are focused on more of the duties historically provided by asset managers. Firms working on the highly lucrative, client-facing side of the distribution chain are adding more value and personalization to their services, focusing more attention on meeting client needs, valiantly fighting against a squeeze on profitability and making certain that clients see legitimate value in the fees charged.
The past decade has seen a frenzy of production activity by asset managers with an increase in products created to cater to increasing market niches. The idea behind this is classic supply-side economics: where new supply is created, the market demand should ultimately follow. This trend may have worked for the industry during the last three decades, primarily as the result of the creation of the equity culture in the late 1980s. However, projecting forward, it is likely that manufacturers and distributors alike will exercise far more prudence in deciding on the array and number of products with which to work. An inevitable process of rationalizing the number and type of products on the market, driven by both distributors and manufacturers, is well underway.

Number of mutual funds and ETFs in the US

<table>
<thead>
<tr>
<th>Year</th>
<th>Number of Mutual Funds</th>
<th>Number of ETFs</th>
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<tbody>
<tr>
<td>2002</td>
<td>8,243</td>
<td>113</td>
</tr>
<tr>
<td>2003</td>
<td>8,125</td>
<td>119</td>
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<tr>
<td>2004</td>
<td>8,042</td>
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<td>2005</td>
<td>7,974</td>
<td>204</td>
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<td>2006</td>
<td>8,117</td>
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<td>2007</td>
<td>8,023</td>
<td>629</td>
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<tr>
<td>2008</td>
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<tr>
<td>2009</td>
<td>7,659</td>
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<tr>
<td>2010</td>
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<td>2011</td>
<td>7,580</td>
<td>1,134</td>
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<tr>
<td>2012</td>
<td>7,582</td>
<td>1,194</td>
</tr>
<tr>
<td>2013</td>
<td>7,707</td>
<td>1,294</td>
</tr>
</tbody>
</table>

Note: Data for funds that invest primarily in other mutual funds were excluded from the mutual fund series. ETF data includes ETFs not registered under the Investment Company Act of 1940 but excludes ETFs that invest primarily in other ETFs.

On the manufacturing side, managers, responding to heightened competition, are starting to intensify the sales support given to distributors. At the same time, those asset managers are also evaluating the profitability of their individual distribution relationships more closely. The average national accounts team for an asset manager will likely focus more of its sales efforts on fewer distributors. With more time, energy and investment given to distributors, asset managers can be expected to make decisions about rationalizing the number of distributor relationships they have in place based on a careful profitability analysis.

For most managers, the product suite will also likely come under close profitability scrutiny. For global fund families, some market niches may have several dedicated products to address local market requirements. For the largest bulge-bracket asset managers, which offer several hundred products, there are firms where fewer than 5% of their funds generate more than 50% of total revenues. This type of highly bloated product suite is maintained in the belief, rightly or wrongly, that sooner or later, many of the smaller funds contained within the 95% will take off and start generating significant revenues. However, the era of effectively subsidizing smaller underperforming products purely on the basis of wishful thinking for the future is coming to an end. For all but the smallest boutiques, consolidation and rationalization of product suites is an inevitable trend that will be implemented to control costs and safeguard margins.

Distributors, for their part, are also narrowing the field of managers they do business with and, like manufacturers, are starting to rationalize and downsize the number of products they offer. The largest distributors are under extreme stakeholder pressure to improve margins. Particularly within the large wire houses, there is an ongoing search for costs to cut, processes to streamline and new sources of revenue enhancement. In addition to demanding and receiving hikes in distribution fees from manufacturers, reducing the number of fund families offered will likely be the next logical cost-cutting exercise for distributors. Many small asset managers who fail to clearly differentiate themselves and mid-sized firms that lack the size and scale to maintain a large sales force to successfully compete will likely find themselves on the wrong side of the rationalization equation.

