Investment Management Review

ADVISORY REVOLUTION FROM NEW US RULE AND ADVANCES IN ROBO-ADVICE
Top institutions accelerating automation growth (p.6)

Plus

REGULATORS INVESTIGATING CLOSET INDEXING (pp.16,18 + editorial)
Flaws in identification serious problem

SUCCESSFUL SUING OF US GOVERNMENT OVER ‘TOO BIG TO FAIL’ (p.22)
Regulator’s authority suffering damage
FROM THE EDITOR

CLOSET INDEXING: MOUNTAIN OR MOLEHILL?

Widespread closet indexing (index hugging) is believed to be prevalent in the fund management industry. Regulators across Europe have announced finding some evidence of this.

However, what exactly ‘closet indexing’ is has not been clearly defined. This lack of clarity applies to both aspects of the term. ‘Closet’ hints at secrecy, misrepresentation and even dishonesty. ‘Indexing’ suggests ‘too close to the index’. Closeness to the index has led to accusations of both excessive fees and dishonesty. The authorities are keeping clear of the fees issue, but misrepresentation and the connected topic of secrecy is what bothers them.

But the authorities will have a job on their hands in achieving more precision in the concepts of secrecy and how close is too close, before they can possibly consider making closet indexing a serious offence, as many of its detractors are demanding.

Several metrics are suggested for measuring the level of active management. The newest is the one that has caught on, the concept of ‘active share’, based on a 2009 paper by two academics. However, the conclusions of this paper are flawed, according to a paper published this year in the prestigious Financial Analysts Journal, one of the most authoritative publications in the asset management industry.

Large-cap and small-cap effects are lumped together in the original 2009 paper, causing confusion. Stripped of this, there is no case for the ‘active share’.

An important reason for large-cap and small-cap to be treated separately is that large-cap stocks are inherently treated as lower-risk than small-cap funds, which has a bearing on ‘active share’. Furthermore, large-cap companies are more at the mercy of macro-economic shifts that are not too easy to predict, making very large and frequent bets relatively unsafe and even speculative at times. On the other hand, in the small-cap sector the duds are easier to spot and macro-economic influences in many cases loom less large.

The conclusion of this year’s paper is supported by another important study. Shorn of the supporting data, what promoting active share amounts to is effectively saying that the higher the risk, the better. This is a recipe for the unskilled, the mediocre and amateurs to lose a lot of money. Only that rare breed of highly talented fund managers would be reasonably safe. Neither do the other suggested metrics, such as tracking error and correlation, predict performance.

The question of secrecy and disclosure is another grey area. It is all well and good to classify funds that as a matter of policy avoid business risk as closet indexers. But what about fund managers who temporarily de-risk and go close to passive for a time? Calling them closet indexers would not be reasonable, but what length of time can be treated as acceptable in this context? Furthermore, marketers in many industries do tend to indulge in hyperbole, and fund managers are not exceptions when it comes to advertising publicly. The line between exaggeration and dishonesty may not be clear-cut.

The Italian authorities, having adopted a light touch with asset managers whose marketing material is not up to scratch, might be a sign of the ultimate outcome. So might the UK Financial Conduct Authority’s not having found outright dishonesty. It is not certain that the regulators will ultimately unearth more than a few very serious offenders when they succeed in defining the offence.

Fees are another matter. While regulators will not and should not be involved, it matters very much to the clients, who justifiably will not pay active fees for nearly passive portfolios. But this is a matter for the advisory industry. Apart from this issue of fees, the closet indexing controversy could turn out to be a much smaller mountain than it appears to be now.

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UPHEAVALS IN US FINANCIAL ADVICE

A new US government rule announced in early April is set to cause the most radical transformation seen in the US financial advisory industry for decades. The primary motivation is to help middle-class retirees to enjoy a better retirement. Currently many lose out from poor advice arising from their advisers' conflicts of interest.

The amounts involved are gigantic. Individual retirement accounts (IRAs) collectively had assets of $7.3tn at the end of 2015, estimated to be equal to the combined GDP of Germany and Japan. The 401(k)s and other employer-sponsored retirement plans account for another $6.7tn, according to the Investment Companies Institute (ICI), the highly respected and authoritative trade group for US fund managers. The combined figure of $14tn is a sizeable chunk, not just of the US asset pool but also globally, as worldwide assets under professional management amount to between $60tn and $100tn, depending on the definition and measurement methodology used. The magnitude of the rule's impact on these accounts is further highlighted by the fact that 60% of US households possess retirement plans, either through their employment or based on IRAs.

This rule, introduced after six years of gestation in the face of industry comments of both the constructive and the vested interest varieties, has already set in train a massive restructuring of the financial advice industry in the US.

The US Labour Department has emphasised the importance of protecting individuals at the time of their rolling over their 401(k) into an IRA as they cease employment. A 2013 report by the Government Accountability Office found brokers...
often providing biased information and marketing IRAs aggressively.

Some 7% of advisers were disciplined for misconduct, a third being repeat offenders. Scandalously, more than 90% of them either kept their jobs or were hired by other firms.

The Economist magazine cites a study, The market for financial adviser misconduct by Mark Egan, Gregor Matvos and Amit Seru, which comes up with even more disturbing conclusions embracing a database of 1.2 million individuals in the ten years to 2015. Some 7% of advisers were disciplined for misconduct, a third being repeat offenders. Scandalously, more than 90% of them either kept their jobs or were hired by other firms.

The authorities have indicated that the new rule will benefit middle-class families who have significant retirement assets. They have estimated that currently poor advice based on conflicts of interest cost them $17bn annually, and that the rule can increase their investment return by up to 1% per annum, which in a typical case can amount to $27,500 instead of a much higher $37,500. These figures are disputed by many industry objectors to the new rule, many of whom, of course, have a vested interest in saying so.

What the rule requires

The rule governs the nature of the advice that should be given to holders of retirement investment vehicles, including the widely held 401(k) and IRAs. On retiring, workers roll over assets held in employer-sponsored 401(k)s into private IRAs. Hitherto, at this rollover as much as 10% of the retirement assets were paid over as commission by the provider of the product to the adviser (broker).

The aim of the rule is to end conflicts of interest by imposing the fiduciary standard already applicable to RIAs and fee-only planners on all who advise on retirement savings. Brokers can continue to rely on commission structures, but subject to various provisions. When advising on retirement plans, they can only charge reasonable compensation, and in selecting investments they have to serve their clients' best interests, regardless of their own. These stricter criteria contrast with the current standard which has encouraged some advisers to charge excessive fees or advise investing in vehicles that offer high commission rates regardless of clients' interests.

All advisers now have to make clients aware of their rights to complete information about the fees that are charged. Advisers will need to take a closer look into the investor's circumstances and maintain a paper trail of their work, as well as allowing for the risk of litigation. The rule will force radical changes on how broker-dealers, their staff and other similar firms operate. Compliance costs are expected to increase.

Under the new rules, any financial adviser being paid for a 401(k) rollover will now have to assert that the fees are reasonable and the investment strategies appropriate, to reveal potential conflicts of interest and to provide a contract promising to serve the client's best interests.

