Investment Management Review

Hedge funds and private equity fight on each other’s turf

Fund managers of the future could emerge

Plus

Asset managers’ role in Trump’s infrastructure plans
China in the vanguard of global retail infrastructure

Gigantic two trillion plus company launch
Waves likely in global stock markets and asset management

Manipulation of US company earnings attacked
Shares could be seriously hit
FROM THE EDITOR
NEW TYPE OF ALTERNATIVES — POTENTIAL FUTURE OF FUND MANAGEMENT

Activist hedge funds and buyout firms invading each other’s territory reflects the changing character of shareholder activism, a topic of immense importance to the stock market valuation and management of many large companies in the US and elsewhere. The development also carries significance for the future shape of the heavily clouded fund management industry.

The incursions by the two alternative groups, activist hedge funds and buyout firms might smack of hostility, but not really. In many cases, they are cooperating in their new approach. This possibly heralds the expansion of a new breed of alternative firm, neither private equity nor hedge fund but a hybrid.

Hybrids are promising to take shareholder activism to a new level of effectiveness. Activist hedge funds used to have a terrible reputation for being destructive predators, but no longer so. Academic research has shown that by and large they do good and are now highly welcome by many companies and institutional investors.

The modus operandi of activist hedge funds in recent years has been more friendly than hostile, aligning their style with that of the buyout firms. Both sectors are adopting each other’s methods for reasons of capacity. The activist hedge funds are taking over entire companies in the manner of the private equity firms who in turn are content to go for just non-controlling stakes along the lines of the activists.

Having common targets of improving companies and making a profit as well as shared skills in analysing underlying long-term value has allowed these invasions to take place. Well known activists such as William Ackman are endeavouring to employ the financial and operational discipline, previously the preserve of the buyout firms in their involvement with public companies.

In many cases, private equity firms and activist hedge funds have been operating in the same target companies. The changes make it very logical for the formation of the hybrids which house under one parent company two separate arms, facilitating cross-fertilisation.

These hybrids, albeit much modified and enhanced, could play a major role in the asset management industry of the future. True, it might sound ridiculous how this tiny corner of the investment world could eventually become much more important.

A close look at the long-term prospects for mainstream asset managers explains why. Many traditional fund managers are forecast to disappear. This is not to say that mainstream active managers will become extinct but they will shrink as the headwinds they face are not just short-term. The question is what will take their place.

The solution for the industry is felt by many to lie in long-term orientated funds investing in illiquid holdings. But these require a different mindset and approach that most managers in the mainstream sector are not trained for. Thus, the traditional industry cannot change tack quickly enough, making shrinkage almost inevitable.

Other developments add to the potential for hybrids. Buyout firms are adopting much longer time horizons, even up to 20 years. The largest, Blackstone, is already more a fund manager than a private equity firm.

This is not to say that hybrids will be the fund manager of the future. For a start, they don’t operate in retail and have a reputation, justified or not, for rapacity rather than being client service orientated. It is not just these hybrid firms that are backing long-term holdings. Legal and General Investment Management in the insurance sector, for example, is venturing into new long-horizon unorthodox areas and respected for social consciousness rather than being criticised for greed.

At this stage, it is rash to forecast how the industry might change but change it must and radically so. Enhanced hybrids deserve watching. They might have a good chance of becoming an important part of the industry’s future.
INVESTMENT MANAGEMENT REVIEW

A SNAPSHOT OF THIS ISSUE

REVIEW OF WHAT OTHERS HAVE SAID

WHILE US INFRASTRUCTURE GRABS THE ATTENTION, A RETAIL INVESTMENT MODEL, ADAPTABLE GLOBALLY, HAS SPROUTED IN CHINA

ASSET MANAGERS’ ROLE IN TRUMP’S INFRASTRUCTURE PLANS
The investment management industry is likely to play a substantial part in infrastructure development under the new President, but not in the way they want.

CHINA IN THE VANGUARD OF GLOBAL RETAIL INFRASTRUCTURE
The Chinese retail public has been attracted to backing infrastructure investments through a system that can be applied globally.

CHINA IN THE PERILOUS FOOTSTEPS OF JAPAN’S DOWNFALL
China’s rapid climb and recent policies uncannily parallel Japan’s meteoric ascent and subsequent downturn, thus provoking fears for the country’s future and the global economy.

FEARS SURROUND SINGAPORE’S TOP FINANCIAL CENTRE STATUS
Singapore’s position as a top global financial centre will be in peril unless it undergoes a major transformation, with the issue being of considerable importance to the prospects of the post-Brexit City of London, particularly in the UK’s fund management industry, according to the prestigious Euromoney magazine.

GIGANTIC TWO TRILLION PLUS COMPANY LAUNCH
An initial public offering of shares amounting to nearly five times as much as the biggest to date, Alibaba, is already causing excitement among investment bankers at the planning stage. When finalised, it will create huge waves in global stock markets and asset management.

HEDGE FUNDS AND PRIVATE EQUITY FIGHT ON EACH OTHER’S TURF
The boundaries between some hedge funds and buyout firms are blurring through their copying each other’s approaches in targeting companies. This development promises to take shareholder activism to a higher level of effectiveness and is also significant for the future of fund management.

SMALL FRENCH FUND MANAGERS ARE PROSPERING BUT HINDERED IN EXPANSION PLANS BY TRANS-NATIONAL SALES PROBLEMS

BOUTIQUES THRIVE IN FRENCH ASSET MANAGEMENT
Asset managers owned by banks currently dominate in French distribution. So, on the face of it, boutiques should find life difficult in France, yet they thrive.

EUROPEAN RETAIL INVESTORS NERVOUS OF CROSS-BORDER FUNDS
The ‘UCITS’ label is considered as gold standard in much of the world, apart from Europe itself where it strangely carries much less weight among the public.

CROSS-BORDER INVESTMENTS GROWING WORLDWIDE
Despite potential de-globalisation on the trade front, investment of fund management assets outside of the home country continues to grow strongly. Whether this expansion is sustainable over the medium-term, or might even be reversed, is another matter.

AN INTERESTING NEW SLANT ON EXCESSIVE CEO PAY
Academic research blames excessive CEO pay rises in the past on ignorance about how options worked.

MANIPULATION OF US COMPANY EARNINGS ATTACKED
Manipulation of published US company earnings against the rules has caused the Securities and Exchange Commission to go on the attack. The reverberations might eventually have an adverse impact on US stock market levels.

REGULATOR’S FUND LIQUIDITY SUSPENSION CRITICISED
Asset managers might be forced to impose redemption gates, the suspension of rights to instant withdrawal of their money from mutual funds by investors, under extreme market conditions. This watershed proposal by the Financial Stability Board has been much criticised in the industry.

FACEBOOK TYPE NETWORK PRIZED BY TOP PROFESSIONALS
A thriving social network, SumZero, which preceded the similar Facebook and had employed Mark Zuckerberg shortly before he founded the giant group, is highly valued by professional investors for stock selection and might be imitated by other fund managers.
HIGH-FREQUENCY TRADING HAS ENTERED A NEW ERA OF MORE ACCEPTANCE BUT LOWER PROFITABILITY

HIGH-FREQUENCY TRADING – GOOD OR BAD? 24
While high-frequency trading used to be much vilified, a substantial shift has now occurred. The question is how justified the new attitude is.

NASDAQ JOINS THE HFT SPEED BUMP GAME 26
The business of slowing down trading to curb high-frequency trader abuses is catching on.

HFT INDUSTRY IN UNPRECEDENTED DOWNTURN 28
Times have changed for the once all-conquering high-frequency traders. They are now adapting to adversity through different routes.

US STUDENT LOANS BUDDING ASSET CLASS UNDER TRUMP 30
The US student loan market, approaching $1.5tn, is attracting lenders and investors not just for itself but also as a conduit to another market that dwarfs it in size.

THE FCA CASTIGATES ASSET MANAGERS BUT GOES MUCH FURTHER IN CONSIDERING SERIOUS ACTION AGAINST INVESTMENT CONSULTANTS

THE FCA QUESTIONS VALUE ADDED BY ASSET MANAGERS 31
Asset management in the UK does not emerge in a very good light in the interim report on the industry by the FCA. Interest centres on the regulator’s actions that might follow.

INVESTMENT CONSULTANTS SAVAGED BY UK REGULATOR 33
The FCA has taken aim at the UK’s investment consultant industry with potentially damaging accusations involving conflicts of interest and the utility of their advice.

CONTRIBUTIONS FROM INDUSTRY EXPERTS

REGULATORY SPOTLIGHT:

UK REGULATOR CALLS FOR OVERHAUL OF FUND INDUSTRY 35
Dr Wolfgang Mansfeld, former president of European Fund and Asset Management Association, assesses the impact of the FCA’s interim report on the asset management industry in terms of the potential enhancements it might bring about.

SUB-ADVISORY IN JAPAN: AN INDUSTRY AT A TURNING POINT 37
Jag Alexeyev, founder of Impactvesting and former head of global research at Strategic Insight, explains the strong opportunities for global asset managers in the rapidly changing Japanese asset management market for external sub-advisory managers.

ROBO-ADVISERS ON THE RISE GLOBALLY AND CONTINUE TO EVOLVE 39
Bryan Liu, managing director of global research at Strategic Insight, provides a comprehensive overview of the fast-moving and globally expanding robo-advisory market.

INDUSTRY PERSPECTIVES IN FIGURES 41
This section provides a statistical perspective on the key trends in important sectors of the asset management industry: mutual funds, pensions, insurance, exchange-traded funds, hedge funds and private equity. Figures in billions and trillions are bandied around. Comparisons put them into perspective.

© All rights reserved.
No part of this publication may be reproduced or used in any form of advertising without prior permission in writing from the editor. No responsibility or loss occasioned to any person acting or refraining from acting as a result of material in this publication can be accepted. On any specific matter, reference should be made to the appropriate adviser.

ISSN 1746-8078
ASSSET MANAGERS’ ROLE IN TRUMP’S INFRASTRUCTURE PLANS

President Trump's infrastructure goals stand out as one of the most predictable programmes of his administration. All eyes around the world are focusing on the extent to which the private sector, including asset managers, will participate in the implementation of his infrastructure program.

Progress here might serve as a blueprint for moving forward elsewhere. Controversy surrounds the issue of what might be achieved. On the evidence, it looks as if fund managers will play a substantial role in Trump’s plans, but not in the way they would want.

The following topics are subject to uncertainties and debates:

- The benefit to the economy of the President’s infrastructure proposals.
- Obstacles to implementation once the go-ahead is given and financial arrangements are finalised.
- The role of the private sector, in particular the asset management industry, in participating.

Economic consequences

The fact that infrastructure expenditure will boost economic growth is widely taken as a given amongst economists,
The recent experience of China and Japan, the two biggest economies in the world apart from the US, helps to substantiate the case against infrastructure helping growth generally. Despite a massive infrastructure boost at the beginning of the 1990s, Japan has signally failed to ignite an economic take-off. China might have added to its growth during its infrastructure spending spree, but with a surfeit of useless infrastructure, it is apparently now paying the price in reduced growth.

While Trump in his various speeches mentions roads and other big projects, and decries the standard of US airports, the widespread feeling is that what America needs is not these big high profile projects, but a vast amount of overdue maintenance. Repairs required cover potholes in roads, decaying bridges as well as school and hospital buildings.

According to a well-known study by the American Society of Civil Engineers (ASCE) in 2013, the roads, biggest water systems, schools and transportation facilities deserved only a very low grading, while 85,000 bridges are functionally obsolete, and 14,000 dams represent a high hazard. The California Dam near disaster in early February 2017 was a red-flag warning of the dangers posed by neglect.

On the evidence, it looks as if fund managers will play a substantial role in Trump’s plans, but not in the way they would want.

At least on the question of restoring existing infrastructure, there is virtual unanimity. If the decaying bridges, roads in a parlous state and other similar small projects are not attended to, the cost will be felt in a few years through a serious drag on productivity and growth. In 2016, the ASCE, in a report called Failure to act: closing the infrastructure investment gap for America’s economic future, estimates that deficient infrastructure spending could cost the economy $1.4tn in GDP up to 2040. Thus, if infrastructure spending is focused on these types of maintenance projects, then the economy will benefit by avoiding such damage.

In the short term, an infrastructure spending boost could provide a stimulus to the economy, a belief underlying stock markets’ enthusiastic reception of Trump’s plans from election night onwards. But it is argued that this is only a temporary boost, the benefits of which will expire, as did the effects of Obama’s infrastructure stimulus.

Obama’s $831bn stimulus in 2009, which included transportation spending, had its biggest impact in 2010 boosting GDP, according to a Congressional Budget Office (CBO) report in 2014. That effect had largely faded by 2013, and the CBO estimated that the stimulus would reduce GDP after 2016 because of the increase in the Government’s debt.

The recent experience of China and Japan, the two biggest economies in the world apart from the US, helps to substantiate the case against infrastructure helping growth generally.

Additionally, there are arguments pointing out the potential displacement effects of a hike in infrastructure spending. The US economy is not suffering a downturn currently, and many regard it as not far from full capacity. Thus, the spending on infrastructure could result in displacing outlays in other areas such as housing, and stoke inflation without helping the economy.

Infrastructure expenditure on construction projects, for example, will not lead to the unemployed getting more jobs. The people who work on these projects tend to be highly skilled workers who are already satisfactorily employed and the housing sector is suffering from a shortage of skilled workers.

Obstacles to implementation

The economic debate will not stop Trump going ahead with his program, but there are formidable obstacles to achievement. The regulatory system is creaking and represents a massive source of delay for the actual implementation of projects. This was not so in the past when US efficiency in meeting formidable challenges rapidly
The Trump team envisages a large role for the private sector in its plans to jump-start the economy with a $1tn stimulus in infrastructure spending. The detailed plans were formulated during the election campaign by two of Trump's leading economic advisers at the time, Peter Navarro, director of the new White House National Trade Council and Wilbur Ross, Secretary of Commerce.

It is not clear exactly how the $1tn will work and various commentators have reacted either with enthusiasm or criticisms and doubts. Overall, it appears that the Trump team suggests that the $1tn boost will not affect overall debt as it will be revenue neutral through extra taxes.

The $1tn is expected to be channelled through the states to execute the programme. On the other hand, this $1tn over ten years is by some estimates considered to fall far short of the $3tn plus needed for US infrastructure.

New construction requires up to 19 years from initial planning to final completion

Navarro and Ross have proposed that the Government should offer an 82% tax credit to attract private equity investors into infrastructure. Their critics include Alan S Blinder and Alan B Krueger, Professors of Economics at Princeton University. Referring to a typical public-private partnership of $3bn, they point out that according to the plan, somewhat over 80% will be financed by municipal bonds, a little over a seventh by tax credits from the Federal Government, amounting to approximately $400m, and about $90m coming from private equity.

The fact that consequently $90m of private equity money will be controlling $3bn of investment with an effective leverage ratio of over 30/1 is blasted as ridiculous by the two professors. Their opinion is that the programme is more about enriching private equity investors than repairing the US’s decaying infrastructure.

Regardless of the critics, clearly what the President’s team has in mind is for the private sector to come in through two distinct paths: firstly, as the buyer of municipal bonds and secondly, through equity investment, sweetened by the 82% tax credit. These two channels for private investment need to be looked at from the perspective of the asset management industry which has preferences among the different types of infrastructure investments possible (see box 2).

2. Extract from 'Virtues of infrastructure investment questioned', Investment Management Review, April 2015

The critical question for the asset management industry is what it might be able to, or want to, provide and to what extent its potential outlays will impact on its overall exposure to infrastructure as a proportion of its total assets under management. It is not at all clear that the asset management industry can come up with the money on the scale suggested.

Distinctions must be made between different types of infrastructure investment. The primary way of dividing this class is in terms of whether it entails greenfield (new) ventures or brownfield ventures (infrastructure facilities already in place). A third dimension is the buying of shares in (both listed and unlisted) companies involved in the area. There is also the choice between infrastructure equity and debt.

One of the major attractions, especially for institutions, particularly pension funds, is the long-term inflation-linked nature of the asset class, although this pertains more to infrastructure equity than to debt. Macquarie stands out for offering inflation-linked debt instruments, because this is not generally true. A significant chunk of institutional investment is through debt funds, the number of which is increasing globally.

Much of the equity type financing by fund managers is going to companies already established in infrastructure, rather than to new developments.