At the same time, distributors will also become far more interested in enhancing the commercial relationships they do retain. Revenue-sharing agreements between distributors and manufacturers may become more demanding and more aggressively priced. But the upside for the asset manager is that they will likely benefit from closer partnerships and more detailed reporting by distributors about platform activity and better access to client-facing advisors. The takeaways and feedback from advisors will prove highly valuable for manufacturers. Such market intelligence can be critical to asset managers as they carefully examine the profitability metrics of their product suite, overall marketing strategy, distribution channels and the most efficient and cost-effective ways to serve each channel.
In the UK, the entire system of distribution fee-sharing has come under radical regulatory overhaul with the implementation of the Retail Distribution Review (RDR), which went into effect at the end of 2012. RDR requires advisory firms to explicitly disclose and separately charge clients for services. Advisors must also clearly describe their services as either independent — thus entirely free from any conflict of interest and connection toward any product line — or restricted, where a connection of preference toward a product line exists. The biggest change for distributors is they can no longer accept commission payments or revenue share from asset managers for selling products. Instead, they must be paid directly by the clients they advise.

The push to eliminate sales-based incentive payments from manufacturers to distributors has already substantially increased the production of low-cost share classes that offer lower management fees and, at the same time, permit more leeway for distributors to charge clients directly for investment advice. Most distributors will likely push manufacturers for even better deals in terms of share classes offering razor-thin fees, allowing customers to buy funds at “super-clean” rates rather than the standard “clean” prices available elsewhere. Clean funds – versions of existing investment funds that include no commissions for distribution expenses – are already a growing product class among investors. Yet again, the few basis points of revenue enhancement sought and won here by distributors will likely come out of the manufacturer’s bottom line.

Although the jury is still out on the exact effects RDR will have on profitability for both asset managers and distributors, some critics have argued that small- and mid-sized manufacturers could see new business volumes decline by some 15% to 20% as a direct result of shifting consumer demand and shrinking availability of advisors. Further, a large number of smaller advisors will likely disappear – with the upside potential that more business will be directed toward larger advisors. Given RDR’s requirement that all pricing become fully transparent, consumers are likely to spend...
differently. Reduced spending for advisory services will inevitably lead to a shakeout and downsizing of the number of client-facing advisors and reduced demand for many types of fund products that relied heavily on generous commissions and aggressive sales and marketing. The downside is that lower net worth investors may be left behind from an availability of advice perspective due to the shrinking number of advisors.

The US market has so far escaped any significant regulatory overhaul like RDR in the UK. However, such actions by non-US regulators, including the type of sales inducement bans now being sought by regulators in Europe, may influence local actions throughout the globe. In fact, the UK regulators who painstakingly formulated and implemented RDR over nearly a decade have always been in close communication with regulators throughout the EU. Similarly, EU regulators are in close communication with the Securities and Exchange Commission (SEC). Conflicts of interest within the asset management industry continue to be major priority for the SEC – particularly under its new Chair Mary Jo White, a former US Attorney and partner at a Wall Street law firm. The complex system of expense allocation among distributors, manufacturers and clients is just one of many areas where potential conflicts of interest have been reported to the SEC. Already, the SEC has issued several official statements about its intention to focus on specific conflicts within the asset management firms it inspects, the steps taken to mitigate conflicts and the exact disclosures made to investors, as well as the governance framework to manage conflicts on an ongoing basis.

Fund distribution payments have moved to the top of the SEC’s agenda and will likely become an exam priority nationwide. Exam letters from some regional offices have already gone out to firms inquiring about distribution payments. Of particular concern to SEC examiners are what they deem “Payments for Distribution in Guise.” Payments by asset manufacturers to distributors can go by many names and are purportedly made for a variety of services. According to recently released SEC statements, upcoming examinations will focus on four areas: (1) 12b-1 fees paid by the fund manager to the distributor; (2) revenue-sharing agreements in which the fund managers pays the distributor; (3) fund managers paying shareholder servicing fees to a distributor; and (4) conference support fees, in which a fund manager pays a distributor for access to conferences and client meetings.

Further, in a statement released in February 2013 specifically addressing distribution payments, the SEC noted that one of its exam priorities would be “the wide variety of payments made by advisers and funds to distributors and intermediaries, the adequacy of disclosure made to fund boards about these payments, and boards’ oversight of the same.”

