The Contribution of the Asset Management Industry to Long-term Growth

by

Gian Luigi Costanzo

The global asset management industry was severely hit by the worldwide financial crisis, but has recovered well from the crisis. The resiliency of the asset management industry can be explained by a more diversified industry and investors turning to greater diversification in asset classes. The asset management industry is a vital source of economic growth as intermediary in the savings-investment channel. The industry is also one of the most important providers of liquidity needed to ensure smooth functioning of capital markets and provides the means for its clients to diversify their portfolios and achieve their investment goals. Asset managers should act as the ‘stewards’ of their clients’ interest. But less ‘sticky’ liabilities tend to create short-termism of asset managers. A sound governance framework, more transparency, better communication with clients and better management of their expectations may be needed to overcome this problem. But clients themselves, at the institutional as well as retail level, will also have to adopt a more long-term view to appropriately evaluate the risk and returns of their portfolios. Vehicles for long-term retail investment need to be developed and support by fiscal and other incentives may be considered.

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I. Developments in the global asset management industry

The global asset management industry was severely hit by the worldwide financial crisis in 2008, with all regions suffering a severe contraction in assets. According to EFAMA, the value of assets professionally managed in Europe suffered a fall of 21%, from EUR 13.6 trillion at end 2007 to EUR 10.8 trillion at end 2008. Thanks to the stock market rally and the recovery of net inflows into UCITS, the value of assets under management (AuM) bounced back in 2009 to an estimated EUR 12.8 trillion at end 2009.

In relation to GDP, total AuM in Europe is estimated to have reached 100% at end 2009 from 80% at end 2008. This percentage is an average hiding a wide dispersion of situations across Europe: the AuM/GDP ratio was well above the European average in three countries: UK (209%), Belgium (136%) and France (131%), where clearly asset management plays a relatively more relevant role in matching the needs of savers and investors, both in the domestic market and capturing the international flows of capital.

2010 has been a good year for fund and asset managers. In 2010 the European investment fund industry bounced back to the asset level reached before the global financial crisis. The recovery benefited all categories of long-term funds, notwithstanding the unprecedented crisis that hit the euro area.

The resiliency of the asset management industry can be explained by the wide range of funds following different types of investment strategies on offer: investors can shift their portfolio between fund categories according to changes in the global economic outlook and the perceived investment risks. For example, the sustained sovereign debt crisis in the euro area led to outflows from government bond funds in December, whereas corporate bond and equity funds benefited from an encouraging economic outlook for 2011. Investors are turning to greater diversification in asset classes to protect their portfolios from market movements and generate higher returns. The investable universe that once centred around two asset classes – equities and bonds – has been expanded to include new strategies and asset classes, including real estate, hedge funds, private equity, currencies, commodities, natural resources, infrastructure, and even intangibles (e.g., intellectual property rights). The only period when diversification has not helped was in the aftermath of the Lehman crisis, when correlation amongst most asset classes shot up and most investment strategies could not protect investors from suffering heavy losses. In this context, such concepts as the core-satellite approach and benchmarking lost relevance.

With asset allocation re-established as the most important factor explaining returns, asset allocation products have shown strong growth. Investment products with an element of active asset allocation are now being engineered both for defined-contribution plan members and for retail investors. Lifestyle funds are one example. Finally, an increasingly large number of new UCITS funds are adopting “absolute return” strategies quite similar to those applied by the hedge funds: although these so called NEWCITS funds have not yet been thoroughly tested during a severe downturn – and concerns have been raised about their massive use of swaps, derivatives and leverage as well as of “custom-
made” eligible assets – they are attracting interest both from institutional investors and from high net worth individuals.

Box 1. Investment funds: selected developments

Investment Funds assets growth and net sales in 2010 – key data:

- **Increase in investment fund assets**: investment fund assets in Europe increased by 13.7 per cent in 2010, from EUR 7 061 billion at end-2009 to EUR 8 025 billion at end-2010.

- **Sustained demand for both UCITS and non-UCITS**: UCITS registered net inflows of EUR 166 billion in 2010, compared to EUR 150 billion in 2009. This result was achieved despite outflows of EUR 126 billion from money market funds.

- **Strong shift towards long-term UCITS**: total net sales of long-term UCITS (UCITS excluding money market funds) reached EUR 292 billion in 2010, compared to about EUR 195 billion in 2009.