While commission payments will continue to be allowed, advisers have to demonstrate that they are reasonable and in the best interests of the client. Implicit pressure is imposed to go for lower cost products and not only disclose but justify commission payments. Inevitably, more compliance costs will be required, encouraging a shift to fee-based accounts.

The losers

Unfortunately, not all end-customers will benefit. Because of the additional compliance costs and the increased risks of litigation, many advisers will find those with assets of less than about $50,000 uneconomic and abandon them.

The new provisions surrounding commission payments, together with the extra compliance burden, are likely to result in many of the small advisers being unable to cope on their own and joining bigger groups. Some smaller broker-dealers are expected to merge and the fiduciary-state standard will be more painful for brokers who have gone for the products offering the fattest commissions, in contrast to the advisers who have already been focused on good quality service.

Providers of mutual funds that charge more than average could be more seriously hit as the rule introduces a strong bias to low cost instruments

Mutual fund groups will also be affected. Those firms that rely on making commission payments and annual fees to their distributors might find their margins under pressure through the reduction of fees that are built into their own charges. Providers of mutual funds that charge more than average could be more seriously hit as the rule introduces a strong bias to low cost instruments, with the more expensive vehicles requiring justification. According to the leading research house Morningstar, revenues of almost $2.4bn a year could be lost from the fees incorporated in US mutual fund sales.

Active fund managers also might be in trouble as more advisers go for low-cost passive products. But the biggest losers will be the insurance companies,
who unsurprisingly have complained the loudest about the new regime. One of their products, variable annuities, an instrument for retirement saving and income, is frequently sold by advisers who are rewarded with commissions of 5–7% of the initial investment. The new rule is likely to have a substantial impact on the sales of these vehicles.

The problems are not confined to US companies. Across the Atlantic, several large European life and pension groups are affected. Transamerica, an arm of the Dutch insurer Aegon, and the French group AXA are among the ten biggest variable-annuity providers. The biggest as at the end of 2015 was Jackson National Life, owned by the UK insurance group Prudential.

Across the Atlantic, several large European life and pension groups are affected

The adapters

Many of the bigger firms are likely to accelerate their shift to fee-based products, away from commission payments which involve the hassle of satisfying the new onerous requirements. These fee-paying accounts are more profitable anyway, and the big Wall Street brokerages have already been moving in this direction.

As a result of the new rule, they are expected to remove incentives for their armies of salesmen/advisers to sell inappropriate products. The fee-based accounts yield at least 60% more revenue than commission-based sales, according to Morningstar. Furthermore, fee-based revenue is more stable and less linked to new savings. For instance, Morgan Stanley’s wealth management arm already has 40% of client assets in fee-based accounts that generate 70% of its total revenue. Partly in consequence, the bank has projected a 5%–13% increase in pre-tax profitability over the next year at its wealth management unit. The big Wall Street brokerages on balance stand to gain business. They expect to grow the number of advisers linked to them and the assets which they advise on.

Aftermath

The industry opposition to the rule does not look likely to evaporate and there is much talk about suing the government in the courts. It is also hoped that a new administration after this year’s elections, or a changed composition of the legislative branch, might lead to a revocation of the new rules.

Editor’s comment

The poorest section of the population may be abandoned in an explicit way, but there is a case for saying they were not often given good advice in the first place, and at least this rule brings it out in the open.

Variable annuities with a life guarantee remain valuable instruments. Once the exorbitant upfront charges come to an end under the new rule they are likely to play a strong role in fee-based accounts. Hence life insurance companies’ losses may not be as large as feared, and, like the big brokerage houses, they might actually gain in the longer term.

The changes in the US advisory system allows interesting comparisons with the radical changes under the Retail Distribution Review (RDR) implemented in the UK and the second Markets in Financial Instruments Directive (MiFID II) rules provisions that will govern advice in the EU as a whole relating to commission. While commission is banned outright in the UK, the US and continental Europe will continue to allow this type of payment, but with a big difference. In the US the new rule could lead to the authorities getting involved in whether commission payments are excessive or not. It is believed by many that as a result, the authorities will indirectly play a bigger role in supervising advice in the future.

The big Wall Street brokerages on balance stand to gain heavily from the rule, in terms of attracting more fee-based accounts

In Europe the big institutions seem to have the biggest leeway in continuing with commissions, as analysed in the regulatory spotlight by Dr Wolfgang Mansfeld in this issue.

While a seismic shift is underway in the US advisory industry, the big cloud that hangs over all types of advisors, whether fiduciary or broker, and worldwide is the fast growing development of the robo-advice market.

1‘Rotten advice,’ The Economist, 05.03.16
2‘New race for the saver’s dollar’, Stephen Foley, Alistair Gray and Ben McLannahan, Financial Times, 23.03.16
6‘Holding advisers to a higher standard’, Katherine Chiglinsky, Margaret Collins, Robert Schmidt and Ben Steverman, Bloomberg Business Week, 11.04.16
7‘What’s not to like about the new adviser rules?’, Steve Garmhausen, Barron’s, 18.04.2016

This is the first of two related articles. Please see the next article on ‘Robo-adviser danger to wealth managers draws closer’.
ROBO-ADVISER DANGER TO WEALTH MANAGERS DRAWS CLOSER

Robo-advisers, which have been seen as an incipient long-term threat to wealth managers for over a year now, are becoming a more imminent menace. The big change is that many top financial players are now joining the game and are poised to accelerate the growth of this sector. According to Ian Woodhouse, Partner at PwC, 2016 promises to be pivotal in this regard. And Bill McNabb, Chief Executive of Vanguard, the giant index fund group, describes robo-advisers as ubiquitous.

Various types of big financial institutions … are racing to provide robo-advice, and the trend is gathering speed

Various types of big financial institutions – including banks, brokers, fund managers, insurance companies and wealth managers – are racing to provide robo-advice, and the trend is gathering speed. They see it as either a threat to be fended off or an opportunity to be exploited, or both, and are adapting their business models accordingly.

The growth in robo-advice is concomitant with an expansion of exchange-traded funds (ETFs), the tools most often used in the new technology. In the US, the leading research consultancy Cerulli Associates has predicted that total assets in the sector will reach nearly $500bn by 2020, while the forecast for the same year by the consultancy A T Kearney is a very much higher $2.2tn.

Most important and ominous for the wealth management industry is the fact that the fledging robo sector has become a priority for the world’s leading asset managers.

All these institutions have recognised the fact that robo-advice enables them to cheaply reach large numbers of small savers who were previously uneconomic to service, and that setting up systems and platforms for the robo sector is therefore now worthwhile. Moreover, once these platforms are set up, they can just as well be used more upmarket. According to an RBC survey, 49% of the wealthy are happy to use robo-advice for a part of their portfolios, asset management activities. These include Wells Fargo (US), National Australia Bank (Australia), Toronto Dominion (Canada), Mizuho (Japan) and Deutsche Bank (Germany).
with the rest in higher-risk assets. The millennial generation of young professionals currently in their late twenties and early thirties are described as high earners but not yet rich. But it is believed that they will become wealthy later and that it makes sense to grab them at this early stage. In contrast, the established wealth managers have tended to wait until people are actually affluent before seeking them as clients. They need to change their ways or risk missing the boat in the long term.