It has been almost 15 years since the SEC has issued significant guidance in this opaque area of expense allocation. Today, fee sharing has become a critical issue for the industry, as the costly distribution side of the equation now accounts for an excessively large proportion of total fees paid by the investor. SEC examination staff making routine inspections of asset managers will likely heighten their focus on whether various payments made to distributors are in compliance with regulations or are instead payments for preferential treatment.
An even more uncertain wild card in the evolving distribution landscape is predicting how exactly the Dodd-Frank rulemaking process now underway by the SEC and the US Department of Labor (DOL) will eventually play out and what effect new rules on disclosure will have on the broader asset management industry.

In response to several US Congressional inquiries into the obscure system of how service providers charged fees and expenses on retirement plans, the DOL has implemented regulations detailing administrators’ responsibilities regarding disclosure of investment-related information, including fee and expense information. Previously, it was often exceedingly difficult to calculate exactly how much beneficiaries were paying for retirement plan services.

As a result, the DOL’s Employee Benefits Security Administration is now enforcing rules regarding disclosure of management fees and expenses charged to certain types of retirement plans under the general fiduciary provisions of the Employee Retirement Income Security Act of 1974 (ERISA). Under the new regulations, plan administrators of “covered individual account plans” that allocate investment responsibility to participants and beneficiaries must ensure that beneficiaries are made aware, on a regular and periodic basis, of their rights and responsibilities with respect to investments in their accounts and are provided sufficient disclosure regarding all fees and expenses as well as designated investment alternatives.

Inevitably, the disclosure practices related to ERISA plans will slowly take effect for the entire industry given the market demands and an increasingly better informed investor base. In short, with increasing disclosure and investor understanding of pricing, margins across the entire distribution life cycle will inevitably be scrutinized – and relentlessly squeezed. Given the general industry trend of more disclosure of more pricing information, manufacturers and distributors across the value chain will be forced to adapt to a brave new world of informed investors who command far more pricing information than ever before – and who will clearly implement their investment decisions based, in part, on pricing factors.

Another crucial regulatory area now under review is the complex and overlapping responsibilities of broker-dealers compared to investment advisors. Presently, there are two complicated and confusing federal statutes that underpin the selling of investment products to investors. Broker-dealers, such as large financial institutions, including the major wire houses accounting for some 700,000 individual registered representatives, are regulated under the Securities Exchange Act of 1934. Under the Exchange Act, brokers are obligated to sell investments that are merely suitable to clients. By contrast, investment advisors, a smaller group, are regulated under the Investment Advisers Act of 1940 and are obligated to carry out a far more burdensome fiduciary duty of care when selling to clients.

In countless federal court decisions over several decades, investment advisors have been deemed to be fiduciaries to their clients. This is due to the recognition by the courts that clients entrust investment advisors with assets and investment authority. By contrast, since creation of the first round of federal security regulations in the 1930s, broker-dealers were generally viewed not as fiduciaries, but rather as salespeople whose primary function was distributing and selling securities and executing securities transactions.
However, given the rapidly increasing overlap between the two functions, in the public marketplace today, there is virtually no differentiation between brokers and investment advisors. Identifying this highly homogenous nature of the two extremely similar roles, the Dodd-Frank Act granted the SEC new authority to adopt rules establishing a uniform fiduciary standard of conduct across the industry for brokers and advisors alike when providing “personalized investment advice about securities.”

For the brokerage industry, adoption of a far more rigorous fiduciary standard in day-to-day sales operations will require a re-evaluation of the product line offered to clients, far greater compliance costs and a likely significant hit to the bottom line. For asset managers, while it is far from clear how precisely the industry will change and conform to tighter regulations, increased costs and decreased profitability for brokers — one of the most important distribution channels — will in some way lead to an increase in the cost of distribution or reduction in the number or type of relationships in this channel.

Tightening the regulatory burden on the client-advisor relationship is part and parcel of the SEC’s renewed drive in the post-global financial crisis market toward enhancing investor protection. As another example, the SEC’s Office of Compliance Inspections and Examinations (OCIE) recently issued a Risk Alert on the due diligence processes that investment advisors use when they recommend alternative investments, such as hedge funds, private equity funds or funds of private funds.