Confirming Investment Funds strong growth over the last decade:

- UCITS and non-UCITS assets at end 2000 stood at EUR 4 560 billion. Total assets reached EUR 8 200 billion at their peak at end June 2007 before the financial crisis started to unfold. The value of investment fund assets tumbled to almost EUR 6 trillion in early 2009, before recovering to EUR 8 025 billion at end 2010.

II. Developments in the European asset management industry

**Investment funds represent approximately 50% of total AuM at end 2008**

Looking again at the European asset management industry as a whole, investment funds represent approximately 50% of total AuM at end-2008, whereas discretionary mandates account for the remaining half. Typically, asset managers receive mandates from institutional investors and high-net-worth individuals, whereas investment funds serve both the retail and institutional markets.

**Institutional clients represent the dominant segment of the European asset management industry**

Institutional clients represent the dominant segment of the European asset management industry, accounting for around two thirds of total AuM in Europe. They dominate the asset management landscape in the UK, France, Germany, Portugal, Hungary and the Netherlands, reflecting the ability of these countries to attract institutional mandates from two key institutional client categories, insurance companies and pension funds. Although these investors continue to manage part of their assets in-house, increasingly many of them rely on the expertise of third-party asset managers. In addition, asset managers serve other institutional clients by managing financial reserves held by non-financial companies, banks, government, local authorities, endowments and others. Many of these clients invest through a combination of investment funds and discretionary mandates.

**Many institutional clients provide intermediary services for households**

It is also important to note that many of the institutional clients of the industry provide intermediary services for households. For example, apart from direct investment by households in asset management products, households also account for a significant share of the institutional client segments through their ownership of unit linked products offered by insurance companies, or defined
contribution schemes offered by pension funds and others. Moreover, retail investors increasingly access investment funds through platforms, funds of funds and similar approaches that are considered as institutional business. This is an important reason why institutional investors represent the largest client category of the European asset management industry.

Finally, the border between different asset management product types is blurred. Apart from the frequent allocation of discretionary mandates to investment funds, certain investment funds display similar characteristics as discretionary mandates (for instance, Spezialfonds in Germany). In France, the large degree of institutional clients is partly due to the popularity of unit-linked and other wrapper products containing asset management solutions offered to retail clients via intermediaries, as well as the important role played by money market funds in cash management of many French corporations.

Vice versa, discretionary mandates may also be retail oriented (like for instance in Italy) and mimic the investment strategies and structures of investment funds. Thus, product types with similar properties may be categorized differently, although differing primarily in terms of the wrapper used for their distribution.

Different investment product categories, i.e. different “wrappers”, might have to submit to different transparency and selling rules. The resulting distorted competition hampers investors’ ability to compare alternative investment options and weakens their position with both distributors and product providers. In order to create a level playing field, the same distribution standards, including in particular transparency rules for the products and appropriateness rules for the clients, should apply across all retail investment product categories. In this context we should support the EU initiative on Packaged Retail Investment Products (PRIP). PRIP’s objective is “to introduce a horizontal approach that will provide a coherent basis for the regulation of mandatory disclosures and selling practices at European level, irrespective of how the product is packaged or sold”.

In order to establish an effective level playing field, the scope of PRIP should be extended to capture the full universe of substitute investment products. This could eliminate existing inequalities and thus improve comparability across product categories.

III. Asset management to foster economic growth

Asset management is a vital source of economic growth. It provides a link between investors seeking appropriate savings vehicles and the financing needs of the real economy.

Asset management offers a crucial contribution to the European economy: total investment fund assets represented 66% of the European Union’s GDP at end-2010 whereas total assets professionally managed amount to more than 100% of EU GDP. This confirms the important contribution of investment funds to the European economy, as financial vehicles raising capital from retail and
The European asset management industry fulfils three essential functions for the European economy:

Firstly, it channels capital from where it is in surplus to where it is in short supply. By providing equity capital in both primary (IPOs and private placements) and secondary markets, as well as credit to corporations and financial institutions – directly via corporate bonds or indirectly via money markets – and finally by helping fund government deficits, asset managers are fuelling the real economy and represent an essential link in the financial market chain.

Secondly, the industry is one of the most important providers of the liquidity needed to ensure soundly functioning capital markets.

