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PRODUCT TRENDS

What the Future Holds

By Michael Andrews, CFA®

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Like a never-ending hurricane, disruptive forces continue to buffet the investment management and wealth management industries. The challenges include fee compression, technology, and regulatory uncertainty, and the list goes on. To find out more, in the spring of 2019 we surveyed heads of product management and product development from 35 firms across the industry to get their perspectives on key issues. We also sat down with approximately 15 product leaders for a discussion about the key issues affecting them, and what we heard was very interesting. Approximately 75 percent of the firms we surveyed closed funds in 2018, 80 percent planned to close funds in 2019, and this trend line is expected to continue into 2020. No surprise, it is "lack of asset growth" combined with "platform rationalization" that is driving these fund closures. Although there is a large degree of institutional inertia behind keeping funds open, whether due to the belief that a particular strategy will one day be in favor or portfolio managers with a keen interest in a certain fund, it seems clear that the tide has turned against keeping funds open as a form of optionality. Additionally, price cuts continue, with some 75 percent of firms planning to cut prices on selective products. As an example, in the summer of 2019, a major firm announced that it cut fees on a large number of its funds. We calculated that the annual hit to revenue from the fee cuts to the first 11 funds would be more than $25 million.[1] Needless to say, these types of cuts are substantial, and they present a large challenge to managers looking to gather assets and drive revenue growth. We believe that the industry will remain challenged well into 2020 and beyond.

ENVIRONMENT, SOCIAL, AND GOVERNANCE

Regardless, we also are confident that asset managers will continue to innovate with new investment strategies and product structures. For example, we continue to see new environment, social, and governance (ESG) products as ESG becomes increasingly mainstream and moves beyond just equities into fixed income and even money market funds. A number of firms have indicated interest in bringing these strategies to the market. In fact, when we asked firms to rank their top five product launch priorities, ESG strategies ranked #2 on a weighted basis and multi-asset model portfolios were #1. Morningstar reported that there were 351 sustainable U.S. mutual funds and exchange-traded funds (ETFs) at the end of 2018, up almost 50 percent from 2017. These figures indicate rapid growth in the number of ESG products. But the difficulty in determining which products are ESG-focused remains, especially in an environment in which an increasing number of managers claim they integrate ESG considerations across their product lines.[2]

Overall, we believe ESG funds are likely to continue to take in record amounts of net new money even as the industry as a whole struggles. Globally, ESG ETFs have about $25 billion in combined assets under management (AUM). This figure does not represent a large share of total ETF AUM, but many large asset managers see this market as a significant area of growth. BlackRock, for example, predicts the ESG ETF market will hit $400 billion by 2028.[3] As such, the company continues to roll out new ESG-, thematic-, and impact-based ETFs, offering 14 such funds as of the end of 2019.

Given the academic research and investors' growing appetite for ESG approaches—if not ESG-specific products—asset managers and financial advisors would do well to take note of the ESG landscape. Clearly, many ESG managers are betting on ESG as a successful strategy. As a result, the number of new ESG products continues to rise, even as other product lines are shuttered, and some leading industry players work to integrate ESG analysis throughout their investment and research process. It seems likely that the industry is entering a new phase of responsible investing—in which these are no longer niche products or approaches but simply a more fundamental aspect of investment analysis.

MODEL PORTFOLIOS

Within our survey, larger firms were more likely to express a more definite intent to launch model portfolios than smaller firms (see table 1). Larger firms are manufacturing these products as both a complement and a competitor to in-house models offered by distributors. In our opinion, it seems likely smaller firms have evaluated the market and decided that they do not have the scale to compete successfully in this space. Rather, they will concentrate on bringing best-in-class products to markets that

Table 1

MODEL PORTFOLIO TRACTION—BY SEGMENT

We asked: Do you offer multi-asset model portfolios? Are you considering offering model portfolios in 2019?

	Firms with > $100B	Firms with $25B–$100B	Firms with <$25B
Currently offer model portfolios	8 of 12	7 of 13	2 of 10
Percentage of firms	66.7%	53.8%	20.0%
Do not currently offer model portfolios	4 of 12	6 of 13	8 of 10
Percentage of firms	33.3%	46.2%	80.0%
Currently do not, but are considering for 2019	3 of 4	2 of 6	2 of 8
Percentage of firms	75.0%	33.3%	25.0%

can be used in a "plug and play" manner with third-party models. Conversely, larger firms that have operational scale and are increasingly desperate for new revenue see models as a source of potential growth driven by packaging existing mutual funds and ETFs into new wrappers using already well-developed asset allocation capabilities.

Wealth management firms clearly have increased their consumption of models. They are using more models in their managed account lineups as a way to efficiently package investment advice and to add personalization. For investment managers, however, access to large platforms will remain difficult, because home offices are looking to maximize revenue opportunities and potentially limit the number of third parties with whom they do business. After all, home offices are only now winding down an exercise in which they significantly rationalized the number of third-party mutual fund offerings available within their systems. Further, home offices continue to search for ways to capture new revenues inside their own firms. This is shown by their large investments in people and resources on both the investment and research sides to support the internal development of products and sales throughout their organizations.

DIRECT INDEXING

Beyond models that fit extremely well with the continued growth of the unified managed account, we also are looking to the potential adoption of so-called direct indexing on a more widespread basis in the coming years. Together with the introduction of non-transparent active ETFs from firms such as Precidian Investments and Blue Tractor, we believe direct indexing has the potential to be quite disruptive to existing business practices.