Already, the SEC noted that advisors have substantially stepped up their due diligence process, which is not surprising, given a number of high-profile investment scandals that resulted from poor to non-existent due diligence of alternative managers in the past. Nonetheless, SEC staff observed certain deficiencies in the due diligence process of several of the firms they examined, including:

- Omitting alternative investment due diligence policies and procedures from their annual reviews, even though these investments comprised a large portion of certain advisors’ investments on behalf of clients
- Providing potentially misleading information in marketing materials about the scope and depth of due diligence conducted
- Having due diligence practices that differed from those described in the advisors’ disclosures to clients

In short, a substantial overhaul of the regulatory system underpinning distribution is already well underway. The only certainty is further uncertainty about exactly how the rules will be eventually drafted and implemented, the greater compliance costs for brokers and advisors, and ultimately, the greater distribution costs for asset managers.
Technology in the smartphone era: friend or foe?

As smartphones become ever more potent pocket computers, the asset management industry will be forced to embrace not just smartphones, but the rapidly rising share of smart consumers who increasingly rely on those smart devices to access information and conduct their personal financial transactions.

Technology has the long-term potential to restructure the asset management industry with the same magnitude as Microsoft Word restructured the typewriter manufacturing industry in the 1990s. The escalation in computational power, sophistication and market adaptation of mobile technology will continue to intensify.

Mobile technology adaptation in financial services has accelerated over the last decade. However, as recently as five years ago, the core business development strategy of the asset management industry rested not on technology, but on personal relationships and the affable financial advisor. After all, asset management and sales of financial products were widely considered a high-touch “people business” based on personal relationships and face-to-face client interactions. Similarly, many analysts in the retail and travel industry initially dismissed internet-based merchants and travel websites as marginal tech toys primarily intended for impecunious college students looking to save a few dollars.

Today, there is a new paradigm. Mobile technology is rapidly usurping those past bedrock sales relationships and becoming a key component of sales, marketing, investor communication and education. Much like the preference for consumers, particularly Gen Y, to move away from using a travel agent for advice on purchasing an airline ticket or a cruise, consumers will slowly shun personal relationships and move toward technological interfaces to implement their financial decisions. Given that the mobile tech boom and smartphone era have only recently begun in earnest, spending across the entire financial services industry specifically dedicated to mobile intermediation will likely increase to double-digit growth rates for the next several years.
Spending on front office technology to support mobile intermediation is forecast to grow

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f: Forecast


In the near term, rapid advances in technology will play out in the distribution space in several key areas:

- **Transparency of information.** Investors, particularly further up the socio-economic ladder, are bombarded daily with market commentary and financial news. In addition, firms must now disclose an enormous amount of once non-public information to regulators. Much of this, such as detailed information on total fees and expenses, will eventually become public domain. In other words, everyone in the distribution life cycle – from wholesalers to retail investors – will know a lot more about products, their pricing and performance than ever before.

- **Relentless margin compression.** Transparency of information gained through technology has significantly affected profitability margins in wide areas of the capital markets, such as investment-grade fixed income and foreign exchange. Distribution in the asset management industry is by no means immune to further margin pressures. Pricing transparency due to technology is part of the broader trend of increased transparency of information and has squeezed margins across the global economy, from retail distribution of books and used cars to travel and insurance. In the recent past, the distribution chain within the asset management industry had remained highly resilient to price elasticity. But that won’t be the case for
long. As pricing information becomes increasingly transparent, combined with the growing acceptance of low return capital markets for the foreseeable future, investors will increasingly demand every basis point in cost savings.

- **Sophistication and education.** From both a retail and institutional perspective, investors are vastly more sophisticated, educated and, to a large extent, far more skeptical about the industry than ever before. Local financial scandals in one tiny market can go viral on a global basis overnight. The distribution life cycle will in turn become highly flexible and responsive to market conditions and investors preferences. As more information becomes available to an increasingly sophisticated market, this will mean that quality and timely market intelligence relevant to distributors become utterly essential.