Thirdly, it gives its clients access to a range of instruments and markets to diversify their portfolios and achieve their investment goals.

In properly pursuing their mandate, asset managers should stimulate overall economic development by continuously monitoring developments in industries, countries and regions; by identifying companies with the best prospects of successfully implementing novel innovations, processes and strategies; and by allocating financial resources to those most promising. Responsible ownership in equity (and possibly also corporate bond) investment is increasingly becoming part of the fiduciary duty of asset managers, consultants, trustees and asset owners, even though there is still a lot of room for improvement in this area.

Asset managers should act as the “stewards” of their clients’ interest. Their value proposition must be to enable their clients to reach their investment objectives and to increase their financial prosperity. The property of the assets remains with the client, i.e. they are not on the balance sheet of the asset managers. The asset managers are, however, in charge of the assets managed and accountable to the clients for those assets. Still, the asset managers act in an “agency” capacity to manage assets at the request of the “principal”, i.e. the client, in accordance with the terms of the agency agreement. Therefore it is very important that the terms of the agency agreement are properly specified and targeted to achieve the asset owners’ objectives, which is often quite difficult for institutional investors and even more so where retail investors are involved.

In particular, as opposed to pension or life insurance funds, mutual funds’ liabilities (and, more in general, liabilities of asset managers) are less “sticky”, i.e. clients can withdraw their money on (almost) daily notice. This might lead to excessive “short termism” from asset managers as well as “herd” behavior, following the well known statement that “it is better to be wrong with the crowd than to take the risk of being right with a happy few”. In order to be able to face volatile flows of capital into and out of their funds, often due to short term over- or underperformance of a given benchmark, asset managers need to keep a close eye on “liquidity” of their investments, thus foregoing opportunities that might arise in less liquid – but potentially more profitable – areas of the market.
Fund managers depend on the quality of advice to end investors

Finally we should not overlook the role and relevance of the distribution channels linking asset managers to final retail clients: when dealing – directly or indirectly – with retail clients, fund managers are always dependent on the quality and independence of advice given to the end investor at the point of sales by distributors.

IV. Challenges facing the European mutual fund market

Industry shortcomings are increasingly being voiced

The asset management industry has seen tremendous growth over the past ten years. However, the sustainability of this success is under question and industry shortcomings are increasingly being voiced by regulators, investors and even the industry players themselves.

Spillover effect from the crisis

Surveys among investors have shown that the asset management industry has become increasingly distant from the consumers of its products over the past few years. Even though asset managers were not at the center of recent turmoil, did not take extravagant bonuses, and on the whole, did not blow up, there has been a tremendous spillover effect from other areas of the financial sector more negatively affected by the crisis.

Regaining investors’ trust by more transparency, more communication and better management of expectations

After the market crash of 2008, the biggest challenge confronting everyone in the asset management industry is to regain the trust of the investor. This effort will require more transparency, more communication with investors (especially about risk), and better management of expectations than is currently done by the asset management industry. Asset managers will have to redefine their offering, aligning promises with their ability to deliver. They will likely play a bigger role in asset allocation – advising institutional investors and engineering products for retail investors – and in risk and liquidity management. But it is clear that also asset owners – institutional and retail, the latter through the distribution networks that service them – will have to adopt a more long-term view, to appropriately measure the returns of their portfolios, but also the associated risks, and thus properly evaluate the value added by their asset managers.

Well-educated investors need sound governance framework

In order to ensure the sustainability of the industry’s value proposition, we need well-educated investors who receive appropriate advice, with access to an industry with a sound governance framework and which provides them the right product at the right price and with the right level of transparency.

V. Difficult time for money market funds

In 2010 investors shifted away assets from money market funds

Very low short-term interest rates, competition from banks seeking to strengthen their balance sheets by increasing the share of the deposits and encouraging economic outlook convinced investors in 2010 to shift assets away from money market funds.

Money market funds are vital for capital markets

Money market funds came to life in the 1970s, as banks were forbidden to reflect the high inflation rates of the time in what they paid depositors. They have since become an important part of the “shadow” banking system, being vital for the smooth functioning of capital markets, as they are the repository for
a lot of the short-term paper issued by corporations and, even more, by other financial institutions. On the other hand, investors and corporations are sitting on a lot of cash, and still value money market funds for their stability, diversity of counterparties, credit analysis and liquidity, while the yield is often considered less important.