Fund management companies and institutional investors are exhibiting severe risk aversion in terms of investing in greenfield projects with their construction and cash flow risks, except possibly through guaranteed or insured debt instruments.

How does the new White House programme measure up against these
preferences? The suggested private equity involvement is likely to pertain to relatively high profile greenfield assets, such as a new road, rather than to the more staid and boring maintenance of existing assets. But these greenfield assets are not without risk. One of the major attractions of infrastructure for institutional investors over the past ten years has been the inflation protection and relative immunity to the business cycle because of monopoly characteristics.

However, the pace of disruption and change across all industries is now so rapid that it is dangerous to make assumptions, such as any particular infrastructure project being independent from the overall economy. Such independence of the country’s economic performance has been considered a strong attraction of infrastructure for fund managers.

Even at a micro level, a ‘safe’ toll road could be overtaken by other toll-free roads nearby. The economics of road usage could well change through the use of electric vehicles and self-driving cars. What institutions find particularly alluring is the long-term nature of infrastructure, covering decades ahead, but who can certainly say that any industry or locality will stay the same over 30–60 years hence?

Furthermore, political and regulatory risks constitute some of the most serious problems. The financial terms of a project covering a long time horizon must be agreed between the private sector player and the public authority. A ‘no win’ situation can arise for the investor. Should the terms prove too tight for the private sector firm, it could lose money. But if the deal turns out to be much more profitable for it than expected, political pressure from the public can lead to more adverse regulations that reduce sharply the value of the investment.

It is understandable why the mainstream asset management industry is not enthusiastic about greenfield investments. So, the way is left open for private equity as envisaged by Trump’s advisers, but the question is whether 82% tax credit is too high. First, to benefit from this credit the firm must have substantial alternative income to set it off against. For instance, if it puts up $30m, about $165m of tax credits will need the equivalent amount of income in other parts of the operation, to some extent justifying the criticism that it is a deal for the very rich. The issue here is not the principle of the tax credit itself but whether 82% is too high. If so, what lower figure is fairer?

Then we come to bonds. The Federal Government is planning on tax subsidies to municipal bonds issued for infrastructure and it might well be the case that they are likely to prove attractive for investment managers, particularly in bond departments. But these lack the much sought after features of inflation linking and thus are not really vehicles for infrastructure investment per se.

**Political and regulatory risks constitute some of the most serious problems**

**Editor’s comment**

Higher productivity is key to the lasting economic benefits of an infrastructure boost. High profile projects are more glamorous but they need to pass the productivity test.

The vast multitude of repairs urgently needed in the US satisfies the productivity criterion handsomely. This is where the asset management industry comes in. They are likely to be buyers of the expected massive issue of municipal bonds which will be sold to finance the necessary maintenance. Mainstream asset managers would not find the tax credit of 82% of much use as, handling mainly client monies under strict controls, they lack the income of their own needed for mopping up the tax handout.

Unfortunately, bonds are not what fund managers find attractive about infrastructure investments. They were drawn to the sector because of the inflation linking available which these bonds will not provide. So, they might end up supporting Trump’s plans in a big way, but not in a manner they want. Equity financing of the big projects is likely to be the wealthier private equity groups, should any take place.

*Sage & Hermes Research*

This is the first of two related articles. Please see the next one on ‘China in the vanguard of global retail infrastructure’.

**CHINA IN THE VANGUARD OF GLOBAL RETAIL INFRASTRUCTURE**

The Chinese retail public has been attracted to backing infrastructure investments through a system that can be applied globally.

The vehicles for retail investors are industrial funds referred to in Chinese as ‘chanye jijin’. Hundreds of these funds have been established, backing a range of projects including renewable energy in Guangdong, the expansion of a port in Shanghai, enterprises in housing, wastewater treatment and care of the elderly in Henan.

What individual investors get by and large is neither equity nor debt. Often they obtain a fixed return but can also lose their entire capital in the event of failure.

The process of raising funds is China’s equivalent of the public-private
partnership much in President Trump’s sights. An example is the city of Wenling that wanted to establish a highway project including a new bridge costing over $1bn. The city had limited room to manoeuvre financially because of budget constraints following long periods of overexpansion and a warning by the Central Government that it had already overborrowed.

So, the city got together with Bank of China to create the industrial fund for ordinary investors, the Bank of China Wenling City Development Fund, with the city providing 20% of the near $200m in seed capital and Bank of China supplying 80%. The fund has a term of six years before the end of which the city must buy out the Bank of China’s investment.

The city is obliged to pay back the capital to its investors with a fixed return. This process has attracted criticism as disguised debt adding to the strain on the public sector, though the private investor stands to lose their savings, should things turn bad.

After the fund was established, it took control of two builders run by the city that had contracts to build highways including the bridge. The main driving force behind the formation of the industrial funds has been the excessive debt piled up by cities all over China through investment in infrastructure. The industrial fund trend has been seen as a way around it.

Editor’s comment

In China, the approach used is seriously flawed on two counts: first, the level of state control and second, the overinvestment in infrastructure. These deficiencies, however, can be easily eradicated in more open markets.

The above link between the local authority, a bank and retail investors is a modification of the public-private concept in the West where only two parties, the public sector body and a private institution, are involved.

Moreover, a situation where the retail investors get only a fixed return while standing to lose all their money makes it more akin to a junk bond. But the most important fact is that banks have managed to sell the concept to the retail public en masse, a phenomenon that has not taken off in the West yet. Perhaps the key to retail enthusiasm elsewhere lies in a local approach. Note that retail investors in Wenling invested in the local highway and bridge in their city, something they can identify with themselves.


This is the second of two related articles. Please see the previous one on ‘Asset managers’ role in Trump’s infrastructure plans’.
CHINA IN THE PERILOUS FOOTSTEPS OF JAPAN’S DOWNFALL

China’s rapid climb and recent policies uncannily parallel Japan’s meteoric climb in many specific ways. Sadly, it appears to be imitating the steps taken by Japan in the aftermath of its global ascent decades ago and subsequent downfall, a very worrying development for the global economy.

On the face of it, the two countries are very different. Japan is considered a historically preeminent country that has gone down and incapable of recovering anything like its former glory. China’s superpower status seems unassailable.

On an ongoing basis, the Chinese authorities look like being on course to repeat Japan’s mistakes.

Moreover, Japan’s downturn was not presaged while at the top. On the other hand, China’s rapid take-off had been accompanied by frequent prognostications of doom which have never become reality and this latest danger might be cast in the same mould.

But apart from the unrealised warnings of the worst, there are too many resemblances between how Japan and China accomplished their stellar status to be complacent. The very methods of achievement sowed the seeds of Japan’s subsequent fall from grace and the same factors seem to be operating in China. On an ongoing basis, the Chinese authorities look like being on course to repeat Japan’s mistakes.

The dangers facing the Chinese financial system and stock market in following Japan’s footpath were analysed by Gillian Tett of the Financial Times (see box). However, the similarities are not just to do with the financial sector but embrace the two countries’ wider economies, posing fears for the world economy.

Extract from ‘Disturbing connection between China’s and Japan’s market interventions’, Investment Management Review, January 2016

Gillian Tett, the well-known Financial Times columnist, has identified disturbing similarities between the Japanese Government’s stock market manipulations of about a quarter of a century ago and recent Chinese Government action.

But in 1997, as it became known that banks had massive unrecognised losses, a financial crisis was the consequence, with asset prices falling again. By then, the financial system had become subject to a corrosive lack of trust.

A similar erosion of trust is underway in China. Before the crash, the Chinese population reposed massive confidence in their Government’s ability to control events in general and the stock market in particular.

The trust in both officials and the market has already been undermined and Tett hopes that Beijing remembers the potential dangers.

The disturbing parallels include:

• Industrial strategy - Close co-operation between the Government, the largest companies and the banks enabled the Japanese authorities to influence a national industrial policy including the protection of new industries and channelling funds to selected sectors. China’s industrial policies have followed the same road in its achievement to date.

• Excess capacity and zombie investments - The Japanese authorities prevented companies in trouble from failing, keeping them alive with various devices such as loans and debt for equity swaps. These ‘zombie’ companies are still a source of economic stagnation. Though China has promised to kill them off and officially intends reforms, it has kept them going by swamping the economy with credit. In October 2016, policymakers announced a debt-for-equity swap likely to perpetuate excess capacity, particularly in areas such as steel mills, cement plants and property on a massive scale.

• Stimulus with adverse effects - The Japanese Government attempted to sustain growth since the peak was achieved by measures such as deficit spending on infrastructure and central bank printing money. China is doing the same thing. In Japan’s case its total debt by the end of 2015 had expanded to more than three times GDP but has not succeeded in reviving the economy.

China is on the same path but the credit is not boosting the economy as hoped for. Some argue that China’s debt represents to a large extent loans made by state banks to state enterprises and that the Government is likely to intervene. Furthermore, Chinese debt is mainly domestic with a massive savings pool also available as a buffer. Therefore, China is less vulnerable to outside shocks. In counter to this it is pointed out that Japan enjoyed very large savings.
and was a creditor nation. But this did not prevent a financial crisis.

However, while it might still muddle through, the Japan-China parallel adds to the dangers already posed by China to itself and the rest of the world.

Various other commentators are ringing alarm bells. Goldman Sachs has warned that China will mirror Japan in facing much reduced growth. Moody’s analysts are alerting that prolonged suboptimal economic performance or even deflation could be in store.

Editor’s comment
The fact that China’s debt is mostly between the state and state-owned enterprises can make a big difference as opposed to Japan’s situation where the private sector was also involved. It is much easier for the state to cancel debts to itself as effectively it is an internal balance sheet transfer. But when the private sector is involved, cancelling specific debts is another matter altogether with more potential ramifications throughout the financial system.

There are other reasons to be more sanguine about China in that it is becoming less dependent on exports than Japan and has more natural resources. These differences make the outcome more unpredictable. Furthermore, the Chinese Government may not follow Japan’s path exactly. However, while it might still muddle through, the Japan-China parallel adds to the dangers already posed by China to itself and the rest of the world.

Another important difference this time militating against China is that it is much more vulnerable to potential social unrest given the authoritarian nature of the regime, unlike Japan’s democracy. The latter enjoys more cushions and channels for peaceful protest. The biggest danger of all is that, if China does go down, it could turn to more militarism as others have done before it. The whole world must fervently hope that it muddles through.

‘How do you say ‘Déjà Vu’ in Chinese?’ ,
Michael Schuman, Bloomberg Businessweek, 07.11.2016

FEARS SURROUND SINGAPORE’S TOP FINANCIAL CENTRE STATUS

Singapore’s position as a top global financial centre will be in peril unless it undergoes a major transformation, according to the prestigious Euromoney magazine, with the issue being of considerable importance to the prospects of the post-Brexit City of London, particularly in the UK’s fund management industry. Whether the Euromoney magazine is being too alarmist in the conclusions of its in-depth analysis is examined below.

The SGX’s takeover of the Baltic Exchange, the powerful source of shipping information, is a move, enhancing the global profile of Singapore

Two of the most important components of Singapore’s financial prominence facing problems are considered to be the Singapore Stock Exchange (SGX) and its private banking industry which acts as a hub for the southeast Asian region as well as globally.

SGX’s malaise
The exchange is going down in terms of listings. In 2015, SGX raised only about $420m dwarfed by a higher figure of over $30bn in Hong Kong through 123 initial public offerings, according to Deloitte, the consultancy.

Several structural reasons underlie the decline. The local blue chip companies are already mostly listed. While 40% of currently listed shares come under the non-Singaporean category, one of the reasons underlying a decline of foreign listings is the failure over the past ten years of several Chinese companies quoted on the SGX.

The CEO of the exchange, Boon Chye Loh, who took up his position in mid-2015, pointed out that for quite a few years the SGX has been aiming to be a multi-asset exchange and other asset types such as derivatives, fixed income, currency and commodities are important.

The SGX’s takeover of the Baltic Exchange, the powerful source of shipping information, is a move, enhancing the global profile of
Singapore, that underscores Loh’s assertion (see box). It shares with London the status of being leading maritime hubs and this takeover has been an important step in this direction.


The venerable Baltic Exchange, of massive importance to the shipping industry as a global centre for maritime trade and a clearing house for shipping contracts, is about to come under the control of the SGX, enabling the latter to achieve several important objectives.

The exchange will remain at its City offices, as this gives the SGX a London bridgehead to build contacts in Europe. It furthers Singapore’s aim of becoming a leading global maritime financial centre and it is also expected to give a boost to SGX derivatives business. Moreover, it fits in with SGX’s strategy of developing Asian benchmarks pricing commodities. As a pillar of maritime commerce, Baltic shares a lot of synergy with its new owner, as Singapore is one of the world’s biggest container ports.

Real estate

Property has been another core area for Singapore. Here, Singapore is well ahead of its Asian rival Hong Kong with 41 Real Estate Investment Trusts (REITs) with $55bn assets under management (AUM), compared with Hong Kong’s mere 12 comprising $30bn AUM. Most of the large local properties in the city have already been securitised and floated as REITs. Thus, local real estate is not likely to be a source of growth here.

Given that Singapore is already the largest forex trading hub in Asia with 10% of the global daily volume, currency derivatives are also a very likely prospect

However, the potential exists for substantial increase in assets from elsewhere in the world to be securitised and put into Singaporean REITs. Already, nearly three-quarters of the latter hold overseas properties in countries such as Germany, Japan and the US.

It is suggested that more REITs based on these countries can be established. In addition, potential is seen in developing countries which need extra effort in building the required infrastructure.

Start-ups

A possible future lies in start-ups. An increasing number of fledgling companies have been set up, and the usual paraphernalia of potential investors, such as crowdfunding and venture capital firms, are keen to invest. The three big Singapore banks have developed structures to support such infant companies, as has Temasek, its giant sovereign wealth fund.

It has also been hit by a tax amnesty in Indonesia, some of whose residents had hidden money in Singapore

2014 was looked upon as a watershed as the number of tech start-ups jumped by 45% to 4,500 compared with the previous year, according to the National University of Singapore. In the same year, the city saw four new unicorns – start-ups with valuations exceeding $1bn.

A big problem faced not just by the SGX but all top Western exchanges is the phenomenon of more companies either deferring a publicly quoted status or staying private forever. In addition, Singapore suffers from the specific problem of Singaporean tech companies preferring to launch on Nasdaq or the Australian Securities Exchange.

Other asset classes

Singapore has lots of iron in the fire. Apart from the Baltic Exchange, establishing a freight derivatives centre is a natural step that follows, particularly because of Singapore’s proximity to China. Nasdaq reportedly in August 2016 announced a plan to launch China commodity derivatives and enter the freight derivatives area in Singapore. Its global head of commodity sales, Hanne Johansson, points out that they and the SGX will mutually increase liquidity.

Given that Singapore is already the largest forex trading hub in Asia with 10% of the global daily volume, currency derivatives are also a very likely prospect. Other commodities mentioned by Loh as part of the future portfolio of businesses include iron ore, coal, steel and rubber, the last benefiting from the neighbouring Malaysia and Indonesia.

Private banking

Singapore’s private banking hub has become a magnet for wealth around the region and globally on the back of its strong reputation for tight financial regulation and supervision.

Recently, however, there have been some setbacks which have been highlighted by Euromoney as sources of concern. Singapore has been beset by being embroiled in the 1Malaysia Development Berhad (1MDB) scandal in its neighbouring country and has fined two big banks, DBS and UBS, while expelling a third, the Swiss-based Falcon Bank.

It has also been hit by a tax amnesty in Indonesia, some of whose residents had hidden money in Singapore. The Monetary Authority of Singapore is not overly perturbed as it considers these problems to be specific situations in the past and not representing a systemic danger.

The bigger problem affecting private banks in Singapore is the global force of financial disruption from users of new technologies such as robo-advice type products. However, Asia is still seen as the region with the most attractive long-term prospects. Julius Baer, a Swiss private banking group, suggests that high-net-worth individuals will increase their wealth to $14.5tn by 2020, representing a growth rate of 160% compared with the start of the current decade.

Investor base

Pension funds are much less present in Singapore than in other developed countries and private banking is much more important, while insurers, family offices, fund managers and sovereign wealth funds are well represented.

Editor’s comment

Euromoney has made an apparently strong case for worrying seriously about Singapore’s future, but several important issues are under-emphasised or overlooked.
The SGX is not alone in its travails. All the leading exchanges in the West are also suffering from similar problems arising from a dearth of company listings, but all of them are diversifying in other ways.