The primary attraction for automated advice among retail investors is the low fees. This is a serious threat to the wealth management industry. Just as index funds and ETFs are exerting downward pressure on active management fees, so will cheap robo-advice drag down revenues and margins in wealth management, and sooner rather than later. The threat is amplified by Vanguard’s hybrid model of combining robo-advice-type portfolio selection with an active human interface. William Trout, Senior Analyst at the research company Celent, fears that asset managers with successful robo-advice arms will gain at the expense of other wealth managers and human advisers.

The many different companies that have either entered the sector or are planning to do so include the leading names Vanguard, Fidelity, BlackRock, Robeco, Invesco and Aberdeen, among the fund managers. Other leading players include Hargreaves Lansdown, which is one of the UK’s biggest online players, Charles Schwab and Goldman Sachs.

The many different types of computer based advice are classifiable according to various dimensions: the level of sophistication, business models, client age distribution and human advice interface.

The established wealth managers have tended to wait until people are actually affluent before seeking them as clients. They need to change their ways or risk missing the boat in the long term.

The many different types of computer based advice are classifiable according to various dimensions: the level of sophistication, business models, client age distribution and human advice interface.

The level of sophistication

Invesco intends to provide actively managed funds, quantitative strategies, sophisticated index tracking products and the funds of other investment houses in its robo-advice portfolios. This contrasts with the original simple model of passive ETFs being combined. Fidelity’s advisory service will include its own Spartan funds and some BlackRock iShares ETFs. Interestingly, it has also launched a Visa signature card. Charles Schwab is operating similarly by linking its service to American Express cards.

Deutsche Bank is the most ambitious. It wants to ultimately develop cutting-edge robo-advice-type products based on investment solutions that take account of wealth and liability profiles. Subject to top manager approval, it will produce algorithms taking account of employment prospects, wealth planning and security of salary, as well as expenditure on big items.

Other players tend to group investors into different categories and then provide uniform off-the-shelf portfolios to each category. In contrast, Deutsche hopes to deal with individual preferences on a one-to-one basis. The ambition is to display to clients the risk if markets crashed and also to review portfolios when circumstances change. In spite of all this sophistication, the underlying portfolios will be restricted to ETFs.

Scalable Capital claims to differ from competitors with its sophisticated risk-based asset allocation strategy. The US provider Motif allows investors to combine their own thematic ETF products for $9.95 a time. Eaton Vance is set to launch active-fund ETFs that will eventually come into their own. It is suggested that multi-asset funds will also be used in a big way.

Business models

The business models also differ. Not all profit directly from robo-advice. Some are producing other instruments that can subsidise the automated advice. For instance, Charles Schwab’s robo service is free but its money comes from the underlying cash and ETFs.

Client age distribution

It is not just in the portfolio approach that differentiation is becoming prevalent. Many of the new large institutions have a different age distribution from the upstart pioneering robo-advisers. At Schwab, three-quarters of those who have taken on its automated service were pre-existing customers. Approximately half of those who have signed up for Schwab’s service are aged over 50. About two-thirds of the clients of Vanguard’s new service are retired or nearing retirement age. In one sense, it is natural for the customers to be weighted towards the older generation, as in the West they have a disproportionate share of assets and savings and many baby boomers nearing retirement need financial help. This is where the young specialist robo-companies have reason to hope: where they are attracting the younger crowd.

Human advice interface

The way advice is given, even when humans are available for this service, varies by company. Charles Schwab clients can contact the company by phone or online before investing. But it’s not compulsory, unlike with Vanguard, where it is a must, with about 40% having video chats.

The competition in the new robo sector is expected to intensify. Not all will survive and some of the winners are likely to be those who are best in a variety of niches that are developing.

So the multiplicity of different types of robo-advice development will have profound implications. There are also differences in the way the new sector is developing, globally speaking. Europe still lags behind the US heavily, with American firms accounting for 79% of funds invested in the sector. However, the potential for growth in Europe could be huge, especially in European ETFs. Retail investors account for only 20% of the ETF sector in Europe, compared with the more balanced division between institutional and retail in the US.

The future

Potential robo-adviser entrants have several strategic choices to make. For instance, they can partner with an existing firm, buy a robo-adviser outright or develop a service internally. Whether to operate purely online or provide some human element as well is another big decision.
The big players have yet another problem to contend with. They cannot contemplate seriously cannibalising their existing business. They have to try to emulate British Airways, for instance, which provides a high-quality top-end service for its first-class while attempting to compete with Ryan Air and Easy Jet with no-frills cheaper tickets, including no baggage.

Consolidation is expected sooner rather than later, because venture capitalists are becoming impatient with the independent pioneering start-ups, scared about the competition from the larger players with their massive distribution networks and the high cost of customer acquisition. The players were initially all business-to-consumer (B2C), whereas in any partnering they will become business-to-business (B2B) with the new partner reaching the consumer, eg, BlackRock. There is the threat of competition from the Chinese tech giants such as Alibaba, Tencent and Baidu, which already have digital funds in their home market.

Insurers are also entering the game, sniffing an opportunity. North Western Mutual and Legal & General are examples. The specialist robo-advisers currently still have the advantage, as they have the technology. But, because they lack the distribution and the powerful brand, they might be better off being acquired while the going is good, before the big players develop their own technology.

William Trout, Senior Analyst at the research company Celent, fears that asset managers with successful robo-advice arms will gain at the expense of other wealth managers and human advisers

However, the industry need not get too excited just yet. A survey by the CFA Institute published in early 2016 found that 85% of Canadians, 73% in the US and 69% in the UK, will continue to want an investment professional’s advice instead of the latest technology and tools over the next three years. Andrew Formica, Chief Executive of Henderson, says that robo-advisers will be absorbed into a traditional advice model and find limited support on their own. He states that currently the interest in robo-advice is much more from within the industry and in the media than among the investors, the most important group.

Regulatory change, social pressure and competitive fears are driving the acquisitions. The ETF market is likely to grow even faster on the back of robo-advice. Currently computer based advice is still insignificant, with less than $100bn compared to a US market of $30tn, but Deloitte figures suggest that robos will reach $5–7tn by 2025. The robo challengers are not overly afraid of the big player threat, because of the latter’s internal conflicts, as with Amazon versus the supermarkets.

Potential robo-adviser entrants have several strategic choices to make

Regulators are very happy with the sector, as they have been worried about the advice gap at the lower end of the market.

Editor’s comment

Formica’s opinion that robo-advisers will be absorbed into a traditional advice model and find limited support on their own might well be correct, but it overlooks one key fact. Investment returns are widely expected to be lower than in recent decades and fees are still too high in comparison. The pressure on fees could be the unstoppable force that proves him wrong.