Though regulators’ actions in the US and Europe have made matters clearer and safer for investors, the risks have not gone away, especially for money market funds that do not mark to market their assets on a daily basis. The highly respected Lex column of the Financial Times has suggested that these money market funds are “too big to fail” and that, if anything threatens them, the Government will have to step in. Its conclusion was that these shadow banks need to be regulated just as tightly as banks are.

Though regulation has reduced some risks, other risks have increased in their place. Corporations are less inclined to issue the very short-term commercial paper that the funds need and their place has been taken by much more volatile short term bank debt. With fewer issuers, the money market funds are over-exposed to some counterparties, with financial institutions high among the list. Also, the money market funds industry has become more concentrated, with the top ten funds commanding 75% of the total in the US. The rating agency Moody’s feels that the parent companies of these funds are much less likely to come to their rescue in a future crisis. Furthermore, in an attempt to pay their way, some money market funds are taking on more risk by moving their investments from Treasury paper to debt issued by corporations, by banks and even by less creditworthy sovereign issuers.

The probability of a run might have become smaller, but it has not disappeared, and the systemic danger to the financial system is still around.

VI. The need to manage retirement provisions

The greying of Europe, coupled with the increased longevity of the population, is posing a problem to pay-as-you-go pension schemes. Today the State pension of one retiree is paid for with the taxes of four workers. By 2050 a retiree will be supported by just two workers. The situation is even worse since State coffers have been raided by bank bail outs and people are living on pensions for considerably longer than when the state pension scheme was first thought up.

European governments are reacting to this issue by shifting the responsibility of retirement planning to the working-age individual.

This, however, creates a new challenge for the person who now has to make investment decisions for his/her own long-term financial well-being. These decisions need to take into account the savings required to meet the longer period of retirement due to the increase in life expectancy, as well as consider the risk of investment and inflation. Therefore the ability of asset managers to better manage risk and offer some degree of downside protection is becoming increasingly important to individual investors: products must be designed, not
only to save for retirement, but also to allow for steady income flow after the accumulation phase and safeguard the investor against the risk of having insufficient cash flows in old age.

The need to shift the offering from investment products for accumulating wealth to products that offer yield and protection against various risks has been identified as a major trend also in the United States, where an estimated 77 million Baby Boomers will be retiring shortly. Using data from the U.S. Census Bureau and a 2004 survey of consumer finances, McKinsey & Company (2006) forecasted that by 2010 almost two-thirds of all investable assets held by U.S. investors would be controlled by retirees or near-retirees. According to McKinsey, its affluent consumer survey showed that the retirement wave is fueling demand for investment products that mitigate various risks: as asset managers move from offering products to offering solutions, they will become more knowledgeable about these risks and will work to improve their risk management systems.

In countries with funded pensions, pension funds assets constitute a substantial source of institutional money. In Europe the importance of pension fund assets varies across countries. Whereas they account for less than 10% of total institutional AuM in France and Italy, they represent the largest type of institutional mandates in the UK and Hungary. These differences are largely determined by the nature of the state pension system. In countries with tradition of relying on funded pensions, pension funds assets have accumulated over time to form a substantial source of institutional money. By way of illustration, pension fund assets as a share of GDP totaled 79% in the UK in 2007, compared to 1% in France, 3% in Italy and 5% in Germany.

VII. Investing for the long term

Investment funds were originally designed to target long-term investors, but along with the increasing sophistication of the market, various investment fund strategies have evolved that pursue not only long-term, but also short-term trading strategies. Nevertheless most funds are still communicated and labelled as being suitable for all investors, ranging from the man in the street to high net worth or to institutional, including asset allocators. Investors can hardly differentiate between funds that are suitable for the long-term or those that have a short-term investment approach. The importance of aligning investor interests, not only as to asset allocation but also to his/her objectives and time horizon, has become evident during the recent crisis; during which the short-term liquidity needs of certain investors conflicted with the long-term investment horizon of others resulting in some significant issues for certain funds. Volatility in asset flows (e.g., the difference between gross and net sales, or shifts from asset management products to bank deposits) has reached a level during the crisis that is fundamentally at odds with the long-term nature of most asset management products. This has meant that many investors have withdrawn assets prematurely, thus cementing losses and missing the benefits of subsequent recoveries as well as forcing sales of the funds’ assets at distressed prices, to the detriment of long term fund holders. This raises questions as to whether the forces at work that drive individuals’ investment decisions are optimally structured and regulated. It also poses a challenge for asset managers because, rather than being able to manage a steady long term asset base, they need to
additionally cope with sometimes extreme volatility of flows and are therefore forced to keep unnecessarily high levels of cash and invest only in the most liquid asset classes.