Singapore’s financial centre future is no more tied up with the SGX than the City of London depends on the London Stock Exchange. The fact that other Asian centres are growing and bringing home some business is not likely to hit Singapore, noting that the multitude of European centres has not impinging on the City of London’s pre-eminence. Moreover, Asia does need a regional hub.

The only serious rivals are Hong Kong and Tokyo. Tokyo, despite weight of money, is too parochial and Hong Kong’s future is clouded with the Chinese hacking at its democratic credentials.

Private banking and pension funds have big question marks over their future prosperity worldwide, as defined contribution schemes expand and robo-advice squeezes margins. On the other hand, sectors such as family offices, Asian insurers and some global fund managers with a significant presence in the city are thriving. Quite a few of them are likely to expand their Singapore operations reinforcing the city’s global position.

Interestingly, the UK and London have a strong vested interest, post-Brexit, in Singapore’s financial centre prosperity. Singapore could be a key here to replacing the City’s European business with global sources.

Singapore could be a key here to replacing the City’s European business with global sources.

Overall, Singapore’s future remains bright as a top global centre in a region that will keep growing despite any short-term Trump-induced setbacks.

‘Reinventing Singapore’, Chris Wright, Euromoney, November 2016

‘Singapore Exchange looks beyond listings’, Chris Wright, Euromoney, November 2016

‘1MDB puts Singapore private banking on notice’, Chris Wright, Euromoney, November 2016

GIGANTIC TWO TRILLION PLUS COMPANY LAUNCH

Aramco, the state-owned Saudi oil company, is set to be floated and become the world’s most valuable quoted company, considered to be worth between $2tn and $3tn. Though only 5% is planned for release, it is no small size, amounting to a mammoth $100bn initial public offering (IPO), the biggest in history. The launch, if it comes to fruition, could have a noticeable impact on global stock markets and affect allocations to the energy sector.

Plans for the launch were first announced by Mohammed bin Salman, Saudi Arabia’s powerful Deputy Crown Prince, who came up with the $2–3tn estimate above. The intention to list the world’s largest oil producing company sparked off excitement throughout the global energy sector. The proposal is part of a vision to transform the country, now heavily dependent on oil.

It is not yet a done deal and according to an unnamed person involved in the planning of the IPO, there are huge uncertainties about the timing and the details of the process.

IPO location and timing

It is believed that a primary listing will be overseas with the secondary quotation in Riyadh. Top international centres under consideration include the obvious ones, New York, London and Toronto as well as the leading Asian centres, Tokyo and Hong Kong.

For quotation on the London Stock Exchange, a free float of a minimum 25% of the shares is usually mandatory, though exceptions are sometimes allowed. To optimise the valuation, Aramco must make its accounts public and emphasise transparency, including independently audited reserves.

The launch, if it comes to fruition, could have a very noticeable impact on global stock markets and affect allocations to the energy sector.

The rules in each exchange applicable to listings on topics such as disclosure and corporate governance are likely to be important in the selection process. Unsurprisingly, the world’s top banks, such as J.P. Morgan and Morgan Stanley, are all vying with each other to get a share of the pie in advising on the flotation.

The uncertainties about timing stem largely from the complex preparations needed. It is hoped that a 5% stake would be offloaded by 2018 but this schedule could fall behind. Furthermore, the number of shares could increase.

Aramco reportedly moved in 2016 to transform itself in order to comply with IPO reporting rules but the Government has to establish a new tax regime for the company (now taxed at 85%) for the 2017 figures and go back two years for proforma accounts on the same basis. A dividend policy is also needed.

The 5% stake valued at up to $150bn based on a $3tn valuation might make it difficult to float in one go, given the problem of attracting a large pool of investors. Accordingly, Aramco might
The world’s top banks such as J.P. Morgan and Morgan Stanley are all vying with each other to get a share of the pie in advising on the floatation.

Aramco is involved in a range of non-oil activities on behalf of the Government, including operating hospitals, education and sports stadiums. But there is a drive to streamline the company by separating its oil operations from broader societal projects. Any activity not fulfilling a strategic purpose has to be avoided.

There are also doubts whether the 31-year-old Deputy Crown Prince can successfully challenge the established order, as giving outside shareholders some influence over Saudi Arabia’s oil policy would be a major departure.

Transparency and oil reserves disclosure

The biggest question, the answer to which the whole world is awaiting, is how much reserves lie under Saudi soil. In previous years, the estimated reserves data has been regarded with suspicion by industry experts as it has not fluctuated since the 1980s. The Financial Times considers it extraordinary if the country actually has a constant 260 billion barrels of oil, the published figure, for 36 successive years. New reserves would have had to be found to replenish exactly the annual pumping rate of over three billion barrels a year.

An audit mandated by Aramco was completed late in 2016 by Gaffney, Cline & Associates, a UK-based consultancy. DeGolyer and MacNaughton, an energy consultancy based in the US, has also reportedly been appointed by Aramco to participate in the audit in view of their experience with the US’s Securities and Exchange Commission rules.

Whether the actual audit has come up with figures different to the long prevalent 260 billion barrels is being awaited with interest. As the Financial Times’s Lombard columnist Jonathan Guthrie suggests, the actual figure is not likely to be far from the 260 billion. He also points out that a much lower figure would reduce the country’s status within the Organization of the Petroleum Exporting Countries. On the other hand, a number far in excess could cause questions as to why it is necessary to move away from oil.

The most recent official assessment of recoverable oil was published in October 2016 when the total reserves were put at about 265 billion barrels in a prospectus for a $17bn bond. This level represents 18% of the world’s total and is slightly higher than Aramco’s figure because a small part of Saudi Arabian oil is not managed by the company. In contrast the largest oil company in the West, ExxonMobil, is valued at $350bn market capitalisation with reserves of 25 billion barrels.

Motivation and diversification

The main motivation for the floatation is diversification from dependence on oil. The Government wants to use the IPO proceeds for investments in a vast variety of industries, including technology and tourism, as it desires to reduce its sensitivity to the oil price. In the energy sector, it is moving towards vertical integration and in pursuit of this, is finishing a $20bn petrochemical complex in a joint venture with Dow Chemical. The company and the economy will generate more domestic jobs and non-oil revenue. The long-term motivations also take into account that alternative energy sources might reduce the demand for reserves, but the need for petrochemicals might remain strong.

The biggest question, the answer to which the whole world is awaiting, is how much reserves lie under Saudi soil

These diversification plans are subject to some doubts. Richard Mallinson at Energy Aspects, a global energy consultant based in London, feels that what is actually achieved might fall short of ambitions.

Editor’s comment

Two major risks are faced by potential investors in the IPO which may not be taken into account sufficiently by the investment banks falling over themselves to participate in the launch.

The first is political risk. Saudi Arabia is arguably one of the most stable regimes outside the developed world in spite of occasional murmurs of protest. This situation is likely to prevail as long as the kingdom remains a relatively benign autocracy. So the risk of a more radical revolutionary regime renationalising the company in the foreseeable future is not high.

The second big risk is global warming and the move away from fossil fuels. Before Trump was elected, oil was not exactly regarded as a safe investment area. Given the new US President’s anti-climate stance, this may be considered less of a factor. However, the risk remains of a continued global shift away from oil towards other forms of energy. Potential investors in Aramco should make up their own mind as to how to allow for this risk in what they are prepared to pay for the shares.

The risk remains of a continued global shift away from oil towards other forms of energy

The chances are, if the valuations are reasonable, that the launch will create waves on an ongoing basis in the global stock market and hence fund management industry, the energy sector and through the latter, the global economy.

’Saudi Aramco’s listing promises to lift lid on level of kingdom’s oil reserves’, Pilita Clark and Anjli Raval, Financial Times, 17.11.2016


‘Saudi Aramco gets ready for ‘no ordinary IPO”, Anjli Raval, Arash Massoudi, Simeon Kerr and Pilita Clark, Financial Times, 09.01.2017

‘Saudi Aramco hires firm to assess oil reserves before IPO’, Summer Said, Bradley Olson and Christopher M Matthews, wsj.com, 26.01.2017
HEDGE FUNDS AND PRIVATE EQUITY FIGHT ON EACH OTHER'S TURF

The boundaries between some hedge funds and buyout firms are blurring through their copying each other's approaches in targeting companies.

Active hedge funds which are associated with buying stakes, then putting pressure on management and making a handsome profit, are now embarking on full-blooded takeovers. On the other side of the fence, buyout firms that focused previously on acquiring entire companies are now taking just non-controlling stakes in public companies.

The main rationale for the two alternative types invading the other's turf arises from supply and demand problems. Much more available money is chasing a smaller opportunity set of suitable investments. Private equity firms and activist hedge funds are consequently forced to go for the same situations.

The two approaches always have much in common with the target of identifying underperforming companies and improving them in one way or another, so that they become outperformers.

Buyout firms, in particular, have been hit by competition from corporate purchasers and regulatory curbs on leverage levels. Activist firms are enjoying increased popularity and are awash with billions of dollars which they have difficulty in deploying in their usual ways. Consequently, they are undertaking purchases of the entire company, often at the request of management.

Two examples of the competing activities involve Elliot Management, an activist hedge fund investor, and KKR, the giant private equity firm. Elliot approached the CEO of CDK Global, a software company, in order to buy it out entirely for $9bn. KKR met with EMC's (currently Dell EMC after Dell's acquisition in 2016) head at the time, Joseph Tucci, with the announcement of a buyout proposal. But, in fact, after having acquired $250m worth of EMC's shares, KKR went on to provide suggestions for improving the business, mimicking the modus operandi of activist hedge funds.

In each case, neither Elliot nor KKR were successful with their objectives. CDK turned down Elliot, but the hedge fund made a profit on the company's increased share price. A similar result occurred after KKR's investment when its target EMC agreed to be bought by Dell. KKR also realised a gain, though it failed to implement intended strategy.

Vista Equity Partners, Golden Gate Capital and Sycamore Partners, all private equity firms, have bought public stakes in companies where hedge fund activists have already operated. In some cases, however, the targets were full buyouts. Blackstone, the largest buyout group, invested over $800m in NCR, the automated teller machine maker and Marcato Capital Management, an activist firm, shed their stake. In another example of buyout firms and activists targeting the same company, Avon, the large cosmetics company, disposed of a stake in December 2016 to Cerberus Capital Management after pressure from an activist. Alexander Navab, head of Americas Private Equity at KKR, has pointed out that hedge fund activism is a catalyst for private equity initiatives.

The two types of firms share a common origin. In the 1980s, Wall Street players targeted mammoth companies aggressively and became known as 'corporate raiders'. Since then they have branched out into two camps: the private equity firms and the activist hedge fund operators. The former, supported by public pension funds who are averse to hostile deals, adopted in general a friendly and consultative...
approach to take over companies, while the latter continue to be agitators.

KKR has invested about $1bn in public companies in the two years to October 2016, either to provoke spin-offs or to prepare for an eventual takeover. Reportedly, about $1.4bn of its $9bn buyout fund has been set aside for similar stakes. There are difficulties faced by KKR in its partial metamorphosis. Although it has to resort to filing, it is having to cope without access to management and strictly confidential information.

Activists in turn are copying the special skills associated with private equity, financial and operational discipline, to improve companies. Well known players of this breed, Nelson Peltz, Jeffrey Ubben and William Ackman, have stated that they adopt private equity methods in their investing with other shareholders also benefiting.

ValueAct Capital established a holding in Seagate Technology at the invitation of the company, following in part a private equity approach. Elliot has established Evergreen Coast Capital to focus on corporate buyouts.

The shared activity of activist hedge funds and buyout groups does not, of course, mean a full merger of the two alternative sectors, as the shared interests only apply to some in each group. Many hedge funds are short-term trading, frequently day-to-day. Only the relatively long-term-orientated and larger ones with the skills to analyse value along private equity lines can be classed as having a common approach. Buyout firms too, must be large and generalist, and not small and specialist in areas such as infrastructure as well as particular countries.

Consequently, they are undertaking purchases of the entire company, often at the request of management.

In recent years, both alternative sectors have come somewhat under a cloud with many questioning whether they on the whole add value. The problem here is many mediocre players who have been attracted in the past decade or two and have pulled down the average. Some of the best are still doing well and remain in high demand. The players operating across each other’s territory tend to be among this better performing group.

It makes sense for the relevant alternative firms to change to a hybrid form, rather than to be purely hedge fund or buyout, having two legs with a foot in each sector. They must be sufficiently big in order to acquire cross-fertilisation skills. In this way, they might well become an important part of the mainstream fund management industry of the future.

Blackstone has already moved in this direction (see box 2).

Another change in the private equity sector is militating in favour of a strong fund management future (see box 3). Some buyout firms have been extending the horizons of their portfolios to as long as 20 years, which chimes very well with the belief that long-term illiquid investments are the way forward for the industry.

‘Barbarians and raiders increasingly play the same game’, David Benoit and Liz Hoffman, wsj.com, 27.10.2016

Editor’s comment

Hedge funds and private equity firms engaging in turf wars is not new but there is a big difference now (see box 1). While expansion was the main aim in 2005, the driving force between the two camps.

Overlaps and turf wars between hedge funds and private equity firms were a much-discussed issue in the spring of this year. It has been suggested that many leading hedge funds are considering invading the private equity arena. Starved of opportunities in their traditional areas, hedge funds are eying the more lucrative private equity pot.

It is not all battle lines, however. On the principle of ‘if you can’t beat them, join them’, there has also been talk of co-operation between the two camps.

Editor’s comment

Clearly, Blackstone is no longer a pure buyout firm. It has too many other diverse interests that do not fit in. Its property arm makes it a large real estate operator...

In moving towards offering longer term buyout investments, it is going to some extent in Warren Buffett’s direction, as is the case with other leading private equity firms. Blackstone’s current size of $361bn assets under management now put it within reach of the higher echelon of global fund houses. In the next decade, it could well reach the ranks of the top ten, though it would defy classification as a conventional fund management group and could perhaps be described then as Berkshire Hathaway number two.


Overlaps and turf wars between hedge funds and private equity firms were a much-discussed issue in the spring of this year. It has been suggested that many leading hedge funds are considering invading the private equity arena. Starved of opportunities in their traditional areas, hedge funds are eying the more lucrative private equity pot.

It is not all battle lines, however. On the principle of ‘if you can’t beat them, join them’, there has also been talk of co-operation between the two camps.

The main motivation for this shift appears to be pressure from long-term-orientated institutional funds, such as pension schemes or insurers, which have no requirement to get their money back soon.

Editor’s comment

The current shift of mainstream buyout houses towards the long term is thus very encouraging. Private equity might well be the future of fund management, provided it overcomes its widespread image for rapacity and becomes more unambiguously service-orientated.


Editor’s comment

Clearly, Blackstone is no longer a pure buyout firm. It has too many other diverse interests that do not fit in. Its property arm makes it a large real estate operator...

In moving towards offering longer term buyout investments, it is going to some extent in Warren Buffett’s direction, as is the case with other leading private equity firms. Blackstone’s current size of $361bn assets under management now put it within reach of the higher echelon of global fund houses. In the next decade, it could well reach the ranks of the top ten, though it would defy classification as a conventional fund management group and could perhaps be described then as Berkshire Hathaway number two.

The main motivation for this shift appears to be pressure from long-term-orientated institutional funds, such as pension schemes or insurers, which have no requirement to get their money back soon.

Editor’s comment

The current shift of mainstream buyout houses towards the long term is thus very encouraging. Private equity might well be the future of fund management, provided it overcomes its widespread image for rapacity and becomes more unambiguously service-orientated.


A shift has begun in buyout firms’ investment horizons to a much longer time frame from the typical seven years. Recently, several buyout firms have been setting up funds to mature after up to 20 years... Significantly, they are also content with lower returns of 12–15%, even 10% compared with the typical 20% of the traditional type. Their fees also are substantially lower, at 1% per annum, compared with the more usual 2% before.
BOUTIQUES THRIVE IN FRENCH ASSET MANAGEMENT

Asset managers owned by banks currently dominate in French distribution. In addition, Amundi, Europe’s largest asset manager and in the top ranks of global firms with more than €1tn in assets under management (AUM), looms large. So, on the face of it, boutiques should find life difficult in France, yet they thrive.

Marketing is still tough for them (see box).