However, the upstarts may not last. While the robo-advice model is likely to thrive, the entrepreneurial start-ups have less hope. Many of them are unlikely to survive. They are destined to either be swallowed up in the maws of the bigger predators or die a natural death as is often the way in new industries.

There is every chance that robo-advice will fall into two distinct camps – the low end streamlined automated model with perhaps some human interaction thrown in, and the high end wealth planning model which Deutsche is embarking on, with substantial academic work focusing in this area.

Robo-advice at the mass end can be seen as the extension in the shift from active to passive. Index funds and institutional passive funds started decades ago. Then ETFs were introduced and were almost all passive initially. More sophisticated passive vehicles, including some smart beta variants, were the next development. Robo advice at the cheap end may be the final leg. But just like ETFs, this new sector is also branching into the more active variety as it is no longer a homogenous cheap product but is more differentiated and potentially very sophisticated.

The seriousness of the giant fund management houses and wealth managers in playing in this market is open to question. It is dubious whether the really big successful active asset managers, such as Fidelity and Schroders, as opposed to the index providers BlackRock and Vanguard, will put their heart and soul into the bottom end of the market and cannibalise their own profits. They are more likely to treat it as a gesture, making it available to the less affluent. They cannot afford to decimate their own revenue by treating the new technique as a core product. A parallel lies with the big airlines who really are not competing effectively at the bottom end of the market with the likes of Ryan Air and EasyJet and perhaps are not that interested in doing so. However, regardless of their enthusiasm level, their very presence in the market could exert downward pressure on wealth management fees.

Already the robo-advice sector is being transformed at a speed that is mind boggling, given that it has barely started. The different forces at work, changes in advisory payment structures and quality as mandated by regulators, robo-advice, other technological advances and generational shifts in attitudes are likely to make the advisory model unrecognisable in ten years’ time. Those in the industry not close to retirement need to think about how they should adapt. Chances are many will have to leave and think of early retirement or another career.

Sage and Hermes Research

This is the second of two related articles. Please see the previous one on ‘Upheavals in US financial advice’.
EU AUTHORITIES EVASIVE ON ADVISER RULES

Editor’s introduction

The EU is being accused of giving way to intensive lobbying by big financial institutions, such as banks and insurance companies, in two separate instances, and thereby not clarifying key regulations. Retail investors could suffer as a result.

The big problem is that complex funds are not defined. Sven Giegold ... who led the overhaul of the regulatory framework for Europe’s retail funds in 2014, worries that the failure will cause confusion across the industry.

The definition of complexity sidestepped

New rules are coming into play in 2017, through the Packaged Retail and Insurance-based Investment Products (PRIIPS) directive, that requires asset managers to take special care in selling complex investment funds. But the big problem is that complex funds are not defined. Sven Giegold MEP asserts that the European Commission has failed in this respect. Giegold, who led the overhaul of the regulatory framework for Europe’s retail funds in 2014, worries that the failure will cause confusion across the industry and undermine confidence in the investment market. He points out that the market will function better if investors understand what they are buying. Without a definition, asset managers could use whatever term they like, which would be very unsatisfactory.

Sharon Bowles, former chairwoman of the European Union’s powerful Economic and Monetary Affairs Committee, said that nobody on the regulatory side wants to take responsibility for sorting this problem out. She said that the market will function better if investors understand what they are buying. Without a definition, asset managers could use whatever term they like, which would be very unsatisfactory.

This sentiment was echoed by a senior asset management executive speaking anonymously. He thought that the Commission had been influenced by the lobbying of banks and insurance companies, which are frightened of their products being branded as complex. The damage was done by the 2007 rules that allowed hedge fund strategies to be sold under the Undertakings for Collective Investment in Transferable Securities (UCITS) label. This has been considered a long-standing tarnishing of the UCITS label, which had been praised when introduced a few years previously. The executive was afraid that many investors are exposed to the risk of heavy unexpected losses. He said that the European Commission should have done more to address the problem, but nobody has been able to persuade it to do so, despite several national authorities being clearly worried about the complexity of many retail funds.

The executive was afraid that many investors are exposed to the risk of heavy unexpected losses

Some of the national regulators in Europe have already attempted to restrict what can be sold to unsophisticated investors through UCITS funds. Belgian, French, Dutch and Italian regulators have prohibited or imposed restrictions on the type of funds that can be sold to the retail public. These actions by national regulators were carried out following the introduction of the much criticised 2007 rules allowing complex strategies to be sold.

Editor’s comment

The UCITS label has been regarded as the gold standard for investors, who have been attracted to buy European products from all over the world. But in the years immediately after the 2007 rules were introduced, many regulators in Asia and other places became worried.

The failure of the authorities to define what is complex is setting the scene for an accident or big mis-selling scandal. The EU regulators have on the whole had a good record in producing effective regulation. The very existence of the gold-standard UCITS label is a testimonial to some of their outstanding achievements. But this complexity problem also highlights their weak spot – of being susceptible to large-scale lobbying. Unless something is done by somebody at the very top, the problem risks tarnishing their reputation and authority.


This is the first of two related articles. Please see the next article on ‘Retail investors hit by regulation ambivalence’.
RETAIL INVESTORS HIT BY REGULATORY AMBIVALENCE

European regulators are accused of pandering to the big banks at the expense of the retail public in another key area – the distribution of funds.

Over the past two years, independent asset managers and investor rights groups have become increasingly concerned about banks selling only their own funds to European retail investors, instead of also offering them a choice of third-party providers. According to a press release by the leading research consultancy Cerulli Associates, 90% of new flows into European funds between 2009 and 2013 went into those managed by independent fund management houses. In contrast, from 2014 only a third of such funds were received by these independents, with the large majority of the rest going to bank-owned funds. Seven of the ten best-selling asset management companies in Europe last year were subsidiaries of banks.

This trend has been driven by the rapid growth of the banks’ asset management divisions. Cerulli believes that this reflects banks boosting their efforts to reclaim customers and rebuild margins.

JPMorgan Chase had to agree to pay a $307m penalty to two regulators in the US: the Securities and Exchange Commission and the Commodities Futures Trading Commission. In the former case, it admitted wrongdoing in failing to disclose conflicts of interest to wealth management clients. It had not revealed that it was selling them the bank’s own investment products rather than those offered by rivals, though less expensive, thus generating more profits for itself. In the case of the latter, the bank was accused of failing to disclose its preference for clients investing in vehicles connected with JPMorgan Chase.

Madison Marriage of the Financial Times worries that similar things could be happening here. The regulators have attempted to address this problem by issuing guidelines in January, coming into effect in 2018, that allow the payment of commission to distributors only if a number of instruments from third-party producers are sold to the customers. Unfortunately, a loophole was included, enabling banks to circumvent the guidelines if they reviewed the customer’s portfolio annually.

Some of the big players – Goldman Sachs, Deutsche, Credit Suisse and Morgan Stanley – claim to offer a high proportion of external funds, but have not been willing to provide figures on this. That the banks are not willing to disclose the proportions of their third-party sales is a problem, according to a senior regulatory official in the EU.