Direct indexing offers advisors even greater flexibility than most of the current managed account technology. A type of next-generation passive separately managed account (SMA), linked to automated tax optimization technology that captures tax losses attributable to the underlying securities held in the account, could impact even the largest ETF providers if it takes hold. This new type of SMA may rival even the latest moves by several industry participants to launch low-cost ETFs and fund them internally with what the industry calls Bring Your Own Assets (BYOA).

With direct indexing, portfolios can be further customized for portfolio tilts or ESG parameters off the index. It is easy to imagine a world in which distributors could utilize artificial intelligence to disintermediate investment managers; after all, we increasingly live in a world in which many tasks previously done by humans are now being done by machines. The challenge for investment managers will be to get their unique intellectual property into portfolios and get paid for it. Bottom line: In the coming years, asset managers will need to dig deeper for unique, new strategies—rather than just more of their core strategies—to help home offices and advisors to continually add value and round out their overall investment programs.

ETFs AND ALTERNATIVE INVESTMENTS

Going forward, there seems to be a consensus that the industry will be looking to innovate in the ETF and alternative space. The recent Securities and Exchange Commission (SEC) decision to approve Precidian's as well as several other firms' non-transparent active ETF methodologies likely will result in a wave of new funds in 2020 as traditional active managers take advantage of a new product wrapper. Although this will present challenges for product development teams at investment managers as well as due diligence teams at broker-dealers, it will be interesting to see if the availability of previously unavailable strategies in an ETF wrapper acts as a true catalyst for new flows. Additionally, will they be a manufacturer-driven product that needs to be sold or a consumer demand-driven product to be bought? Our view is that non-transparent active ETFs have the potential to be very disruptive, especially if these ETFs trade as predicted with a relatively narrow spread and if they ultimately are deemed to be the proverbial better mousetrap because they are more tax-efficient than mutual funds and perhaps cheaper as well. Simply put, distributors may be obligated by the SEC's Regulation Best Interest and the ongoing move to a fiduciary standard to demand these vehicles or risk substantial fines and penalties, much as they have paid out as a result of utilizing share classes that were not the cheapest available. In this environment, investment managers will need to make difficult decisions about which strategies to offer and whether to clone existing funds or perhaps even convert mutual funds into an ETF structure. This, however, will not be an overnight transition. Rather, it will play out over several years as the industry evaluates and adapts to a changed market environment in which the demand for decreased costs, easy access, and personalization are business realities.

Similarly, interval funds, which typically provide limited quarterly liquidity, have been the subject of interest at a number of firms, and a wide variety of these products are in the pipeline to be launched. Sales are picking up, but the market is still dominated by a relatively small handful of firms, often selling specialized investment strategies. Also, in the context of overall industry AUM, interval funds have a small market share. They seem destined to remain important but nonetheless niche products, so, whether they will have the ability to move the sales and revenue needle remains to be seen.

AUCTION FUNDS

A potentially new product structure that we discussed in our meeting with product heads, a so-called auction fund, is being marketed by Nasdaq Private Market. Although it's still very early days, given the decline of U.S.-listed public companies of roughly 50 percent in the past 20 years and the increasing number of investment opportunities outside public markets, it seems apparent that the industry needs to find a structure that will provide access to investments outside the traditional public markets. Auction funds are for all intents and purposes privately placed versions of ETFs for illiquid assets with a market auction, instead of a redemption or tender back to the fund, with a series of mechanisms to keep the auction pricing near the net asset value. One industry participant calls them slow-motion ETFs. As such they may provide access to illiquid investments to a much wider group of investors who require liquidity and perhaps even allow 401(k) plans to more broadly incorporate these investments. Good examples of the type of investors that might make use of these noncorrelated investments are the in-house models constructed by distributors where the ability to rebalance between various asset classes is viewed as integral. Overall, however, it should be noted that the SEC is carefully examining the issues around broader retail investor access to alternatives.

RETIREMENT INCOME

Finally, the financial services industry traditionally has focused on helping individuals accumulate assets as they prepare for retirement and has provided much less guidance on how—and at what pace—to withdraw those assets. Unfortunately, and to their great detriment, aging Americans tend to significantly underestimate their spending rates during retirement, and their portfolios often do not generate enough income to sustain those spending rates over a prolonged lifespan. And, most financial products still focus primarily on wealth creation, rather than income generation. Even vehicles like target-date funds, which help investors automatically transition from wealth accumulation to income generation, are not designed to focus on the withdrawal period. Further, the typical glide paths used by most target-date funds consist of relatively safe and low-yield bonds, which is especially troublesome for people who begin retirement with inadequate assets.

For all of these reasons—low levels of retirement savings, shifting demographics, and the traditional emphasis of the financial services industry on accumulation—retirement income generation likely will be a significant area of growth for the industry in the coming years. Some existing products will target retirees directly as a means to create more retirement income, as has already happened with non-traded real estate investment trusts and business development companies. In addition, new products will be created that will explicitly address the retirement income shortfall. The annuity industry already is innovating in this area, and the investment industry will do so as well. Also, we expect that advisors will target retirement income as an important issue, which in turn will spur more investment managers to take an interest in the problem. Retirement income will, in our opinion, be a hot topic in the industry for many years to come.

CONCLUSION

Although it is clear that the industry is struggling to adjust to a new world, the pool of investable capital continues to increase in the United States and around the world. New solutions and outcome-oriented investments will be required to meet the needs of an aging population that is increasingly bearing the burden of preparing for a future in which the government and employers cannot be relied upon. How firms respond to this challenge, i.e., their ability to deliver consistent alpha in a variety of structures—mutual funds, active ETFs, collective investment trusts, model SMAs, closed-end funds—will determine whether they succeed or not. In this world, the role of product management and product development teams will be critical. Our research indicates that they are actively preparing for this challenge.

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ENDNOTES

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