The problem for the smaller fund managers in the country is that distributors prefer to deal with larger groups. The solution that is suggested for the smaller specialist companies is to attach themselves to large multi-boutique houses, for which France is a major base. These include NGAM and BNP Paribas Asset Management.

While their specialist expertise is of value to the multi-boutique parent, the fledglings also gain from exposure to the distribution and global reach of the larger firms.

Amundi for its own part has been busy acquiring smaller groups in France. A notable purchase has been that of CPR Asset Management. This firm has taken over responsibility for operating Amundi’s thematic equity investments since September 2015. CPR had made its name with Silver Age, a strategy based on the ageing of the population.

Following the financial crisis, the big banks under pressure of the poor performance of their captive funds had to make their distribution channels available to other outside products in a shift to open architecture. More recently however, they have gone back to their old ways of favouring in-house funds as the pressure from poor markets has diminished.

Nevertheless, many boutiques are managing to do well. Carmignac, France’s largest independent asset manager, focuses on retail investors around Europe in its markets and relies heavily on independent financial advisers. Didier Saint-Georges, managing director of the firm, looks forward to distributing through banks when they become more open again.

Insurance groups are another threat to many independents. French funds must contend with the popular guaranteed performance products based on investment-linked insurance contracts. However, as Saint-Georges put it, low interest rates have made it difficult to provide the promised returns and these products will soon come to an end. Though currently, he accepts that they are not easy to compete with.

Another boutique, Comgest, is not as small as to be expected. It has a wide range of global funds and operates outside of France as well, though nearly a third of the company’s AUM is derived from its home country. Its range of global funds is based on a long-term investment approach and has a 20-year track record.

TOBAM, based in Paris, is a fierce critic of benchmark comparisons and has nearly $9bn AUM. La Financière de l’Echiquier is employee-owned with €8bn AUM and famed for its stock picking. Its former CEO, Dominique Carrel-Billiard, claimed that the funds of the firm have more than 85% active share, the proportion of the portfolio that deviates from the index. Though independent, it has offices outside of France, in Milan and Frankfurt.

Some boutiques come under the umbrella of a larger firm while retaining their autonomous status. CPR Asset Management, owing to its parent Amundi, does not have to worry about distribution as well as middle- and back-office, and compliance functions. Currently, it has €38bn AUM and is involved in far-flung areas such as Taiwan, Oman and Korea.

Editor’s comment

The French asset management industry, though having faced difficulties in the past few years, is on an upward trajectory through its largest member, Amundi. But even the boutiques are doing very well and it appears that in global terms the country’s industry looks set to expand. However, poor cross-border distribution within Europe is a hindrance, as outlined in the next article.

‘Unique ingredients’; David Stevenson, Funds Europe, November 2016

This is the first of two related articles. Please see the next one on ‘European retail investors nervous of cross-border funds’.
EUROPEAN RETAIL INVESTORS NERVOUS OF CROSS-BORDER FUNDS

A very high proportion of the retail public distrust funds coming from outside their own country, even from other European countries. The attitude is an effective rejection of a pan-European outlook as far as investment is concerned. Only a comparatively few French, German, Spanish and Italian funds, for instance, are sold in the EU as a whole apart from the home countries.

As many as a third of Undertakings for Collective Investment in Transferable Securities (UCITS) funds marketed on a cross-border basis are sold in only one member state apart from their home country, according to figures from the European Commission (EC).

Several reasons have been put forward by the EC during a recent consultation to improve cross-border fund distribution. It has identified special administrative requirements demanded from foreign funds by some EU countries. In addition, when funds originating from one country are sold in another EU country, they must cope with marketing constraints, regulatory fees and differences in taxes.

However, the problem identified by Guillaume Eliet, head of regulatory policy and international affairs at the Autorité des Marchés Financiers (AMF), the French financial regulator, is that retail investors are not sufficiently confident of regulatory supervision of funds coming from outside of their own country. Eliet’s opinion is that more local supervision of foreign funds is required to enhance the confidence of the domestic public.

Based on data stemming from Thomson Reuters Lipper, the leading research house, an AMF report shows that in April 2016, French funds had 8% market share in Spain, exceeding that of other countries, apart from Spanish funds which had a 19% market share in comparison.

This highlights the fact that the French funds are doing relatively well in cross-border distribution, though still not adequate. They are competing against funds domiciled in Luxembourg and Ireland, which means that the French markets feature high penetration from other European countries. This also shows that France is more open to cross-border but wants more access for its own asset managers in the rest of Europe.

The French are particularly interested in cross-border because the French funds industry is endeavouring to become more global, as indicated in the previous article ‘Boutiques thrive in French asset management’ (p.xx). Furthermore, they are looking to grab more business from London after Brexit.

Overall, Eliet feels that digitalisation will become increasingly important in cross-border sales and help to diminish banks’ dominance of distribution across Europe. Their favouring in-house products makes cross-border competition difficult for foreign managers in countries where banking groups own large domestic fund manager arms.

He points out that nearly 50% of French funds and more than three-quarters of German funds have passports for selling throughout Europe. But despite this authorisation, firms are discouraged from marketing these funds because of the banks.

Retail investors are not sufficiently confident of regulatory supervision of funds coming from outside of their own country

Editor’s comment

It seems that UCITS funds are appreciated much more in far-flung areas of the world, including Asia and Latin America, and considered gold standard. Strangely, the label is less acceptable in the EU countries which produce them.

‘The French are coming’, Nick Fitzpatrick, Funds Europe, November 2016

‘Unique ingredients’, David Stevenson, Funds Europe, November 2016

‘Cross-border dispute’, Nick Fitzpatrick, Funds Europe, November 2016

This is the second of two related articles. Please see the previous one on ‘Boutiques thrive in French asset management’.

Editor’s comment

It seems that UCITS funds are appreciated much more in far-flung areas of the world, including Asia and Latin America, and considered gold standard. Strangely, the label is less acceptable in the EU countries which produce them.

‘The French are coming’, Nick Fitzpatrick, Funds Europe, November 2016

‘Unique ingredients’, David Stevenson, Funds Europe, November 2016

‘Cross-border dispute’, Nick Fitzpatrick, Funds Europe, November 2016

This is the second of two related articles. Please see the previous one on ‘Boutiques thrive in French asset management’.
CROSS-BORDER INVESTMENTS GROWING WORLDWIDE

Despite potential de-globalisation on the trade front, investment of fund management assets outside of the home country continues to grow strongly. Whether this expansion is sustainable over the medium term, or might even be reversed, is another matter.

- In the G7 countries, the percentage of investments held abroad by portfolio managers increased from 35% in 1998 to 57% in 2015. For this purpose, the EU bloc is considered one country.

- Investment in emerging market corporate debt has increased by 100% from 2008 to $1.7tn currently, according to the Bank for International Settlements.

- Asia was the fastest growing asset management region in 2015 with a significant part expected to be invested abroad.

- In the first six months of 2015, for the first time ever, China experienced net outflows in portfolio investment amounting to $57bn, according to The People’s Bank of China.

- Foreign direct investment worldwide has jumped by nearly 40% to a little under $2tn in 2015, according to the United Nations Conference on Trade and Development.

These trends are supported by large institutional asset managers. For instance, the California State Teachers retirement system, the second largest US pension scheme, intends to increase its non-US investments from 9% to 19% of the portfolio, according to Chief Investment Officer Christopher Ailman.

The decline of global banking has been accompanied, to some extent, by bond markets taking up some of the slack in providing debt finance. This also acts in favour of international portfolio diversification.

Editor’s comment

Diversification outside one’s own country has always made sense in terms of investment theory. In practice, the comfort factor has operated with many investors not happy to invest in foreign markets which they are not familiar with.

The trend towards more international diversification has been helped by the diminishing of this fear factor. The growth of the internet, increased travel and greater awareness worldwide of other countries have also contributed.

However, the above statistics reflect the recent past. If de-globalisation remains confined to trade only, while cross-border capital flows are unimpeded, it is all well and good. But, it cannot be taken for granted, under a possible scenario of decreased global trade and a spread of nationalism, that capital flows will stay the same.

The Achilles heel of free movement of capital is the global currency market. Increased volatility here could provoke imposition of capital controls in a growing number of countries. This could be bad for global portfolio diversification, and consequently for fund managers.

AN INTERESTING NEW SLANT ON EXCESSIVE CEO PAY

A fascinating reason has been put forward to explain the rise in CEO pay in the 1990s and early 2000s. The explanation is based on the grant of options in the companies managed.

The authors, Kelly Shue and Richard R Townsend, attribute a substantial part of the rises to the tendency of companies to issue the same number of options every year, instead of adjusting them by their increasing value as equity markets boomed during the period. The evidence is that the rigidity about the numbers of options was based on a lack of understanding within the firms about the valuation of these instruments, a deficiency termed as ‘money illusion’.

The authors expand on the insights from two comprehensive review articles by Kevin Murphy in 1999 and 2013, where a near-perfect historical correlation is demonstrated between average executive pay and the Standard & Poor’s (S&P) 500 Index in the 1990s and early 2000s. Murphy noted that this linkage was consistent with compensation based on the number of options rather than on their value.

Shue and Townsend used executive compensation data from ExecuComp covering S&P 1500 firms from 1992 to 2010. They show that other elements of compensation, apart from options such as salary and bonus, were not adjusted downwards to offset the automatic increases in pay arising from a fixed number of options during booming market conditions.

Furthermore, they find that the rigidity in numbers was more prevalent for compensation in options than in actual shares which are easier to value. There was a spillover phenomenon because of competition for talent between executives who received a rigid number of options and those who did not.

In substantiation of their conclusions, the authors state that the rigidity in the number of options that was granted declined when firms began to disclose and include the value of these instruments in their financial statements. Improved governance also helped.

The inflexibility in the number of options granted without considering their increasing value also explained the increased dispersion in CEO pay between the US and other countries.

Editor’s comment

The authors’ study covers the period only up to the early 2000s.

Since then CEO pay has continued to motor ahead to the extent that politicians and the public has begun to resent the resulting extreme inequality. Such ill feelings are less prevalent in the period analysed in the paper.

However, the above research is not just of historical interest. It constitutes another element in the case against granting options rather than shares. A full analysis of options versus shares is outside the scope of this article.

MANIPULATION OF US COMPANY EARNINGS ATTACHED

Manipulation of earnings published by many large US companies against the rules has caused the Securities and Exchange Commission (SEC) to go on the attack. Such is the scale of the problem that the reverberations might eventually have an adverse impact on US stock market levels. The difference between the recognised generally accepted accounting principles (GAAP) profits and the adjusted figures exceeded 30% in 2015 for Dow Jones Industrial Average (DJIA) companies.

In 2016 the SEC notified companies in the Standard & Poor’s (S&P) 500 whose use of adjusted earnings is under examination. The regulator has become concerned that the difference between these adjusted measures and those under GAAP has widened to its highest level since 2008. The emphasis is on whether the tailored measures increasingly used by companies are too prominent in public disclosures.

Many companies that resort to non-GAAP figures claim that they are truer to actual performance by stripping out factors such as non-reoccurring items that are misleading. But this growing practice has recalled similar manipulation during the dotcom bubble.

New guidelines were issued by the SEC on non-GAAP rules. Since then, letters to the companies have followed. The specific guidelines include details of the unacceptable features of non-GAAP earnings, such as removing costs that are an essential part of performance measurement, or suppressing the correct GAAP numbers. It is believed that the SEC is considering enforcement measures. It has insisted that the companies who publish non-GAAP results in earnings release headlines must also mention the GAAP counterparts.

This growing practice has recalled similar manipulation during the dotcom bubble

The SEC in the past has allowed some latitude in non-GAAP adjustments, provided they don’t overwhelm the GAAP results and a reconciliation is shown between the two. According to research company Audit Analytics, more than 95% of companies in the S&P 500 have taken advantage by presenting non-GAAP adjustments in their earnings releases in the fourth quarter of 2016.

For the most part, the non-GAAP measures exaggerate the performance of the company. The average gap of more than 30% in 2015 between non-GAAP and GAAP profits of companies in the DJIA was much higher than the 12% in 2014, according to FactSet, a data analytics firm. The SEC is becoming alarmed about an increasing number of companies going well beyond GAAP usage and coming up with figures putting them in a better light.

Marc Siegel, a member of the Financial Accounting Standards Board, points out that the non-GAAP figures are hardly ever consistent between companies and do not even use the same methodology in different years.

One of the most prominent companies involved in the adjustment process is the electric car company Tesla Motors that came up with non-GAAP revenue of $1.6bn for its second quarter earnings in 2016, and in August added back nearly $300m from future earnings, contrary to specific May guidelines from the SEC. Since then Tesla has complied by excluding non-GAAP revenues in its third quarter announcement.

An illustration of how serious and misleading the earnings adjustment can be comes from Syneron Medical, maker of medical devices. The company boasted of nine cents per share non-GAAP earnings for its second quarter results in August, mentioning only much lower down in the same document that the GAAP income was just a third of this at three cents per share.
Audit Analytics, in analysing 1,400 plus letters written to listed companies between July and October 2016 found that the biggest number, over a third, represented companies taken to task for overemphasising non-GAAP metrics. But the most remarkable category, numbering about 70, consisted of those using individually tailored methods.

It is believed that companies are taking the SEC strictures to heart. Even the conservative JPMorgan Chase reduced its non-GAAP items by three, from eight to five, in the four quarters up to October 2016.

According to Jack Ciesielski, publisher of the Analyst’s Accounting Observer which was also involved in reviewing the letters, technology and drug companies are particularly bad offenders. Michael Maloney, the chief accountant in the SEC’s enforcement division, is assessing whether enforcement activity is needed.

Editor’s comment

In recent years, the record levels of the stock market have been attributed more to quantitative easing rather than fundamentals. The post-election euphoria in the wake of President Trump’s win has added to the upward push. At some point, fundamentals will reassert themselves.

The average gap of more than 30% in 2015 between non-GAAP and GAAP profits of companies in the DJIA was much higher than the 12% in 2014

At any rate, should many companies show reduced earnings growth in compliance with the SEC’s tightening, it can well have a serious impact on stock market valuations. This might be obscured by a Trump-related boom or make matters worse, should investors get disappointed by the new President.

‘SEC probes whether companies are misusing adjusted earnings metrics’, Michael Rapoport, wsj.com, 27.10.2016

‘The SEC is right to fear the fantasy world off flattering metrics’, Ben McLannahan, Financial Times, 07.01.2017

REGULATOR’S FUND LIQUIDITY SUSPENSION CRITICISED

Asset managers might be forced to impose redemption gates, the suspension of rights to instant withdrawal of their money from mutual funds by investors, under extreme market conditions. This is a key recommendation of the Financial Stability Board (FSB) in Basel (see box). It discusses this in a paper addressing the fund management industry’s structural vulnerabilities.

Extract from ‘What we do – co-ordination of financial sector policies’, fsb.org

The FSB has a unique composition among international bodies, because it brings together senior policy makers from ministries of finance, central banks, and supervisory and regulatory authorities, for the G20 countries, plus four other key financial centres – Hong Kong, Singapore, Spain and Switzerland. In addition, it includes international bodies, including standard-setters and regional bodies like the European Central Bank and European Commission. This means it has all the main players who set financial stability policies across different sectors of the financial system at one table. So, when policies are agreed, they also have the authority to carry it out.

Policies agreed by the FSB are not legally binding, nor are they intended to replace the normal national and regional regulatory process. Instead, the FSB acts as a co-ordinating body.

The recommendation has led to considerable concern among the investment community. Amin Rajan, CEO of CREATE-Research, the consultancy, while accepting the measure has its use, feels that it could be counterproductive in a crisis by reinforcing panic. Paul Stevens, president of the Investment Company Institute (ICI), the premier representative body for asset managers in the US, expressed continuing worry that the FSB’s mistaken beliefs about liquidity risk management in open-ended funds, notwithstanding the ICI’s previous rebuttals of these beliefs.

Altogether, 14 recommendations are contained in the report, covering:

- liquidity mismatch between fund investment assets and redemption terms and conditions for fund units
- leverage within funds
- operational risk and challenges at asset managers
- securities lending activities of asset managers and funds.

The liquidity mismatch provisions of the above are the most relevant to active fund managers who are directly involved in the day-to-day construction of portfolios, and management of liquidity within them.

The FSB acknowledges that non-money market open-ended funds have not been a source of global financial instability. However, they point to several changes in recent
years that may have heightened the risks. These include:

- Some funds have increased exposure to less actively traded asset classes. Also, investment has gone up in asset types currently liquid, but may become less so as conditions change.