The crisis has also demonstrated that funds that are restricted by their investment strategies to have a minimum or maximum allocation within an asset class are robbed of the ability to act more flexibly, especially in times of crisis when rigid strategies can be disadvantageous for the investor and active asset allocation can play a key role in generating returns for institutional and individual investors alike. A fund’s goal should be to manage an objective not a strategy or a single asset class.

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Long-term vehicles should be developed to meet the investor's financial objectives rather than to adhere to a fixed strategy such as a fund limited to a country or industry. The fund industry, when servicing long-term financial needs especially in the space of retirement planning, should shift focus from benchmarks to investors’ time and risk objectives in constructing retirement eligible products. Such vehicles could be used either as building-blocks or have built-in solutions (like lifestyle profiles) for investors looking to plan for their old-age financial security.

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For vehicles categorised as long-term, the need for daily liquidity, as provided for within the major UCITS, is not required and represents a significant additional cost – and arguably a risk – for investors holding for the long-term. Vehicles designed for the long-term should not only be permitted, but should be required to offer liquidity designed with the long-term investor in mind. This could be accomplished through various measures such as managed redemption programs, swing price mechanisms or limitation of redemption possibilities over certain time periods. The current blurring within the UCITS world of vehicles accommodating short and long-term needs should be eliminated or at least managed for the benefit of the long-term investor.

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Transparency within the UCITS world remains extremely high in comparison with other vehicles on offer. Vehicles classed as long-term must all have the equivalent levels of disclosure but the type of disclosure should be designed for the long-term investor. For example, daily price publication or monthly fact sheets with benchmark performance indicators are arguably less relevant for products with a specific end objective rather than periodic (say quarterly) reporting on the performance vs. objective, together with any changes in the underlying risk features of the product.

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Finally, there is a need to align investor and asset manager interests: in order to align the interests of asset managers and investors the industry must be properly incentivised to deliver retirement products of quality. Incentives for retirement savings products should be linked to the risk-return objectives within the investor timeframe (“objective fees”). If providers are able to construct such fee schemes linked to the achievement of the objectives rather than simply the managing of assets, then we could arrive at a remuneration model that is both in the interests of investors and providers alike.

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Market for long-term funds is missing

The implication of all this is that there is a large missing market in the funds space in Europe: the market for funds that are designed for long-term investors and are managed, measured and regulated in such a way that encourages them to maximise long-term absolute returns.

Managers will be judged on longer and more appropriate holding periods

The managers of these “long term” funds will adopt longer term investment policies, trusting that they will be judged on longer and more appropriate holding periods and, not being exposed to excessive out- or inflows, will exploit all the opportunities in the capital market, also those with lower liquidity and longer payoffs. Moreover, they will be more inclined to actively engage with the companies they invest in and assess also the long term risks (environmental, social, etc.) of their investments.

Benefits might justify special fiscal treatment

The benefits of these “long-term” funds, both for investors and for the financing of the economy, might justify special fiscal treatment, with tax benefits for the unit holder increasing the longer the holding period (not just in one fund, since this might reduce competition amongst asset managers, but taking into consideration the holding period in the specific family of products, aimed at long-term investment).

VIII. Conclusions

To summarise and conclude, three challenges should be borne in mind:

- First, short-termism, especially in behaviour and regulation, is a major threat to sound practice, value added and stability overall.

- Second, strengthen the duty to act in the best interest of the client, both at the production and at the distribution level, in order to re-build investor trust in the wider financial services sector and especially in the asset management industry.

- Third, improve on the one hand the quality and transparency of the AM products and on the other the financial capabilities of advisors and investors so as to achieve the proper match between investors’ needs/objectives/investment horizons and the fund’s investment strategy and expected risk-adjusted results.