Guillaume Prache, Managing Director of Better Finance, a leading investor rights group, feels that the banks have no incentive to sell anything other than their poorly performing products, and has suggested two remedies. One is to force banks to legally separate their investment arms, a controversial measure. The second is to compel them to disclose the proportion of own products sold by them.

Editor’s comment

If open architecture is accompanied by the banning of commissions, then it will be a satisfactory outcome, provided banks disclose the proportion of external sales and have to justify this figure being below a predetermined threshold.

As it is, the above mentioned loophole lets through commission payments, and under these circumstances open architecture may not necessarily be in the customers’ best interests, as pointed out in the article on page 34, ‘No breakthrough for open architecture’ by Dr Wolfgang Mansfeld.

‘JPMorgan Chase to pay $307m over disclosure flaws’, Gina Chon, FT.com, 18.12.2015

‘Banks self-serving fund sales must be stopped’, Madison Marriage, Financial Times, 02.05.2016

‘Banks told to stop pushing own funds’, Madison Marriage, Financial Times, 02.05.2016

This is the second of two related articles. Please see the previous one on ‘EU authorities evasive on adviser rules’.
FUND MANAGERS DIVIDED ON SOCIAL MEDIA

Very few would dare to challenge the idea that social media is good for sales. While fund managers have been latecomers to the party, many of the household names are now actively involved. No doubt, most of the larger ones pay lip service to the notion. How seriously they take it is another matter. What they actually get out of it is not generally clear, and how and why they go about it needs examination.

The asset management industry is believed to be reluctant to dive in fully for two reasons

Vanguard was an early mover, having hired a Head of Social Communications eight years ago, at a time when other fund houses considered this function as just one aspect of other communications positions. Woodford Investment Management, founded recently by the superstar Neil Woodford, does not spend on advertising, according to Paul Farrow, its Head of Corporate Communications. He said that they use social media to educate, inform and engage. He went on to say that one year ago Neil Woodford sat down with the company’s digital specialist to make a film which was issued by 4PM. This episode highlighted the usefulness of YouTube for reaching customers when they needed the reassurance of a friendly face rather than anonymous text on a screen.
Vanguard has a big advantage in possessing an investor group who term themselves ‘Bogleheads’ and follow the philosophy of Vanguard’s founder Jack Bogle. This group of private individuals, fully independent of Vanguard, have a well-developed online community, including forum boards and an educational website. Vanguard is not too actively engaged with this fan club, and only intervenes when facts are wrongly stated.

According to Barbara Wall, a managing director at the well-known research consultancy Cerulli Associates, 58% of fund houses plan to increase their social media headcount. The platforms used by the asset managers are mainly LinkedIn, Twitter and Facebook.

The asset management industry is believed to be reluctant to dive in fully for two reasons: first, its general backwardness in using the latest technology, often attracting the appellation ‘Luddite’, and second, the issue of control. According to Wall, they are afflicted by the fear of brand vulnerability. She said that, once something foolish is said on social media, it can be very difficult to repair or retract the damage. Tesco found this out to their cost when their meat products were discovered to include horsemeat. Their customer care manager made a lighthearted joke of it in a tweet, which was initially sent to more than 47,000 followers. This then went viral and was condemned as being in poor taste.

Another major problem lies in recruiting suitable expertise. It is not easy to find people having both financial services know-how and social media experience. Even if a suitable expert is found, it is also believed that both fund managers and senior executives have to be directly involved in a company’s social media activities.

The layers between fund managers and their end-investors need to be minimal, according to Neil Curham, Executive Director at the fund management consultancy Alpha FMC. He posed the question as to how fund managers can be persuaded to participate and, in this event, how they can be protected from any disastrous communication. Vanguard, Head of Digital Marketing at JPMAM, says that “Klout does not reflect how good you are at executing your strategy and reaching the right people”. Dominique Traynor, Head of Digital Marketing at M&G Investments, points out that its measure of success is not just levels of interest but also the ‘shareability’ of content.

Outside fund management, there is much more undiluted enthusiasm about the prospects for generating retail sales through social media. According to Christopher Mims of The Wall Street Journal, Facebook is an unrivalled way to generate a market, more than search, word of mouth and previous types of advertising. It is also pointed out by Tom Montgomery, co-founder of Chubbies, the men’s apparel company, that social media is one of the huge factors that differentiates retail these days.

There is a lack of consensus on exactly how fund managers can benefit from social media

Alpha FMC has studied how well fund houses are performing in social media by measuring their presence, responsiveness and degree of adaptation to each different platform. According to Lali, only three companies, Fidelity, Vanguard and Woodford, have very active two-way conversations. Those who mainly talk to the end-investors are the best at it.

The top five in Alpha FMC’s ranking are:

1. Fidelity UK
2. Vanguard (US)
3. Woodford
4. Legal & General Investment Management
5. J.P.Morgan Asset Management (JPMAM)

A very different ranking system was used by the Financial Times publication, Ignites Europe. It is based on Klout, the social media analytic website.

Another pecking order of social media effectiveness emerged, highlighting the lack of uniformity in what the asset management industry actually wants to get out of social media usage. Part of the problem is that Klout uses a different universe. The companies included are those with the highest assets in Undertakings for Collective Investment in Transferable Securities (UCITS) funds, though some of these companies run their social media out of the US. According to Rob Tarkoff, President of Lithium, which owns Klout, the Klout score is based on 400 signals.

Under the Klout scoring system, the top ten houses were:

1. Deutsche Bank
2. UBS
3. iShares
4. BlackRock
5. Pimco
6. Standard Life Investments
7. M&G
8. J.P. Morgan
9. Schroders
10. Franklin Templeton

The validity of Klout’s scores is questioned by investment professionals. According to Kimberley Yurisich, a director at the wealth and management practice at the consultancy EY, a few impactful interactions can be more powerful than thousands of meaningless ones. These sentiments were echoed by Matt Leslie, Global Head of Digital Marketing at JPMAM, saying that “Klout does not reflect how good you are at executing your strategy and reaching the right people”.

Editor’s comment

Clearly there is a lack of consensus on exactly how fund managers can benefit from social media. For Woodford, it seems to be merely communication and hand-holding, whereas JPMAM indicates a more targeted objective of executing strategy. To some extent, these differences are understandable. It is not yet clear what benefits social media might bring to asset managers’ bottom line. Until solid evidence emerges of the media making a difference to revenue, the industry’s commitment to this channel is likely to be limited.

The major problem here is that not many in the wider world have even heard about fund management, let alone understand what it is about. This is a constraint on the rapid expansion of numbers accessing fund management social media outlets and those who tell their friends about it.

‘Harnessing the power of social media’, Sophia Grene, FTfm, 15.02.2016

‘Deutsche Bank has the most clout on social media’, Ed Moisson, FTfm, 29.02.2016

TOP FUND HOUSE ACCUSED OF GOVERNANCE HYPOCRISY

Fierce controversy has been stirred up by the elevation to the role of Chairman of Michael Dobson, the eminent Chief Executive of Schroders, the highly reputed second-largest listed fund management company in Europe. The group is accused of violating an important best practice rule in its corporate governance code – one that states that the chief executives should not go on to become chairman. The rule of course allows for exceptions when properly explained. In addition to many shareholders, powerful corporate governance organisations have taken up cudgels against Schroders and have advised their shareholder clients to vote against Schroders’ remuneration policy, and in particular Dobson’s huge pay package, at the Annual General Meeting (AGM).