- Investor herding and momentum trading can exacerbate the illiquidities.

- Market stress can be amplified if funds have to sell across asset classes to meet unexpected massive redemptions.

- Corporate bond markets have been particularly singled out as a cause for concern in the light of dealers having more constrained balance sheets and being less able to carry some of the riskier fixed-income assets to a sufficient extent on their books in order to cater for liquidity demands in times of extraordinary stress or crises.

The rules are not directly imposed by the FSB. Instead it makes recommendations to the various national and regional regulators, as well as other official bodies, including the G20 governments, and its proposals carry a lot of weight. A key recommendation of the paper, among others, is that regulators should have the power to enforce redemption gates under extreme market conditions.

It is believed by the FSB that only a rare set of conditions could trigger general market instability, such as a high volume of redemptions leading to forced sales by the funds in asset classes where it makes a significant impact on prices because of less liquidity. The next step in this sequence could be that leveraged funds can get into difficulty and the contagion could spread, affecting other financial institutions and their ability to raise money in capital markets.

The FSB is aware that the introduction of redemption gates itself could cause a spillover of fear and contagion into other funds. It effectively, therefore, stresses that while regulators should have the power to enforce them, they will do so only after careful consideration.

The introduction of redemption gates itself could cause a spillover of fear and contagion into other funds

Editor’s comment

The ICI understandably emphasises in effect that liquidity is not as serious a problem as suggested by the FSB. However, this could pertain just to the US where, by and large, the mutual fund industry has a long record of sensible liquidity management, though the odd maverick can’t be ruled out.

Remember that the FSB’s proposals are global in scope, with responsibility for making recommendations to the G20 nations. The ICI is, therefore, not in a position to make outright assertions about the standards that prevail worldwide.

Structural shifts in markets can lead asset classes to undergo characteristic changes. Property has always been a problematic area but corporate bond funds have been posing serious liquidity risks only since the onset of the financial crisis. Thus, ICI can neither make assertions about worldwide validity nor long-term developments.

The FSB has been very considered in its report and seems to be justified in its precautions.

*‘Policy Recommendations to Address Structural Vulnerabilities from Asset Management Activities’, Financial Stability Board, 12.01.2017*

*‘FSB sets out safeguards for asset managers’, Caroline Binham and Chris Newlands, Financial Times, 13.01.2017*
A thriving social network, SumZero, which preceded the similar and ubiquitous Facebook and had employed Mark Zuckerberg just a few weeks before he founded the giant group, is highly valued by large numbers of professional investors for its stock selection ideas. It is possible that copycat models might sprout among fund management professionals.

Another important differentiating factor between SumZero and others is the tight vetting of the membership for strong professional buy-side credentials.

The eight-year-old website SumZero (sumzero.com) is not open to everybody. Its membership is restricted to professional investors, currently including endowments at prestigious universities, such as the Massachusetts Institute of Technology and Duke University. Before acceptance as a member, each investor is vetted. They have to be professionals, either in an existing fund or with extensive experience. Furthermore, they make available to all others on the site their educational qualifications and career details.

The membership is paying or non-paying. Non-paying members, in order to enjoy their free access, have to post stock selection ideas for sharing with other members. However, not every idea is accepted. Each suggestion is screened, with most of them supported by financial models.

Those who do not provide ideas (only about 10% of the members) have to pay more than $10,000 per annum to become members. The total number in both categories is well over 10,000, embracing fund managers and professional investors with dozens of large funds. At the end of 2016, about 9,000 ideas were featured on the site, which represented both long and short bets and were varied in their time horizon.

In general, some of the stock selections are valid for less than three months while others pertain to much longer periods of up to five years. Over 60% are small companies which are considered to have the highest chance of beating the index. About a fifth are based on the identification of a factor that serves as a catalyst for realising the potential success of the stock idea. Many are foreign.

The famous investor and a supporter of SumZero, Mohnish Pabrai, feels that the best share picks do not come from the established experts and that the network connects people who are passionate stock pickers. He points out that the disruption arising from the web reduces intermediation in the transfer of knowledge.

The ideas are not considered by SumZero as of equal merit. They are scored and ranked with the results published monthly. Some have turned out to be spectacularly successful. The members are also ranked.

First-ranked Dan Rasmussen of Verdad Fund Advisors recommended Quad/Graphics which gained 115% by the end of December 2016 following its introduction in April. Second-ranked Michael Melby of Gate City Capital put forward in May 2016 Gulf Island Fabrication, with another outstanding return of 94% to end December.

The question may well be asked what is so special about this research site, given that large players including Wall Street investment banks, Morningstar, the leading research house, and sites such as the Motley Fool and Seeking Alpha are in the game. In rebuttal, Divya Narendra, the founder of SumZero, says that the recommendations on this site are better because they come from the buy-side.

He claims that they are better stock pickers because they have an actual stake in the outcome with their own capital at risk and have done the necessary research. Furthermore, the published rankings encourage members to come up with their best selections. Another important differentiating factor between SumZero and others is the
tight vetting of the membership for strong professional buy-side credentials.

In 2004, while at Harvard University, a site called HarvardConnection was established by Narendra together with Cameron and Tyler Winklevoss. They employed Mark Zuckerberg for programming. Zuckerberg went on to launch Facebook just a few weeks later and Narendra and the Winklevosses sued him. In 2008 they are reported to have settled with Facebook, which paid them a sum exceeding $50m.

Thus, Narendra has played a significant role in Facebook’s history, featuring in the famous film *The social network* which covered the suing of Facebook by him and his associates.

In 2008 Narendra and another Harvard friend, Aalap Mahadevia, founded SumZero for the buy-side. Nick Kapur, who had been at Motley Fool, became its chief operating officer, and he and Narendra now run SumZero with Mahadevia on the board and the Winklevosses are investors in the network.

**Editor’s comment**

Apart from founding this site, Narendra is set to go down in history as a possible precursor of Facebook’s very formation. Of course, Facebook being much more complex, wider in application and targeted at the whole world, is in a different dimension to SumZero. Thus, the case for the lawsuit was never compelling. Facebook having settled does not necessarily mean that Zuckerberg was in the wrong. Avoidance of embarrassment could have been the motivation.

The scoring and ranking system in theory always increases the attraction of a process such as the one outlined. However, the key question is who does the scoring and ranking and what are their credentials? In any event all such ordering would be subjective, and members need to make up their own minds and might well spot ideas that prove very profitable.

The notion of the buy-side being more effective than the sell-side is not always valid. Some best sell-side analysts have been outstandingly creative but this might be a diminished force in the future with the big banks, in some cases at least, reducing their output. Their having lost reputation and the buy-side having become relatively more popular might also be a factor in the latter attracting better talent than in the past. Furthermore, it is well known that only a small minority of buy-side fund managers do well, and many in this small group may not want to share their ideas, having enough sources of their own or generating their own picks.

Another important issue is how sustainable the ongoing results from this website are. It is all well and good for *Barron’s* to highlight the spectacular performance of the top stock pickers and in doing so it has performed a valuable service. But how does the totality of ideas turn out on an ongoing basis? The question cries out for independent academic research.

The sharing of investment ideas by buy-side investors is not novel. For instance, investment clubs among amateurs have thrived. The big difference here is the screening for professionals. There is always a danger of conflicts of interest when people are buying in their own right and also making recommendations for others. But this is not an insuperable obstacle as clearly it is being managed successfully.

It is not sure where the membership of this site comes from – is it mainly the US or more widespread? Certainly it is open to stocks all over the world but appears to be largely focused on selections in the US. Currently it is a US market in terms of both investors and small companies. This is understandably so as it is the US that has a stock market with large depth in numbers of professional investors, volume of deals and information availability.

Stock markets and fund management industries are developing worldwide and this idea might well attract imitators eventually. Whether the concept of this network will take off on a wider scale remains to be seen. If it does, it is not likely to be one mammoth company but to have many different pools of investors.

HIGH-FREQUENCY TRADING – GOOD OR BAD?

Just a few years ago, high-frequency trading was much vilified by fund managers as well as academics. A substantial shift has occurred among both groups but criticisms continue. The key question remains as to how justified the new attitudes of investment managers and academia are (see box). At any rate the evidence is that at least some large institutional investors are benefiting from high-speed trading.

Extract from ‘Surprising partnership between fund manager and high-frequency firm’, Investment Management Review, January 2017

A surprise trading link between a top fund manager and a high-frequency trader (HFT), unthinkable just a few years ago, has brought into the spotlight the trading relationships between the buy-side and sell-side. The link is signalling undergoing a radical transformation in the investment dealing landscape.

Editor’s comment

A few years ago, high-frequency trading was a source of concern on the part of large numbers in fund management. Union’s link with the high-frequency firm is a clear indication that many among investment managers see their benefits.

There is no shortage of adverse opinions among the powerful. The Bundesbank in Germany has suggested that high-frequency trading can help to trigger flash crashes and Hillary Clinton had included monitoring this activity as an election issue, with other democrats still remaining very much averse.

However, HFTs are more lauded than not in the latest university research. Since 2013, studies in favour of high-frequency trading have been double the number of those against, as an examination of the 30 most widely-quoted papers on HFTs has shown. In contrast, in the previous three years most of the academic conclusions have been either negative or neutral, according to Microsoft’s search engine covering academic research.

Two important papers that are referred to most are strongly positive.

The paper that is cited most, more than 350 times, is *High-frequency trading and price discovery*, written by Jonathan Brogaard of the University of Washington, Terrence Hendershott of the University of California Berkeley and Ryan Riordan of the University of Queen’s. The second most quoted work, mentioned over 300 times, is *Low-latency trading* by Joel Hasbrouck and Gideon Saar of New York University and Cornell University respectively.

The papers counter the widespread belief of market fragility increasing because of HFTs. The conclusion is that these firms restore prices into balance even when volatility goes up, thus improving market stability and efficiency.

The research also deals with the accusation that HFTs profit at other investors’ expense by using their technology to get ahead of them. The actual finding, based on Nasdaq data shows otherwise. Bid-ask spreads were narrowed and short-term swings decreased, neither of which would be the case if other investors were being exploited. The latter’s transaction costs would be higher in this event. Their having fallen is a strong counter to the accusation.

Academic conclusions in the three years prior to 2013 were much more negative on high-frequency trading than the positive verdict in the past three years. This was explained by Brogaard saying that it is as simple as having a bigger quantity of data of higher quality to analyse. Automatic trading has become prominent only in the past ten years or so and therefore, the researchers in earlier work did not have much information.

Reasons have been put forward to challenge the latest academic research. It is felt that much academic research is biased by too close relationships.

 Extract from ‘Surprising partnership between fund manager and high-frequency firm’, Investment Management Review, January 2017

A surprise trading link between a top fund manager and a high-frequency trader (HFT), unthinkable just a few years ago, has brought into the spotlight the trading relationships between the buy-side and sell-side. The link is signalling undergoing a radical transformation in the investment dealing landscape.

Editor’s comment

A few years ago, high-frequency trading was a source of concern on the part of large numbers in fund management. Union’s link with the high-frequency firm is a clear indication that many among investment managers see their benefits.

There is no shortage of adverse opinions among the powerful. The Bundesbank in Germany has suggested that high-frequency trading can help to trigger flash crashes and Hillary Clinton had included monitoring this activity as an election issue, with other democrats still remaining very much averse.

However, HFTs are more lauded than not in the latest university research. Since 2013, studies in favour of high-frequency trading have been double the number of those against, as an examination of the 30 most widely-quoted papers on HFTs has shown. In contrast, in the previous three years most of the academic conclusions have been either negative or neutral, according to Microsoft’s search engine covering academic research.

Two important papers that are referred to most are strongly positive.

The paper that is cited most, more than 350 times, is *High-frequency trading and price discovery*, written by Jonathan Brogaard of the University of Washington, Terrence Hendershott of the University of California Berkeley and Ryan Riordan of the University of Queen’s. The second most quoted work, mentioned over 300 times, is *Low-latency trading* by Joel Hasbrouck and Gideon Saar of New York University and Cornell University respectively.

The papers counter the widespread belief of market fragility increasing because of HFTs. The conclusion is that these firms restore prices into balance even when volatility goes up, thus improving market stability and efficiency.

The research also deals with the accusation that HFTs profit at other investors’ expense by using their technology to get ahead of them. The actual finding, based on Nasdaq data shows otherwise. Bid-ask spreads were narrowed and short-term swings decreased, neither of which would be the case if other investors were being exploited. The latter’s transaction costs would be higher in this event. Their having fallen is a strong counter to the accusation.

Academic conclusions in the three years prior to 2013 were much more negative on high-frequency trading than the positive verdict in the past three years. This was explained by Brogaard saying that it is as simple as having a bigger quantity of data of higher quality to analyse. Automatic trading has become prominent only in the past ten years or so and therefore, the researchers in earlier work did not have much information.

Reasons have been put forward to challenge the latest academic research. It is felt that much academic research is biased by too close relationships.
with the industry. This feeling is held across a wide swathe of commerce and naturally embraces finance and high-frequency trading.

The latter’s researchers collaborate often with firms in the industry for access to market data. For instance, Brogaard mentioned in the above paper that Nasdaq provided data for academic purposes only after he signed a non-disclosure agreement. Hasbrouck has acknowledged his teaching activities at a high-frequency trading company while working on the above paper. But a disclaimer asserted that the study wasn’t specifically supported by any separate body. He points out that since the credit crisis, professional associations have rules governing dangers of bias which they are expected to follow.

Nasdaq emphasises the value of independent research and states that its HFT data set is widely used for research. Hendershott, while admitting that conflicts of interest are a concern, opined that what is really important is how the research was conducted.

The above research is countered by another paper, Moore’s law versus Murphy’s Law: algorithmic trading and its discontents, Andréi Kirilenko, the director of the Centre for Global Finance and Technology at the Imperial College Business School and Andrew Lo of the Sloan School of Management at Massachusetts Institute of Technology. This paper found that HFTs contributed to the $1tn that was temporarily lost by US stocks in the flash crash of May 2010.

In another paper, The externalities of high-frequency trading published in 2013 by Mao Ye, Chen Yao and Jiading Gai of University of Illinois at Urbana-Champaign, University of Warwick and University of Illinois at Urbana-Champaign respectively, it was found that speedier trading does not tighten spreads or improve volume but increases volatility. The concern is also that though the day-to-day trading might be enhanced, a more complex system can interact unpredictably when things go wrong and be more dangerous.

Hendershott’s conclusion is that while high-frequency trading has strong merits, some potential demerits must not be forgotten. He feels that the arguments have become more considered, and not in a black and white way as before.

Editor’s comment

The critical conclusions outlined in the last two mentioned papers above are not inconsistent with the positive results described earlier. The Kirilenko and Lo paper concerns a black swan event that does not pertain to an everyday activity. Moreover, it refers to contributing to rather than causing the flash crash. The question of increased volatility, if temporary, is seemingly countered by the contention that HFTs bring prices back into balance quickly even after a spike in volatility.

The experience of Virtu in suffering from market-induced low volatility, which it could do little about, as outlined in the related article ‘HFT industry in unprecedented downturn’, constitutes strong evidence that high-frequency trading firms react to rather than being harmful sources of volatility. The speed bump issue as described in another related article, ‘Nasdaq joins the HFT speed bump game’, on the other hand points to some abuse occurring. The new speed bump system, if widely adopted, could bring this to an end anyway.

If speed bumps end the abuses of some high-frequency trading firms, it looks as if this sector is more of a boon than a drag to the market, especially to large institutional investors.

‘Wall Street’s speed demons are heroes’, Camila Russo and John Detrixhe, bloomberg.com, 26.10.2016

This is the first of a group of related articles. Please see the next two on ‘Nasdaq joins the HFT speed bump game’ and ‘HFT industry in unprecedented downturn’. 
NASDAQ JOINS THE HFT SPEED BUMP GAME

Following the new upstart US exchange, the Investors Exchange (IEX) getting approval from the Securities and Exchange Commission (SEC) to introduce speed bumps, Nasdaq has followed suit with plans of its own. The idea is to restore a level of playing field by slowing down trading to prevent high-frequency traders (HFTs) getting an unfair advantage (see box 1).