- **Distribution to Gen X, Gen Y and emerging market client segments.** First-mover advantage is essential to acquiring the “sticky” money of long-term retirement savings. But to gain the much sought-after Gen X, Gen Y and emerging market client segments, every player in the distribution life cycle will need to step up its technology game. These client segments are going online to conduct an increasing bulk of their transactions, such as shopping, bill paying and even paying for parking fines. More specifically, Gen X and Gen Y are allocating more time to smartphone interaction, even as their face-to-face interaction is plummeting. The trend toward greater comfort with completing highly sensitive commercial transactions, such as financial planning, through a virtual interface is clearly accelerating. The explosive growth in internet-based payment systems, banking and even services as mundane yet confidential as tax preparation demonstrates that consumers are more comfortable conducting personal financial transactions without any face-to-face interaction whatsoever. In order to gain favor with the lucrative Gen X, Gen Y and middle-class markets, every player in the distribution life cycle will need to improve its use of technology – and move away from the bedrock primacy of the individual salesperson.

The next few years will see a tipping point in mobile technology in emerging markets, as well as with Gen X and Gen Y investors – all essential market segments for growth. Most Gen X and Gen Y investors may have never purchased a paper airline ticket, manually filed paper tax returns or searched for a job with a paper copy of their résumé. As witnessed in retail banking and the airline industry, mobile technology essentially can usurp traditional face-to-face relationship-based distribution models.
Brave new digital world for US consumers: multiplatform internet usage has led to digital media consumption nearly doubling in past three years

Units: billions of hours

Source: comScore, Inc.
Top distribution predictions going forward

1. **Accelerated margin pressure and its impact to the value chain.** As the market moves toward lower-fee products combined with escalating compliance, administrative and technology costs, asset managers profit margins will be further squeezed. Additionally, distributors will seek to move up the value chain, seek new revenue sources and more aggressively leverage their tight control of the client relationship.

2. **Expansion and branding.** The ongoing reconfiguration of the financial services industry will force both asset managers and distributors to improve their performance. The threat of disintermediation and marginalization across the entire product life cycle is real. Distributors will invest heavily in expanding client services and winning a greater wallet share as well as more clearly defining their strategies based on different strata of investors and their desired approach for interaction and service. To successfully counter this threat, winning asset managers will invest in direct customer solutions and more actively build their brand identity with investors.

3. **Simplifying the business.** Despite the general rise of global AUM, in the drive toward growth and enhancement of margins, asset management firms will seek to streamline operations by rationalizing products and relationships and simplifying their business overall. Consolidation of funds and share classes will lead to fewer products, more concentrated guided architecture and fewer, more optimized profitable relationships. For all players in the distribution life cycle, streamlining operations, improving processes and maximizing fewer relationships and products will become core priorities.

4. **Winning in mobile tech.** The largest financial services firms have been quick to realize that a growing proportion of personal financial transactions are taking place over the internet and, specifically, on mobile devices. Whether used as a source of market data, financial news or investor education, the widespread adaptation of mobile technology by the asset management industry has now reached a critical level. Therefore, a winning distribution strategy must, by necessity, encompass a winning game plan for mobile technology. Leading firms are examining all options to improve their clients’ mobile experience. Digital teams at asset managers will reassess their sales and marketing efforts and think “client first” with “mobile first” when developing websites and rolling out new technology.

5. **Regulatory overhaul.** Given that addressing conflicts in the asset management industry is a top priority for the SEC and other global regulators, some degree of regulatory overhaul will be announced in the US. While new regulatory initiatives for distribution payments may be far less aggressive in the US than what they are in the UK with RDR or other EU jurisdictions, the new rules will likely create similar challenges to the profitability of both asset managers and distributors.

6. **Final thought: the year of the client.** Whether examining how to build brand identity with investors, establishing direct client relationships perhaps for the first time, personalizing marketing content, increasing investor education and communication, or vastly expanding and enhancing mobile technology capabilities, all players in the distribution life cycle will be forced to refocus their efforts on more efficiently and effectively optimizing the client relationship.
Sea of change on the horizon
US fund distribution 2014
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Sea of change on the horizon

US fund distribution 2014
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