Three proxy adviser organisations are Institutional Shareholder Services (ISS), Glass Lewis, and Pensions & Investments Research Consultants (PIRC), who together advise 25% of clients in the UK stock-market. Expert Corporate Governance Services (ECCS), a network of continental European voting advisors and spearheaded by the French voting agency Proxinvest, has come out against the code. The Investment Association (IA), the UK’s trade body for fund managers, has also expressed reservations through its voting advisory service, the Institutional Voting Information Service, which issued an amber report on the appointment. Manifest, another UK agency which does not recommend on voting, has also opposed it.

The general concern is that Dobson will be a backseat driver. He has vigorously refuted this, saying that in this case the board has decided that it is in the best interest of the company, because of his experience and knowledge of clients at a professional level. His successor as Chief Executive, Peter Harrison, has a strong personality and his own views, and is likely to have a different emphasis which Dobson will support.

Those who know both men tend to concur with this view. Authoritative sources who know both Harrison and Dobson assert that the former will be his own man, and likely to stand his ground. A fund manager familiar with both has said that Dobson is a bit old fashioned while Harrison is very smart, hands on and likely to make decisive moves. This is probably what he was appointed for, given that Schroders, along with the rest of the industry, is facing transformational changes which might need a new direction.

Alan MacDougall, Managing Director of PIRC, called Dobson’s elevation unacceptable, asking whether this rule-breaking is what the family needs right now, and saying that it will be very hard for his successor to establish a new strategy.

The actual AGM transpired as was expected. Some shareholders were vociferous, and about 6% voted against the group but were seen off by the board. Responding to the criticism, Phillip Howard, the Schroders senior Non-Executive Director, stated that the firm had consulted the ten largest shareholders and considered their opinion before the move. It has set in motion plans to improve the independence of the board.

Editor’s comment

Shareholders protesting against Dobson’s elevation was always likely to be of little avail, given that the family controls nearly 50% and probably requires only one pliant institutional holder to give them effective control. Keeping their holding below 50% avoids the issue of minority holdings, but in reality all other shareholders are likely to have no more power than typical minority owners without the recourse to rules that govern the latter.

Nevertheless, Schroders could be faulted for poor communication and style. The big problem is that there is an unsaid fact that Schroders cannot admit to, at least in public. The reality is that Bruno Schroder and the family effectively control the company and that no big move is likely to take place without their sanction. Dobson had a very close relationship with the family, and it remains to be seen what would happen should...
Harrison disagree with either him or Bruno Schroder. That is when the governance issue would be tested.

The company’s lack of style echoes another recent episode, when the group attracted unnecessarily bad publicity in the IA episode leading to the removal of the Chief Executive Daniel Godfrey. Reportedly, Schroders along with M&G were up in arms against Godfrey’s support for more disclosure in relation to fees. Then too, Schroders had some justification in its policy, although it was perhaps not consistent with widespread ethical standards and expectations relating to transparency. But, regardless of justification, they could have done it in better style. On this occasion, however, not being able to mention the key fact of the family having the real control, unlike in most other big companies, might have crimped a more frank level of communication.

The corporate governance rule in question needs some examination. The governance specialists tend to act by rote. As implied in the code, there are several situations where the best practice might need to be ignored. Instead of automatically rejecting the rule violation, a more considered approach might have stirred up less controversy.

The biggest fallout for Schroders does not look promising. Regardless of any justification, any future firm stance they may take against this rule being violated in other companies might be inhibited, and they might lack the authority to influence matters.

‘Schroders shuffle dismays investors’, Chris Newlands, Madison Marriage and David Oakley, Financial Times, 04.03.2016

‘Schroders faces criticism over top roles switch’, Madison Marriage and Chris Newlands, Financial Times, 04.03.2016

‘Schroders under fire for ‘classic City arrogance’, Chris Newlands, Financial Times, 07.03.2016


FAMILY OFFICES MORE DOMINANT IN FUND MANAGEMENT

Editor’s introduction

Offices dedicated to managing the assets of a single family were hitherto considered a backwater of wealth and asset management, but no longer. The clout of family offices is now making itself felt in global asset and wealth management in several ways.

Top fund managers attracted to family offices

It used to be the case that working for a family office was seen as a dead-end in a fund management career, but now the opposite is true. There are several strong reasons why highly talented fund managers could benefit from moving to the private office of a single family. To start with, they can now earn much more than their fellow fund managers in the City of London. A turnaround has led to family offices offering more attractive salaries than the formerly better paid City managers currently receive.

According to recent research, chief investment officers at single and multi-family offices earn an average of £270,000 per annum, while portfolio managers receive £160,000 – with additional rewards averaging over 40% of base salary for each category. Pay-data provider Emolument revealed that fund managers in London get a median salary of about £180,000 (£125,000), and a bonus of another £25,000 (£17,000) for the most experienced.

There are several other enhanced attractions for fund managers moving to family offices. Apart from the higher pay, these offices achieve the most lucrative investment returns in the industry, as opined by Tayyab Mohamed, co-founder of the family office consultancy and recruitment firm Agreus.

Generally, these managers are given a wider mandate and are able to play across all asset classes, giving them the opportunity to gather much more experience and know-how. This is all considered a stepping stone to understanding ultra-high-net-worth families. Their additional expertise is likely to stand them in good stead if they move back to the City later. Admittedly, they have more demanding responsibilities, the main negatives being longer working hours and being permanently on call. So, some leave for a better work-life balance elsewhere. But, according to Matthew Norman, Deputy Chairman of the Family Office Council, the lifestyle is better with a family firm, including a nice office in Mayfair rather than the City. Furthermore, only one client has to be kept happy, so there are fewer investor meetings.

Editor’s comment

One of the big advantages of families managing their own assets is that they can take a long-term view, ignoring short-term fluctuations when appropriate. This allows access to a much wider pool of investment assets than is possible in organisations that have to report to nervous clients and continuously reassure them when things go temporarily wrong.

Chinese family money looms larger

A new generation of family offices in China are now an important source of assets for fund managers and represent one of the first places which hedge funds, buyout firms and
venture capitalists investigate for more backing. This large new pool of funds is even more significant because of the decline of sovereign wealth funds that have been hit by foreign exchange movements and the oil price fall.

The fresh sources of Chinese capital originate mainly from new family offices, including ones owned by Jack Ma, Founder and Head of Alibaba. This relatively new source of money has a bias towards tech investments. Reflecting this, brokers and private bankers in Hong Kong approached a local client to ascertain interest in a private capital raising exercise by Palantir Technologies, an artificial intelligence group pursuing a $25bn valuation. One of the more substantial of the new generation of family offices is Blue Pool Capital in Hong Kong, which manages part of Ma’s wealth, and a greater part of the $7bn owned by his partner Joe Tsai. Ma also has a new family office in Hong Kong and another entity Yunfeng.