The furious controversy surrounding the fairness of high-frequency trading might be at least partly mitigated by a new exchange. The Investors Exchange (IEX), which was given the go-ahead by the Securities and Exchange Commission (SEC) in June, has a very distinctive feature. It is introducing ‘speed bumps’ that aim to deliberately slow down transactions. IEX, while being the first major new stock exchange in the US since 2010, is also the first platform that actually reduces trading speed.

These speed bumps impose a delay of a 350-millionth of a second before transactions are executed, which goes counter to the prevailing philosophy of trades having to be carried out as quickly as possible that had led to the development of ever increasing speed. The motivation is that it can level the playing field by preventing HFTs racing ahead of other investors.

Prior to the approval of the exchange, the SEC went through an agony of indecision because of a potential conflict between its rules. The IEX’s speed bump proposal went counter to the existing regulation that had made it mandatory for orders to be executed as speedily as possible at the best price available. The SEC had asked IEX to modify its application five times and deferred its decision on several occasions.

In August 2016, the Chicago Stock Exchange proposed its own version of a speed bump. Implicitly, Nasdaq agrees with IEX’s blunt message that speed delays help to frustrate aggressive high-speed traders profiting at others’ expense. Tal Cohen, head of North American Equities at Nasdaq, indirectly concurred by saying that the new facility improves market quality.

Nasdaq’s proposals, awaiting SEC approval, are somewhat different from that of IEX. It will allow investors to enter orders, both buy and sell, that last for at least one second. This compares with 350-millionths of a second (micro-seconds). These delays should also be seen in the context of HFTs posting huge numbers of orders within fractions of a second.

Another big difference is that the IEX speed bump applies to all orders entered on its platform. The only choice investors have is whether to use IEX, speed bumps and all, or go elsewhere. In the case of Nasdaq, investors have a choice of whether to use the facility of the minimum one-second delay or not. If they do opt for the delay, they must accept that the order cannot be cancelled for at least one second. In return for agreeing to the restriction, the order would get high priority treatment.

In general, in exchanges where speed bumps don’t exist, the rules stipulate priority arrangements for orders that are entered. The best priced orders are completed first and when there are several orders at the same price, the ‘first come first served’ principle applies through an effective queue. The knowledge of the position of an order is important to traders as they constantly adjust their orders on the exchange in response to new market information. Knowing that they are way down in the queue, for instance, is valuable in this respect as the chances of adverse market movements affecting their deal increase.

The Nasdaq’s proposal of a one-second delay means that those who accept it jump to the top of the queue, as a quid pro quo for the risk of letting their order stay for a full second even though the price may move against them.
The speed bump idea catching on confirms that some HFT activity does need curbing in the eyes of both the SEC and the market. This is of value to big investors who are not short-term trading orientated, such as mutual funds and pension funds. They are less sensitive to the small price changes that are most likely to occur within the one second, while they would suffer more if the orders become held up in a long queue.

Larry Tabb, founder of TABB Group, an advisory firm, agrees that this system will be beneficial for institutions. Not surprisingly, high-speed traders and electronic market-making firms have reservations. Jamil Nazarali, head of execution services for Citadel Securities, says that the one-second delay type order will increase complexity and worsen liquidity and market efficiency. Interestingly, Tabb expresses a different opinion following IEX introduction of its speed bump (see box 2).

Editor’s comment

It is too early to say whether IEX is directly benefiting from any extra market share that might result from investors flocking to its system. But at any rate, it has clearly struck a chord in the market, with other exchanges sufficiently influenced to come up with copy models. IEX deserves plaudits (see box 3).

Larry Tabb, having changed his emphasis from negative to positive in his verdict on speed bumps, is another strong indication that the idea has taken off and many more players could enter the game.

2. Extract from ‘Speed bumps curbing high frequency traders’, Investment Management Review, October 2016

Larry Tabb, founder of TABB Group, an international research and consulting firm that focuses exclusively on capital markets, wonders whether it is a pyrrhic victory. He claims that the speed bump will make determining the right price more difficult, complicating market makers’ activities and resulting in spreads widening between bid and offer prices. The consequence would be to increase costs for end-investors. He argues that, if the change leads to a less competitive and more inefficient market, it could cost everybody more money.

The speed bump idea catching on confirms that some HFT activity does need curbing in the eyes of both the SEC and the market (see box 3), though in general it has received academic approbation as outlined in the previous article, ‘High-frequency trading – good or bad?’


This is the second of a group of related articles. Please see the previous one on ‘High-frequency trading – good or bad?’ and the next one on ‘HFT industry in unprecedented downturn.’
HFT INDUSTRY IN UNPRECEDENTED DOWNTURN

Times have changed for the worse for the once all-conquering high-frequency traders. The reversal in their fortunes is exemplified by one of the largest and speediest high-frequency trading (HFT) companies, Teza Technologies. In November 2016, it announced that it was withdrawing from its high-frequency activity as it was no longer profitable. The group had utilised automation to get to the very top ranks of players in market places such as the Chicago Mercantile Exchange and BrokerTec. The latter is a dealing venue for US Treasury bonds, previously the preserve of banks.

The company had achieved net revenues of $250m in 2012, falling to $80m in 2015, and in 2016 was finding it difficult to make any profits at all. It is departing its core business in HFT and will focus on building up its quantitative hedge fund with assets under management $1bn. This hedge fund subsidiary Teza Capital Management has started managing outside money in October 2014, and according to Misha Malyshev, Teza’s CEO, its future lies in asset management.

Rival HFT groups have also been affected by profit downturns, one of which is Virtu Financial. This firm has experienced declining profits since it went public in 2015, with lower trading income in each quarter of 2016 compared with 12 months previously. Virtu is taking a different path from Teza by diversifying its HFT activities through links with banks and fund managers (see box).

Interestingly, it has reportedly bought Teza’s wireless capacity and hardware, including microwave towers that transmit market data, in Europe and the US. Its reported aim is to strengthen the dealing technology infrastructure that makes partnership with it so attractive to banks and fund management firms such as Union Investment in Germany.

Fascinatingly, Virtu’s profit results since 2015 have been correlated extremely closely with the Volatility Index (VIX), the world-famous volatility measure run by the Chicago Board Options Exchange, based on the implied volatility of Standard & Poor’s (S&P) 500 options. When volatility is high, bid-offer spreads become wider and the ultra-high speed market makers profit. The VIX has remained very subdued since 2015. Virtu points out that average intraday volatility of the S&P 500 in August 2016 was the lowest since 1970. Following President Trump’s election, Virtu shares bounced back after an all-time low immediately prior to the polls. The rally was based on hopes of higher trading activity and volatility.

Extract from ‘Surprising partnership between fund manager and high-frequency firm’, Investment Management Review, January 2017

A surprise trading link between a top fund manager and a high-frequency trader, unthinkable just a few years ago, has brought into the spotlight the trading relationships between the buy-side and sell-side.

While this link would have caused a shock in previous years, several important changes have since occurred, with more complex markets and investors focusing on better execution quality.

One is the banks having a huge cost base in technology that is cumbersome and lags behind that of the high-frequency firms. The second is that the latter, having made a huge investment in dealing infrastructure that is much better than what the banks have, want to capitalise on it through outsourcing agreements with banks. So, Virtu is partnering not just with fund managers but also with banks, and in August entered into a three-year agreement with J.P. Morgan to help it with US Treasury trading.

INVESTMENT MANAGEMENT REVIEW

+44 20 7645 0777

cisi.org/imr

customersupport@cisi.org
The case is thus strengthened for HFT firms doing much more good than bad with the major plank of the criticisms against this activity being undermined.

However, while Virtu’s fortunes have been directly connected to market volatility, the overall problem being suffered by the HFT sector is increased competition in addition to the burden of rising expenditure on infrastructure, including telecoms, algorithmic software and exchange fees to surpass competitors in speed. In recognition of the changed economics, Chopper Trading, another HFT group, opted out of the business by selling out to DRW, a competitor.

Editor’s comment

Virtu’s fortunes tracking closely the volatility index throws light on the charge that HFT activities are a source of volatility. There are two possible hypotheses. The first is that volatility arises mainly from the market as a whole and that HFT firms are relatively passive in the generation of this measure. The second is that HFT firms’ activities actually cause volatility, an argument made in some academic circles as outlined in the related article, ‘High-frequency trading – good or bad?’.

Virtu’s experience strongly indicates that they are just the beneficiaries or victims of market volatility as it rises and falls, causing increasing or decreasing spreads. They are not on their own making an impact on volatility. The case is thus strengthened for HFT firms doing much more good than bad, with the major plank of the criticisms against this activity being undermined.

Fund managers linking up with Virtu and other HFT firms have implications for the industry, of that only the big asset managers can afford such links and it might be thought that bigness confers an advantage, but this is likely to be insignificant compared with smaller fund managers being more nimble.


‘Can Wall Street’s speed merchants get out of first gear?’, Miles Johnson, Financial Times, 27.01.2017

This is the third of a group of related articles. Please see the previous two on ‘High-frequency trading – good or bad?’ and ‘Nasdaq joins the HFT speed bump game’.
US STUDENT LOANS 
BUDDING ASSET CLASS 
UNDER TRUMP

The US student loan market has now reached nearly $1.4tn. Previously, only a small proportion of this (see box) interested investors and lenders who were drawn by the potential for accessing the wider consumer credit market. Now a much bigger slice of the $1.4tn loan book is within the sights of the fund management and lending community in anticipation of liberalisation under Trump's presidency.

Extract from ‘US student loan market enticing to investors’, Investment Management Review, October 2015

The US student loan market is proving to be another lucrative platform for the growing investor interest in private borrowings, an interest that might be a prelude to invading the gigantic arena of US consumer credit. The total loans held by recent graduates amount to more than $1tn in federal and private money. The US Government is currently encouraging its refinancing. A particular sector of this market is considered attractive by investors.

The category that is seen as attractive comprises student loans that are either backed by a guarantor or lent to borrowers with a good record of payment. The platforms are quite fussy about whom they lend to. At the student loan platform, CommonBond, the average graduate has left school several years previously and has an income of more than $100,000 per annum. The proportion of loans that falls into this category is still not very high, given that the US Government originates almost all student loans. Vince Passione, Founder and CEO of LendKey, assesses this share at about $40bn, with much of it lent at interest rates exceeding 7%.

Changes in government policy responsible for this additional regulation of private lenders also increased after the formation of the Consumer Financial Protection Bureau.

It is expected that there will be more changes, as the Republican Party’s policy during the election demanded the restoration of the private sector on the grounds that it is not a business for the Federal Government.

It is suggested that the Government could begin to remove student debt from its balance sheet by selling the loans to the private sector or facilitating a new bond market for the debt.

The opportunities could vastly benefit the three foremost private lenders to students, Sallie Mae, Wells Fargo and Discover Financial Services. It is felt that other lenders could also join the game. 20% of the $1.4tn being shifted could be attractive but the potential could be much more.

Editor’s comment

The student loan market, being a conduit to the wider consumer credit market, remains of huge interest among lenders and investors. Should the student debt be converted to bonds through securitisation, it will be a welcome fillip for this process, which earned a bad name during the sub-prime crisis and has yet to recover fully. In the event of a new bond market, clearly, the asset management industry will play a big part given that traditional lenders have shrunk with fund managers stepping in.

THE FCA QUESTIONS VALUE ADDED BY ASSET MANAGERS

The asset management industry in the UK does not emerge in a very good light in the interim report of the FCA following its Asset management market study: terms of reference issued in November 2015. A year later in November 2016 it produced its interim report asking for further feedback before delivering its final verdict later (see box 1).

Findings of the interim report include:

- **Competition** – There is price competition only in a limited number of areas.

Many fund managers believe that reducing fees will not procure additional business

- **Fee levels** – The fee levels haven’t dropped for the past ten years. Many fund managers believe that reducing fees will not procure additional business.

- **Passive funds** – The charges by passive funds have fallen.

- **Active fund fees** – The annual management fees of active funds tend to cluster around 0.75–1% with generally no reductions with increasing fund size, effectively


The UK’s FCA has embarked on a sweeping study of asset management, causing alarm in the industry about serious threats to business models and profitability. The central theme of the study is to examine the effectiveness of competition in the industry, insofar as it delivers value for money to end-investors.

The FCA identified two main areas for investigation:

1. How competitive forces work to deliver value.
2. Willingness and ability of fund managers to control cost and quality along the value chain.

The FCA is also concerned about potential barriers to innovation and market competition. Christopher Woolard, director of strategy and competition at the FCA, emphasised that the UK is a world leader in asset management, and the market study aims to ensure that both retail and institutional investors can get value for money.
allowing fund managers to benefit entirely from the decreasing costs generated by the higher economies of scale, while the clients get a zero share from these savings.

- **Profit margins highly lucrative**
  – Based on a six-year sample, the fund managers have been earning a consistent profit margin of around 36%, even higher if the profit element of asset managers’ pay is added back.

- **No added value to clients**
  – Overall, fund managers do not outperform benchmarks after costs, though many active managers do outperform before costs. The FCA draws the implication that the added value by fund managers is entirely retained by them through the fees with their customers getting nothing on average.

- **Disconnect between performance and charges**
  – The level of performance of funds is not correlated with charges.

- **Absolute return funds**
  – The FCA has two important concerns. First, many do not report performance against objectives against benchmarks promised to investors. Second, performance fees are charged by some for returns less than the target.

- **Negotiation of fees**
  – Retail and small institutional investors have limited ability to negotiate fees unlike large institutions.

- **Performance not comparable**
  – It is difficult to compare performance figures published by different funds because they cover different time periods. Also, poorly performing funds are often taken off the table through mergers or liquidations.

Thus, their clients are left with the unwarranted impression that, overall, the funds from the particular group have done better than they actually have. They are unaware of the disappeared failures which, therefore, are not taken into consideration.

- **Performance prediction**
  – Past performance is a poor predictor of future performance.

- **Problems of small pension funds**
  – The small pension funds have far less resources and therefore, are less knowledgeable than the big ones.

- **Consolidation needed**
  – Because of the problems of being small, pensions schemes should ideally amalgamate, but this is difficult to achieve in practice due to their having different objectives.

**Remedies considered by the FCA**

- **Clearer communication of fund charges.**
- **Increased transparency of costs and charges for institutional investors.**
- **Discussing potential benefits of greater pooling of pension scheme assets with the government.**
- **Publishing charges in terms of all-in fees, including transaction costs.**
- **Greater clarity of communication with retail investors about objectives and achievements.**
- **Strengthening fund governance.**
- **The existing AFM (see box 2) structure could be reformed by creating an additional governance body or replacing AFM boards with others having majority of independence, similar to US fund structures.**

2. Extract from Asset management market study: interim report (page 88), Financial Conduct Authority, November 2016

The Authorised Fund Manager (AFM) of an authorised fund has responsibilities to ensure that the fund it acts for meets its regulatory and legal responsibilities. The AFM is typically a subsidiary company within the company group structure that sponsors the fund range. Its board members are usually employed by and have operational roles within the group, and are frequently junior to the members of the group company board and its executive committee.

Publishing a single figure for charges including transaction costs is the most controversial and the asset management industry has been resisting this. Their objections are encapsulated in a response by Old Mutual Global Investors (OMGI) who pointed out an unintended consequence that could actually reduce the alignment between the interests of the fund manager and the end client.

There could be circumstances where trading is absolutely necessary, such as a big expected change in markets and the fund manager needing to trade in the interests of the client. But if it has already exceeded the limit stipulated by the all-in fee already quoted, then it might actually desist from trading to avoid absorbing the cost itself and it is the end clients’ investments that could suffer.

**Fund managers benefit entirely from the decreasing costs generated by the higher economies of scale, while the clients get a zero share from these savings**

**Editor’s comment**

When the FCA announced its market study in November 2015, there was reason to hope that it might come up with insights that would lead to the asset management industry overcoming its many weaknesses relevant to its clients’ needs. Apart from its pronouncements on the consulting industry, so far it has produced very little that was not already well known (see box 3).


**Editor’s comment**

The FCA study may well be a damp squib or at the other extreme provoke revolutionary industry changes. But, at the least, it promises to be an important study throwing much light on the workings of asset management, which is likely to be valued worldwide.

The industry and regulators everywhere might draw many insights that can be adapted locally.

On the fees front, it is very difficult to see what can be achieved in practice in reducing fee levels, apart
Focus on the Future

The Financial Planning Annual Conference
25 – 27 September 2017
Celtic Manor, Newport, United Kingdom

Three days
Four streams
Five-star setting
And over 13 hours of CPD up for grabs

Our leading conference is back again this year with dedicated streams for wealth managers, financial planners and paraplanners.