These family offices collectively control tens of billions of dollars and frequently are more sophisticated than the fund managers that seek to manage their money. The billionaires’ tendency to support tech investments both abroad and in China also plays a positive role in the Chinese economy, where new jobs in ecommerce and technology can replace those lost in manufacturing.

Editor’s comment

The sophistication of Chinese family money echoes that of other family offices elsewhere as they become more expert players in global asset management.

There is a big question mark over which way China will go. But what is clear is that the local rich are hedging their bets by sending their money abroad, exploiting all the available loopholes. Whichever scenario China follows, it looks like the flood of Chinese money will increase. Political uncertainty will produce more flight capital, while continued stability and growth will generate more wealth, some of it going abroad.

‘High-flying managers in demand from family offices’, Hugo Greenhalgh, Financial Times, 08.02.2016

‘Chinese family money fills gap after retreat of the wealth funds’, Henny Sender, Financial Times, 30.03.2016

EXCESSIVE COMPANY PROFITS DAMAGING US ECONOMY

Profits are supposed to be good for an economy, but The Economist argues strongly and persuasively that US corporate profitability is much too high, for unfair reasons, and needs to be reduced, for the sake of the economy and capitalism itself. This may not be music to the ears of the many fund managers wedded to the fortunes of the bigger, publicly quoted equities, but the statistics are telling.

A suspicious fact points to incumbents lasting for longer because of reduced competition

The US was once regarded worldwide as a land of opportunity. But two-thirds of Americans now believe that the economy is manipulated in favour of vested interests, opportunities are confined to the elite and it is no longer the haven of free enterprise. The rise of Donald Trump and Bernie Sanders is widely attributed to the fury at this situation. Their campaigners often blame free trade and Wall Street, but the figures suggest, in The Economist’s words, “a naughty secret” of US firms – namely that operating domestically is much easier, with return on equity 40% higher than in foreign countries. Profits relative to GDP are nearly at record levels.

These high profits may be justified if they arose from brilliant innovation or good long-term investment policies. But a suspicious fact points to incumbents lasting for longer because of reduced competition. Very profitable US firms now have an 80% chance of remaining so ten years later, compared with a 50% chance in the 1990s.

The Economist’s explanation is that more concentration has reduced competition. According to census data analysis, more than 60% of the country’s almost 1,000 industries are more concentrated since 1997, and a tenth of the industries are dominated by only a handful of firms. Since 2003, $10tn of mergers has raised concentration further. Many firms in these deals promised to reduce costs, adding 10% to profits rather than passing on the gains to consumers. If these profits are not reinvested or spent by shareholders, demand can be depressed. A tax system encouraging corporations to not repatriate foreign profits makes matters worse. If US firms reduced prices leading to profits falling to historically normal and uncontroversial levels, consumers would find their bills 2% lower.

Regulation also has an adverse effect on competition, but has intensified since the financial crisis of 2007/08. Big companies have an advantage here, in that they have more lobbying power than smaller companies and are better able with their larger resources to master the red tape. Lobbying has increased by a third over the last ten years. In the financial sector, although regulations were brought in to fence in the banks, there has also been the unintended consequence of shielding them from new rivals. Against this background, it is not surprising that small company formation is at its lowest rate since the ‘70s.

Furthermore, the ability of large companies to enter new markets is inhibited by their large institutional investors pushing for their focusing on only a few activities and keeping margins high. The investment maestro Warren Buffett makes a particular virtue of companies that have established moats around themselves to guard against competitors.
Most politicians’ solutions for the US’s economic ills represent counter-productive measures. Higher taxes discourage investment and minimum wage rises in *The Economist*’s view reduce employment. If the other bugbear of free trade is met with protectionism, this bolsters the dominance of domestic firms.

It is not surprising that small-company formation is at its lowest rate since the ‘70s

So *The Economist* argues that more competition is the answer to weakening the position, and bringing down the excessive unfair profits, of the big incumbents. Antitrust measures need to be strengthened and mergers that might result in excessive market shares and pricing power need to be monitored. There is a fear that Google and Facebook, though not yet rent-exacting monopolies, might become so, and that they are indeed valued by investors on this basis.

A second approach is to institute measures making life easier for small firms, and to end occupational licensing.

**Editor’s comment**

*The Economist* makes a fair point about the need for competition generally, but this may not apply to the companies with global reach, such as Microsoft and Google on the one hand and some of the big oil majors on the other. These groups, while not facing direct rivals in their speciality, still have to contend with possibly different products and services. Having a worldwide brand is also important in this era of globalisation, which requires commensurate size. However, the general point about competition is valid. If it is achieved, the long-term implications for equity markets and the mainstream active fund management industry which draws its sustenance largely from the latter could be dire.

However, what *The Economist* recommends is easier said than done, and, short of much more social protest, it might be difficult for the US political system to move in the right direction.


**CLOSET INDEXING UNDER REGULATORY SCRUTINY**

European regulators have come out with initial findings that closet indexing is rife in retail funds. In recent months, the rule makers across Europe, at both the national and the EU level, have either scrutinised closet indexing or announced their intention to do so.

These include the national authorities of Italy, Ireland, Luxemburg and the UK, which together account for more than a fifth of global retail-fund assets. Norway, Sweden and Denmark have been studying the problem for some time, and the German regulator BaFin has also announced an enquiry.

The European Securities and Markets Authority (ESMA) published its preliminary results in early February. It found that between 5–15% of a sample of 2,600 Undertakings for Collective Investment in Transferable Securities (UCITS) equity funds domiciled in EU member states could potentially be closet indexers. It examined the performance and disclosure documents of these funds between 2012 and 2014, covering funds with over €50m that were launched before 2005, with fees exceeding 0.65% and not classified as index-tracking UCITS. ESMA stated that, in partnership with national regulators, it will take a closer look at the issue. Definitions of active and passive management, setting out a clear distinction between the two, would be considered.

The regulator found quite a few examples of misleading material

The Italian regulator looked at its ten largest domestic asset management groups. A spokesman said that remedial action was taken against some of them, which it declined to name. They were made to modify fund documents, to ensure consistency, and the regulator plans a further investigation.

After a year-long investigation, the UK’s Financial Conduct Authority (FCA) came up with the most detailed disclosure of findings. It examined marketing material from 19 asset management companies, and 23 actively managed funds with combined assets of £50bn. The documents analysed included the mandatory key investor information documents (KlIDs) containing the short summary that must be provided to retail investors describing the fund, its strategy and key features in clear language.

The regulator found quite a few examples of misleading material. Seven
KIIDs did not have clear descriptions of how they were managed. Three of the funds had only limited freedom to deviate from the benchmark, but this was not disclosed. One of the funds had used jargon that a retail investor would not understand. In three cases, actively managed equity funds employed enhanced indexing but did not properly disclose it in terms of what the index was, or how much freedom was available to deviate from it. Two funds had large passive holdings in approximately 20% of the portfolio, but this was not revealed. However, a spokesman for the FCA said there were no extreme examples of closet tracking, defined as deliberate dishonesty.