Book your place by 26 May to receive a 10% discount.

cisi.org/fpac17 #FPAC17
from greater transparency. Trying to regulate fees opens up a can of worms, perhaps striking at the very heart of a market economy involving price controls. Regulators have already said on other occasions that it is not their business to prescribe fees.

Furthermore, the FCA refers to fund managers not cutting fees because it does not bring in further business. This is a very common situation in other areas of commerce. Top lawyers and doctors cutting fees only evoke questions about quality. For similar reasons, purveyors of luxury goods know that cutting prices is counterproductive, so this is an area which regulators can only venture into under peril.

All they can do is insist on more transparency and clarity. It is possible that they already have the powers to do so as the various regulations on investor communication suggests this. In any event, market forces, including passive growth, are exerting downward pressure on fee levels and the effects should be discernible within a few years.

**Because of the problems of being small, pensions schemes should ideally amalgamate**

The most controversial aspect of the FCA's thinking is the question of quoting a single figure for all charges, bringing in transaction costs. If this figure is an absolute commitment, OMGI's comment about damage to end-investors encapsulating industry resistance to this measure would appear to have some validity. But if it is just provided as an estimate that might be exceeded under justifiable circumstances, then the objectives lose force. However, explaining and justifying should perhaps be insisted upon.

Having a target transaction cost figure to play against will have the undoubted benefit of reducing short-term trading

One area that they have done well to highlight is the plight of small pension funds which don't have the resources and expertise to match their bigger brethren. Not just investment consultants, but investment banks also have in the past assumed that they do not need to worry about the smaller schemes' expertise under the general assumption that all businesses can look after themselves. The presumption is that business to business advice does not need the same protection as business to retail. If a positive change improves the lot of these smaller funds, then the FCA review process would achieve something very solid.

Please see the article 'UK regulator calls for overhaul of fund industry' by Dr Wolfgang Mansfeld for an analysis of what the FCA might do and achieve overall following its final report due later this year.


‘Industry warns FCA of ‘unintended’ risks of all-in fee proposals in response to Market Study’, Jayna Rana and Daniel Flynn, investmentweek.co.uk, 20.02.2017

‘FCA Asset management market study: interim findings’, pwc.co.uk

This is the first of two related articles. Please see the next one on ‘Investment consultants savaged by UK regulator’. Please also see ‘UK regulator calls for overhaul of fund industry’ in the ‘Contributions from Industry Experts’ section.

**INVESTMENT CONSULTANTS SAVAGED BY UK REGULATOR**

The FCA has taken aim at the UK's investment consultant industry with some potentially damaging accusations involving conflicts of interest and the utility of their advice. Their criticisms appear in its interim report of November 2016 issued on the investment management industry (see box 1).

1. **Extract from ‘Investment consultants under the microscope’, Investment Management Review, April 2016**

In investigating the asset management industry, the FCA has also brought within its sights the workings of investment consultants who advise pension funds in the UK. The FCA's main focus is the impact of these consultants on competition for institutional asset management:

1. How does advice given by investment consultants affect competition for asset management?
2. How are conflicts within the business model of investment consultants managed?
3. Can clients monitor the services provided by investment consultants?

The FCA's main conclusions are:

- **Investment consultant ratings** – Investment consultant ratings of asset managers do not appear to be of help in institutions selecting the managers of funds with the more superior performance.

- **Small institutions suffer** – The consultants apparently do not help the smaller institutions to reduce prices charged by asset managers.

- **Excessive concentration** – The consultancy market is dominated by the top three firms with about 60% of the market. The level of switching between advisers by clients is low with 90% not having done so in the past five years.

- **Assessing advice quality** – Many institutional investors find it difficult to assess the advice they get and check whether the consultants are acting in their best interests.
• Conflicts of interest I – Fiduciary management combines advice, governance and implementing investor instructions. Consultants operating in this territory are effectively distributing asset manager services while actually competing with them, with a clear conflict of interest involved.

• Conflicts of interest II – Investment consultants accept hospitality, including concerts, from asset managers and the regulator is concerned about poor results suffered by end investors on this account.

Remedies suggested by the FCA

• Increased transparency – More transparency and standardisation of charges are needed for institutional investors.

• Fiduciary management conflict – Better and clearer disclosure of fiduciary management fees and performance is required.

• Market investigation – The regulator is considering making a market investigation reference to the Competition and Markets Authority with respect to marketing institutional investment advice.

• FCA covering institutional advice – Recommendations to the treasury that the FCA’s regulatory brief from the Government should embrace institutional investment advice provision.

Editor’s comment

In the case of consultants, the FCA is once again saying very little that is not already suspected within the fund management industry (see box 2).

Investment consultants accept hospitality, including concerts, from asset managers and the regulator is concerned

However, action seems to be called for, should the FCA prove to be justified in its conclusions. In this case, the regulator is likely to pursue matters with the competition authority, which could be to the good of the clients.


This is the second of two related articles. Please see the previous one on ‘The FCA questions value added by asset managers’. Please also see ‘UK regulator calls for overhaul of fund industry’ in the ‘Contributions from industry experts’ section.

2. Extracts from ‘Investment consultants under the microscope’ and ‘Consultants attacked for conflicts and other practices’, Investment Management Review, April 2016 and July 2015

The inclusion of consultants in the FCA’s enquiry is widely welcomed by many in the industry … Because many of these asset managers are beholden to the consultants for putting pension funds business their way … it is understandable that asset managers are generally reticent about voicing their reservations in public.

Some of the consultants have fund managers as clients, supplying them with services such as research or charging for access to events where the consultancy and its other clients are present. For example, Mercer levies a fee of $35,000 from fund managers attending its global investment forum events.

Editor’s comment

The issue of consultants charging for services to fund managers has not been mentioned by the FCA, but given its prevalence in the US, its possible transatlantic applicability should not be excluded. The big three asserting that they can be trusted because of internal controls needs to be examined. Top lawyers and top doctors are largely high quality professionals who can claim the trust of their clients. The same used to apply to actuaries at all levels in the consultancies.

The game has changed … potential conflicts of interest have come into play. It is, therefore, not at all clear whether the top consultancy firms can demand trust as a matter of right.
Professional Refresher
Your online training tool

Test your knowledge on over 90 industry topics and earn CPD

Latest modules
• Human Trafficking and the Modern Slavery Act
• Budget (Spring 2017)
• Business Protection
• Presentation Skills
• Managing in the Regulatory Environment

Top five modules
• Anti-Money Laundering
• Client Assets and Client Money
• Conflicts of Interest
• Integrity and Ethics
• Financial Crime

Free for CISI members
Log in at cisi.org/mycisi
REGULATORY SPOTLIGHT: UK REGULATOR CALLS FOR OVERHAUL OF FUND INDUSTRY

Dr Wolfgang Mansfeld

For almost a decade now, the fund industry has been subject to regulatory scrutiny and a vast amount of additional regulation – EU Directives, Level 2 Commission Directives, the European Securities and Markets Authority guidelines and – not to forget – ongoing national regulations.

One would assume that regulators, having completed their work, would lean back and look with satisfaction at an industry which is resilient, transparent and working in the best interests of the customers.

Obviously, this is not the case. The FCA, the UK regulator, has recently undertaken a market study of the UK fund industry. In my eyes, this is one of the most comprehensive and ambitious investigations that a regulatory authority has ever taken to analyse the industry that it oversees.

Findings

The interim findings have now been published. All in all they draw a critical picture of the industry.

Some key findings of the study are:

1. Charges of actively managed funds have stayed broadly the same for the past ten years, whereas the charges for index trackers went down. At the same time, asset management firms earned an average profit margin of 36% over the past six years. According to the FCA, the profitability of the industry is high compared to similar businesses.

2. Actively managed funds do not outperform their benchmarks after costs. Funds for retail investors even underperform their benchmarks after costs. Some asset managers charge high fees for active management although in fact they stay close to their benchmarks (closet tracking).

3. A wide range of low-cost index funds is available for retail investors, which would provide them with exposure to the risk and return of a target market index. Investors however tend to overlook passive funds when making their investment decisions, which may be to do with the way such products are presented to them in the distribution channel.

4. Instead, retail investors and, to some extent, institutional investors tend to focus on past performance when choosing between asset managers. However, past performance is not a good indicator of future returns. The academic literature shows little evidence of persistence in outperformance.

5. Fund governance bodies do not exert significant pricing pressure by scrutinising asset managers’ costs and do not typically focus on value for money.

In my opinion, the FCA findings are largely valid. Furthermore, they are not new but experts within and without the industry are well aware of them. The new element is that the weaknesses are so clearly highlighted by the regulator.

I would, therefore, not assume that the final report – to be released later this year after a consultation period – will deviate much from the interim report, although the industry will, understandably, do its best to soften the conclusions.

Regulatory action

The FCA wants ‘to ensure that the market works well and the investment products consumers use offer value for money’, which currently is not the case to a significant extent, according to the regulator.

Consequently, the FCA announces a policy package containing regulatory proposals. The intention is to put pressure on active managers to sharpen their value proposition and to reduce costs.

Furthermore, it is obvious that investors will be encouraged to strongly consider switching into passive funds. The entire report shows a thinly veiled sympathy for cheap index trackers. The FCA may hope that regulatory steps will make passive products a more visible choice for investors.

Some observers believe that the study and the intended measures could be the starting point for a far-reaching overhaul of the industry. I have doubts, however, whether the proposed rules can deliver this result. They concentrate on transparency and governance, but do not include product intervention or caps on fees that fund managers may charge.

Transparency requirements

Some of the measures aim to increase transparency for investors on costs, fund objectives and performance reporting. Fund managers should be required, eg, to set clearer and more specific fund objectives. The introduction of an all-in fee shall increase the visibility of all charges taken from the fund.

Measures on transparency can, in theory, improve investor choice and strengthen competition in the market. In the past decade, a lot of regulation has been imposed requiring more disclosures from fund managers. The impact on investor choice and competition has been limited. Most investors are obviously neither interested in more information nor prepared to base investment decisions on them.

The regulator itself seems to have doubts regarding the effectiveness of more transparency and therefore, adds rules on conduct and governance to the package. “Some investors are unlikely to ever drive value for money effectively and therefore, need strong governance to act on their behalf” (page 184).

Goverance and conduct standards

The governance and conduct related proposals include several extended duties for fund governance bodies. Alternatively, the existing governance structure could be modified, adding more independence to governance bodies, thus drawing on the US model for fund governance.

Again one may question the effectiveness. Rules on conduct and governance can ensure that decision-making follows certain standards and procedures. But that does not necessarily mean that the outcome of such decisions is in line with the expectations of the regulator. In my eyes, the US model of ‘independent directors’ clearly shows the limits of such an approach.


Effective competition, according to the textbook, should force managers to behave as if they were obliged to assume a fiduciary responsibility for investors (which in strict legal terms is not the case). Whether competition works that way in reality is questionable. The main problem is the well-known information asymmetry between managers and clients. It is extremely difficult for investors to fully understand the value that the fund manager delivers for them and to compare it with alternative products and providers.

The FCA may hope that regulatory steps will make passive products a more visible choice for investors.

Regulatory action

The FCA wants ‘to ensure that the market works well and the investment products consumers use offer value for money’, which currently is not the case to a significant extent, according to the regulator.

Consequently, the FCA announces a policy package containing regulatory proposals. The intention is to put pressure on active managers to sharpen their value proposition and to reduce costs.

Furthermore, it is obvious that investors will be encouraged to strongly consider switching into passive funds. The entire report shows a thinly veiled sympathy for cheap index trackers. The FCA may hope that regulatory steps will make passive products a more visible choice for investors.

Some observers believe that the study and the intended measures could be the starting point for a far-reaching overhaul of the industry. I have doubts, however, whether the proposed rules can deliver this result. They concentrate on transparency and governance, but do not include product intervention or caps on fees that fund managers may charge.

Transparency requirements

Some of the measures aim to increase transparency for investors on costs, fund objectives and performance reporting. Fund managers should be required, eg, to set clearer and more specific fund objectives. The introduction of an all-in fee shall increase the visibility of all charges taken from the fund.

Measures on transparency can, in theory, improve investor choice and strengthen competition in the market. In the past decade, a lot of regulation has been imposed requiring more disclosures from fund managers. The impact on investor choice and competition has been limited. Most investors are obviously neither interested in more information nor prepared to base investment decisions on them.

The regulator itself seems to have doubts regarding the effectiveness of more transparency and therefore, adds rules on conduct and governance to the package. “Some investors are unlikely to ever drive value for money effectively and therefore, need strong governance to act on their behalf” (page 184).

Goverance and conduct standards

The governance and conduct related proposals include several extended duties for fund governance bodies. Alternatively, the existing governance structure could be modified, adding more independence to governance bodies, thus drawing on the US model for fund governance.

Again one may question the effectiveness. Rules on conduct and governance can ensure that decision-making follows certain standards and procedures. But that does not necessarily mean that the outcome of such decisions is in line with the expectations of the regulator. In my eyes, the US model of ‘independent directors’ clearly shows the limits of such an approach.


Effective competition, according to the textbook, should force managers to behave as if they were obliged to assume a fiduciary responsibility for investors (which in strict legal terms is not the case). Whether competition works that way in reality is questionable. The main problem is the well-known information asymmetry between managers and clients. It is extremely difficult for investors to fully understand the value that the fund manager delivers for them and to compare it with alternative products and providers.

Dr Wolfgang Mansfeld, from 2002 to 2005, was the president of European Fund and Asset Management Association (EFAMA). Until June 2011, he was on the Executive Board of Union Asset Management, the holding company of Union Investment Group, Frankfurt am Main. From 2007 to 2010, Dr Mansfeld was the president of BVI (German Investment and Asset Management Association). From 2004 to 2011, he was a member of the European Securities and Markets Authority (ESMA) Consultative Working Group on investment management.

So all in all the proposed policy package may prove insufficient to “ensure that the market works well and the investment products consumers use offer value for money”. Nevertheless, the market study remains a commendable approach to take the discussion about the industry forward.

Brexit ante portas

Should the UK legislator finally implement several proposals contained in the interim report, another interesting question may arise: what will this mean for the UK fund industry and the EU fund market after the Brexit decision? It is unlikely that the EU legislator will adopt or even consider the UK proposals (although that might not be a bad idea). Will, in that case, EU-based undertakings for collective investments in transferable securities (UCITS) continue to have access to UK retail investors, or will the UK regulator conclude that they do not comply with the enhanced transparency and governance standards set for the UK industry?

Will, on the other hand, the proposed new rules contradict EU requirements (UCITS and the Alternative Investment Fund Managers Directive) in any respect? Will it become more difficult for UK-based funds to meet EU ‘equivalence’ standards which may – instead of passporting rights – be the future regime to preserve access by UK-based funds to the EU market?

It is of course not possible to answer these questions today. But they may give an idea of issues that will require permanent discussion over the forthcoming years.
SUB-ADVISORY IN JAPAN: AN INDUSTRY AT A TURNING POINT

Jag Alexeyev

Japan remains one of the key sources of sub-advisory business for international managers with ¥22tn ($217bn) assets under management (AUM) of outsourced funds. But the market is changing rapidly, transforming opportunities for firms. Among the key developments:

• The industry is taking steps to encourage investing over longer horizons, with less trading activity and a greater emphasis on wealth-building solutions.

• Regulators are discouraging trading activity and new fund launches, which in the past served as effective ways to raise substantial sub-advisory assets.

• Distributors are migrating their business models towards asset-based fee revenues. This is fueling the growth of discretionary managed account programs, fund wraps and separately managed accounts.

• Fund wraps are changing the demand for different kinds of investment strategies, with potentially less reliance on sub-advisers.

• Client demand is slowly evolving beyond high current income needs towards total returns, expanding the opportunity set for asset managers.

• Support of retirement savings, including defined contribution plan reforms in 2016 and the Nippon Individual Savings Accounts introduced in 2014, will influence product architectures.

Some of these changes suggest a more challenging operating environment for sub-advisers, while others point to renewed potential. Established sub-advisers will need to adapt some of their legacy product offerings and distribution strategies as buyer preferences change.

Meanwhile, firms that achieved less traction in the past will find doors beginning to open, especially if they can bring the right mix of investment and service capabilities to support the evolving distribution landscape.

The decline in new fund volumes may be the most significant driver of sub-advisory opportunities, at least in the near term. New sub-advised funds in 2016 captured 40% less in flows compared to introductions just two to three years ago.

Newly launched sub-advised funds raised more than ¥1tn ($10bn) in each of the years between 2011
and 2015, even surpassing ¥2tn ($20bn) in 2013. In contrast, just over ¥0.5tn ($5bn) was collected in 2016 through September. Raising assets through new introductions in Japan is becoming much more challenging, changing the economics of conducting business for sub-advisers. The volume of money raised in each new fund is also, on average, falling.

Yet the potential for selected sub-advisers to collect remarkable amounts through fund introductions persists. SMAM Global AI, offered by Sumitomo Mitsui Asset Management (SMAM) and sub-advised by Allianz Global Investors, raised ¥130bn (more than $1bn) in 2016. This amount though was far less than the ¥514bn ($5bn) captured by Nikko Global Robotics Equity, introduced in 2015 and sub-advised by Lazard.

Meanwhile, product needs are broadening beyond high current income towards total returns as well as outcome-oriented and wealth management solutions. Real estate and high income bond strategies (global and emerging market high yield) achieved significant gains in the past and continue to play a prominent role. But today we see rising demand for equity, multi-asset and alternative investment providers. Real Estate Investment Trust (REIT) and global bond strategies are typically the flagship portfolios of the five largest sub-advisers. This reflects the important role of real estate products in meeting demand for income and growth by Japan investors. Cohen & Steers, Invesco, LaSalle and Morgan Stanley continue to benefit from this long-term trend. In 2016 through September, these four managers together collected an additional ¥1.3tn ($13bn) into their sub-advised REIT ranges.

Overall, flows into sub-advised funds in Japan exceeded ¥10tn ($98bn) in the five years through 2015. The next half decade should offer similar potential, with a cumulative ¥20tn (around $200bn) of net gains expected to benefit investment trusts. Roughly half of this will be captured by sub-advisers, suggesting an additional ¥10tn ($100bn) market opportunity through 2022.

AmOne, Nikko and Daiwa provided the biggest gains for sub-advisers during 2016, but a greater variety of domestic partners now offer an expanding source of assets, including SMAM, Sumitomo Mitsui Trust Asset Management, Okasan and Nissay. Interestingly, multi-alternative funds delegate 62% of assets to external managers, the highest of any investment category. The proportion outsourced has climbed sharply in the past half-decade along with assets in the segment. The specialised skills required to manage alternatives, combined with rising demand for non-correlated and outcome-oriented assets, should support growth for alternative providers. This segment is one of several that will offer fresh opportunities for international money managers in Japan for years to come.

While the emphasis is shifting to equity and multi-asset solutions for wealth-building purposes, persistently low yields and negative policy interest rates will continue to support demand for yield substitutes and non-traditional bond specialists.

The importance of multi-asset capabilities should grow in response to demand for wealth-building programs, outcome-oriented solutions, risk-based funds, absolute return and multi-asset yield substitutes. Already, 58% of multi-asset funds by AUM are sub-advised, matching the proportion of REIT funds outsourced to unaffiliated managers.

These business intelligence insights are just a few of many from Impactvesting LLC’s recent in-depth report, Japan sub-advisory opportunities.

Jag Alexeyev is founder of Impactvesting, a research and consulting firm that helps asset managers create climate resilient and sustainable investment solutions. He advised more than 100 asset managers as head of Global Research at Strategic Insight, a leading provider of fund intelligence. He established Strategic Insight’s international operations in 2001 and led the group until 2014.
ROBO-ADVISERS ON THE RISE GLOBALLY, AND CONTINUE TO EVOLVE
Bryan Liu

Robo-advisers, automated advisory platforms that construct and rebalance portfolios at a fraction of the cost of a human adviser, have disrupted the financial services industry worldwide. Fintech start-ups, backed by venture capital firms and others, were the first to set foot in the robo-advisory space and challenge the traditional financial adviser model. With a goal to minimise human input and automate services, they filled the gap for low-cost investment advice.

Pioneers in the robo-advisory space, fintech firms Betterment and Wealthfront, first launched their products in 2010–2011, and centered their investment model on low-cost, liquid exchange-traded funds (ETFs). SigFig, another fintech company that follows an ETF model, aims to partner with banks and other financial firms rather than focusing on individual investors, unlike its counterparts. SigFig currently works with the largest brokerages in the US, including TD Ameritrade, Fidelity, Schwab, UBS and most recently Wells Fargo, to provide automated investment advice to its clients.

In Europe, there are similar robo-advisory services that apply the same ETF-based model. Examples include UK’s Scalable Capital, France’s Marie Quantier, UK/Italy-based Moneyfarm and Germany’s growney, which all specialise in ETF-based globally diversified portfolios. As the robo-advisory industry is less developed in Europe than in the US, European robo-advisers are likely to be more costly than their American peers.

In Asia, Japanese managers have also actively embraced this technology and incorporated robo-advisory platforms in their businesses as they continue to come up with innovative products. For example, fintech company Money Design launched the country’s first independent robo-adviser, THEO, in February 2016. THEO creates portfolios from a selection of around 6,000 ETFs.

While the first generation of robo-advisory services focuses on purely automated systems that invest mainly in ETFs, hybrid services that combine the benefits of an automated low-cost robo-adviser with a human adviser have gained popularity. With an additional layer of investment support, the hybrid models may invest in a combination of ETFs and mutual funds. Index fund powerhouse Vanguard entered the robo-advisory space in May 2015 with the launch of Vanguard Personal Advisor Services. Through the platform, investors can invest in Vanguard mutual funds (mostly passive index funds) and ETFs, and receive robo-advisory services such as the automatic rebalancing of a portfolio, while being able to partner with a Vanguard adviser.

FutureAdvisor, which was acquired by BlackRock in August 2015, also provides financial adviser support in addition to its robo-advisory services. The platform works with brokerage and retirement accounts held at Fidelity or TD Ameritrade, so pre-existing investors do not have to move their money. It is important to point out that FutureAdvisor uses BlackRock’s iShares ETFs as well as third party funds for the underlying portfolios.
In the UK, Wealth Horizon offers easy accessibility to human advisers, who create a diverse portfolio from a wide range of funds including products from Legal & General, Vanguard, Columbia Threadneedle Investments and Igns Asset Management. Nutmeg, launched in 2011 as one of the UK’s first robo-advisers, offers exclusively discretionary investment services, which means that they make decisions about how to invest their clients’ money on their behalf.

As the robo-advisory industry is less developed in Europe than in the US, European robo-advisers are likely to be more costly than their American peers

In Asia, Singapore’s fintech start-up Mesitis’ Bento, launched in October 2016, uses human advisers and a robo-algorithm termed ‘bionic adviser’ to create liquid and low-cost ETF portfolios for its high-net-worth investors.

ETF-based models, whether they are managed solely by a robo-adviser or a hybrid (robo and human) adviser, currently are the most prevalent structure due to their more liquid nature and low costs. Amid increasing demand and rising competition, robo-advisory services continue to evolve and innovate, and more varied and innovative approaches continue to emerge.

Some robo-advisers specialise in pensions and other financial services. Wealth Wizards in the UK provides pension advice and specialises in working with companies to cover employees. True Potential Investor provides clients with investment choices including a stocks and shares individual savings account, a pension and a general investment account while selecting from a wide range of fund managers.

FundShop, in France, is entirely managed by a robo-adviser and does not sell any product. Instead, investors are offered the opportunity to optimise their existing life insurance contract(s), based on their risk profile and performance goals. The French firm Advize, which offers co-managed savings solutions, has recently announced its plan to extend its range of products to securities accounts, equity savings plans, collective pension savings plans and new investments such as ETFs. Under Advize’s structure, asset allocation recommendations are made by Morningstar (human) advisers, and clients subscribe to a life insurance contract with Generali Vie when they create their account.

In Japan, Pictet launched its iTrust brand, which offers four funds exclusively online with lower management fees than the company’s other products. Nomura claims that its robo-advisory platform, Nomura Goal-Based, is the first to consider investors’ life cycle objectives such as home mortgages and education fees in the portfolio construction process.

In the US, Schwab Intelligent Portfolios offer 53 ETFs to clients, charging no advisory fees, no account service fees and no commissions, while the clients pay the fees of underlying ETFs in their portfolio.

Governments globally encourage and promote fintech innovation. Some provide favourable tax and regulatory environments and some even offer direct financial support, as fintech disruption and/or integration spurs a sea change in the asset and wealth management industry. For instance, the UK, Hong Kong, Singapore and Malaysia have established regulatory sandboxes to address barriers to innovation for fintech start-ups and facilitate development within the industry.

On the one hand, the robo-advisory industry, which has been developing quite rapidly, transcends geographical borders. Not only do a variety of firms offer the possibility to invest in globally diversified portfolios, but some are also physically established in more than one country. A good example is ETFmatic, which is available in 17 European countries and plans to expand further. Its multi-platform application is the most downloaded app in Europe.

The new generation of clients, the tech-savvy millennials, tends to compare traditional financial institutions with digital leaders across all industries. When purchasing financial products, they expect a digital experience that is similar to the ones they are accustomed to in other industries.

Financial service firms and technology companies are, therefore, becoming increasingly interconnected. More innovative and diverse, more mass-customised and adaptive robo-advisory solutions are expected to disrupt the traditional asset and wealth management industry, creating a vast number of business opportunities and challenges for both established players and new comers, probably from many industries.

Bryan Liu, managing director, Global Research Strategic Insight, an Asset International company, is a research and consulting firm, which supports over 250 companies around the world with analysis, perspective and data on the fund industry. Its Simfund Global databases track monthly flows, assets, performance, ratings and other intelligence on more than 60,000 portfolios and many more fund share classes globally, totalling $23tn in assets.
Global managed assets
In isolation, it is difficult to interpret what amounts and growth rates mean. Figures in billions and trillions are bandied around and it is useful to assess how the numbers for each sector relate to the whole.

<table>
<thead>
<tr>
<th>Assets ($tn)</th>
<th>end of period</th>
<th>2015</th>
<th>2016</th>
</tr>
</thead>
<tbody>
<tr>
<td>Regulated open-end funds*</td>
<td>37.2</td>
<td>40.8</td>
<td></td>
</tr>
<tr>
<td>Hedge funds</td>
<td>2.9</td>
<td>3.0</td>
<td></td>
</tr>
<tr>
<td>Private capital**</td>
<td>4.2</td>
<td>4.5</td>
<td></td>
</tr>
<tr>
<td>Pension funds</td>
<td>25.8</td>
<td>26.7</td>
<td></td>
</tr>
<tr>
<td>Insurance assets</td>
<td>28.1</td>
<td>29.3</td>
<td></td>
</tr>
<tr>
<td>Sovereign wealth funds</td>
<td>7.2</td>
<td>7.3</td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>105.4</td>
<td>111.6</td>
<td></td>
</tr>
</tbody>
</table>

* figure 2016 as at end-Q3
** figures as at end-Q2, including private equity, private equity real estate, private debt, infrastructure and natural resources

Estimated global managed assets at end-2016 reached $111.6tn, representing an increase of 5.9%, compared with the corresponding end-2015 figure.

Although hedge funds, exchange-traded funds and private equity are much talked about and receive prolific coverage in the media, it is interesting that they are all (still) small in total relative to mutual funds. The other big asset pools include pension funds, insurance and sovereign wealth funds.

Regulated open-end funds

In the first three quarters of 2016, regulated open-end funds achieved inflows of $0.8tn globally. Regulated open-end fund assets were $40.8tn at the end of the third quarter of 2016, slightly above the end-2015 level.

Exchange-traded products

In 2016, the growth of the exchange-traded product (ETP) industry remained strong, with net inflows into ETPs of $380bn. Total assets increased to $3.5tn.

Pension and insurance assets

Assets of pension funds amounted to $26.7tn end-2016, according to the Organisation for Economic Co-operation and Development (OECD) and Willis Towers Watson (WTW) estimates. Assets of insurance...
Alternative funds

<table>
<thead>
<tr>
<th>Net flows ($bn)</th>
<th>Assets ($tn) end of period</th>
</tr>
</thead>
<tbody>
<tr>
<td>Hedge funds</td>
<td>43.8</td>
</tr>
<tr>
<td>Private Capital*</td>
<td>637</td>
</tr>
</tbody>
</table>

* AUM figures as at end-June, including private equity, private equity real estate, private debt, infrastructure and natural resources.

Top ten asset managers

<table>
<thead>
<tr>
<th>Rank</th>
<th>Manager</th>
<th>Total assets ($tn) end-2015</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>BlackRock</td>
<td>4.8</td>
</tr>
<tr>
<td>2</td>
<td>Vanguard</td>
<td>3.4</td>
</tr>
<tr>
<td>3</td>
<td>State Street</td>
<td>2.3</td>
</tr>
<tr>
<td>4</td>
<td>Fidelity</td>
<td>2.0</td>
</tr>
<tr>
<td>5</td>
<td>BNY Mellon</td>
<td>1.6</td>
</tr>
<tr>
<td>6</td>
<td>J.P. Morgan</td>
<td>1.5</td>
</tr>
<tr>
<td>7</td>
<td>PIMCO</td>
<td>1.4</td>
</tr>
<tr>
<td>8</td>
<td>Capital Group</td>
<td>1.4</td>
</tr>
<tr>
<td>9</td>
<td>Prudential</td>
<td>1.2</td>
</tr>
<tr>
<td>10</td>
<td>Legal &amp; General</td>
<td>1.1</td>
</tr>
</tbody>
</table>

Notes

Investment Management Review (IMR) calculated the statistical figures based on publications of the following institutions: Investment Company Institute, European Fund and Asset Management Association, BlackRock International, HFR, Investment & Pensions Europe, OECD, Preqin, Statista and WTW.

Regular, systematic and authoritative statistics across all sectors are hard to come by in the fund management industry. Given that the statistics are from different sources, there may be some incompatibility in the definitions and assumptions underlying the figures. Hence, the figures reported should be treated as approximate and designed only to give a feel for relative orders of magnitude.

IMR cannot accept responsibility for the accuracy of the figures cited, as they are not based on our primary research and are meant to help our readers to identify the broad trends in the industry across different sectors and their relative importance to the whole.

Growth of the global hedge fund industry amounted to 3.5% in 2016, as a result of slight outflows and moderate performance. Fund assets increased to $3tn at the end of 2016, according to Hedge Fund Research (HFR).

Private capital fundraising was again strong in 2016, with more than $600bn of capital raised and assets reaching $4.5tn mid-2016, according to Preqin research.
Are you ready for the Apprenticeship Levy?

The Government’s Apprenticeship Levy took effect on 6 April 2017 and all UK employers with an annual PAYE bill over £3million started paying the 0.5% tax.

Download your free copy of the Apprenticeship guide for employers or contact us to find out how we can help.

cisi.org/apprenticeships
apprenticeships@cisi.org

All rights reserved. No part of this publication may be reproduced, stored in a retrieval system, or transmitted, in any form or by any means, electronic, mechanical, photocopying, recorded or otherwise without the prior permission of the copyright owner.

May 2017
What does this mean for me?

All CISI members, both existing and new (except students), are required to undertake continuing professional development. As the leading global professional body for securities, investment, wealth and financial planning professionals, we have introduced these new CPD requirements to ensure that all our members, no matter what membership grade they have, job role they hold or jurisdiction they work in, will be unified by meeting strict annual CPD standards.

We know that most of you are already undertaking and recording CPD with us annually. Our aim is to help our members demonstrate to consumers and the industry that they are committed to the highest standards of professionalism and integrity and that these standards are in place for perpetuity.

We provide several resources to ensure members have all the opportunities to learn, develop, progress in their careers and meet their CPD requirements, including:

- A choice of over 500 CISI CPD events globally per year for members to attend in person
- Nine national advisory councils
- Online training through Professional Refresher modules and IntegrityMatters
- CISI TV webcasts, both live and recorded, with currently over 150 to view online
- Industry news through your member magazine – The Review
- Suite of ethics and integrity CPD materials

All the CISI CPD members undertake is automatically added to their CPD records, removing the administrative headache of manually adding CPD.

cisi.org/newcpd

Existing members who join the CISI prior to 1 April 2017 need to start their CPD year no later than 31 March 2018 in order to meet the new mandatory CPD requirements deadline of 31 March 2019.

If you have joined on or after 1 April 2017 the CPD requirements will need to be met within your first year of membership.