The FCA did not look at charges, because it is not a price regulator. Both the FCA and ESMA declined to name the companies involved. So did the Italian regulator. Their refusal to name and shame, despite many campaigning for the revelation of the firms, was on the grounds that their findings were inconclusive.

Editor’s comment
Both the FCA and ESMA are very right to firmly reject any disclosure of the names identified by them as potential closet indexers. Susicion is a far cry from actual guilt, particularly in the case of index-hugging, where no actual offence has yet been defined.

It is another matter if the marketing material goes contrary to the actual practices and policies at the companies concerned. ESMA having based its investigation partly on past performance is questionable, as it is not a reliable indicator of closet indexing. Even highly active managers can and often do produce merely average performance. This does not mean that they are closet indexers by any stretch of the imagination. If, as reported, ESMA has been guided by performance, then it might be misguided.

Both the FCA and ESMA are very right to firmly reject any disclosure of the names identified by them as potential closet indexers

This regulator has the reported ambition of defining active and passive management, but it is taking on a very tricky challenge. Identifying passive is simple enough, but doing so with active goes to the heart of what closet indexing is. The problem of defining closet indexing, let alone identifying it, is complex and ESMA could have a difficult job in bringing it off. These issues are discussed in the following article.

‘Up to 15% of EU funds could be closet indexers says ESMA’ Andrew Pearce, Financial News, 08.02.2016


‘Pressure to reveal closet trackers intensifies’, Madison Marriage, FTfm, 15.02.2016


This is the first of two related articles. Please see the next article on ‘Flawed identification of closet indexing’.
FLAWED IDENTIFICATION OF CLOSET INDEXING

While European regulators have found cause for suspecting extensive closet indexing, a precise definition on a sound basis of exactly what `closet index' means is still to be formulated. Without such a definition, no action taken against its occurrence could possibly be considered fair.

There are two aspects to the term `closet indexing'. First, `closet' indicates undue secrecy, deceptiveness or even outright dishonesty. Second, `indexing' in this context means a portfolio being managed close to its benchmark, in other words, index hugging.

The huge problem in both aspects is identifying exactly what these words mean for the purpose of potential regulation. Secrecy is not a black and white matter, and how close does `close to the index' mean?

Secrecy is the more qualitative concept and, precisely because of this, is more difficult to define. Closeness is quantifiable, but needs to be precisely measurable (see box).

Extract from ‘Closet indexing – the dark art of investment’, Investment Management Review, April 2015

The concept of hugging closely is easy to grasp even in investment management, but this can be a matter of degree, and objectors to closet indexing need to spell out what they mean quantitatively, with parameters identified and thresholds set.

As it turns out, one parameter alone cannot pinpoint closet indexing, but the concept of `active share' (AS) has received much credibility as a primary measure and is fast gaining status as the key identifier. Two other variables that are considered along with this active share are tracking error and costs, but the active share is the easiest to measure, being the proportion of stocks in the portfolio that differ from constituents of the index. By this measure, 100% indicates fully active management and 0% as the other extreme indicates closet indexing or genuine passive management.

The original concept of active share was developed by Yale professors Martijn Cremers and Antti Petajisto. One of their main conclusions was that funds with the highest active share significantly outperformed those with a lower active share and displayed strong performance persistence. They suggested a simple rule for investors to follow: the active share threshold should be set at 60%, and portfolios below this level considered closet indexers.

Overall the statistical evidence supporting the active share concept is inadequate. Are there then fundamental reasons in theory for believing in the active share? Straightforward logic suggests the very opposite.

Other metrics suggested for identifying closet indexing are tracking error, the costs of running the fund and portfolio correlation with the benchmark. Among these various metrics, active share is the one that has gained the most currency. Regulators, campaigners against closet indexing, the investment management industry and the media have all cottoned on to this as the key measure. An increasing number of mutual funds and fund management houses have been boasting of their active-share results. Leading investment consultants also now focus on this metric, so much so that some large pension funds have listed active share as an important criterion for selecting their fund managers.

The widespread following of active share rests heavily upon the implication drawn from Cremers and Petajisto's 2009 paper that active share is a good predictor of future performance. However, an article in the prestigious Financial Analysts Journal (FAJ) by Andrea Frazzini, Jaques Friedman (Principles at the highly respected fund management organisation AQR Capital Management) and Lucasz Pomorski (Vice President at AQR) has analysed the same Cremers and Petajisto paper and pointed out that the implications have been misconstrued. What is widely ignored is that the active funds identified in this paper largely have benchmarks in the
small- and mid-caps sector, while the portfolios identified as closet indexers were measured against large-cap benchmarks. The different correlations of the two sets of portfolios against their respective benchmarks distorts the analysis and causes confusion.

A true ‘apples versus apples’ rather than ‘apples versus oranges’ analysis requires comparing portfolios of active and less active shares (meaning less than 60% active share) that are measured against the same benchmark. On this fairer comparison, Frazzini, Friedman and Pomorski found no statistically significant difference between the performances of the above 60% and below 60% portfolios.

Other studies have supported the weakness of the active share argument, though some less rigorous evidence has been adduced in its support (see box).

David Schofield ... points out the vital importance of closely looking at the investment process

There is a huge danger in active share now developing a cult following, lulling all users into complacency, given that the key arguments are against reliance on it. Active share essentially amounts to saying that taking risks for its own sake is good whereas taking high risks which active share promotes can mean huge losses as evidence suggests.

What about the other metrics that have been suggested? Tracking error, regression and correlation again produce no reliable statistical evidence of outperformance. So the Frazzini, Friedman and Pomorski conclusion is that these other methods of concentration are not effective either.

In a well-argued article in the FTFm, David Schofield, President of the international division at Intec, Asset Management and previous holder of a senior position at Janus Capital, points out the vital importance of closely looking at the investment process when trying to assess the likelihood of future outperformance. He says that a fund that takes sizable active bets in an inefficient way may not produce good performance, while another manager making only small active bets could be extremely efficient at translating them into extra returns. (Also, see box.)

Overall the statistical evidence supporting the active share concept is inadequate. Are there then fundamental reasons in theory for believing in the active share? Straightforward logic suggests the very opposite. When the data is disregarded, what ‘active share’ implies on its own is that deviating substantially from the benchmark has the best chance of producing good performance. If this were true, we wouldn’t need professional fund managers at all. Any person picked from the street at random with zero financial knowledge could be asked to select from a list of shares a portfolio that excludes the benchmark constituents, thereby achieving maximum active share. So, active share makes sense, even if the statistics bear it out, which they don’t, only if there is separate evidence of the required skill. The fact that such skill is hard to spot, as is well known, makes the active share concept highly suspect and even worse.

There is another dimension to closet indexing which the regulators are ignoring, rightly with the FCA saying it is not a price regulator. The issue is one of fees. The authors of the FAJ article point out that while the active share is no predictor of performance, it has a bearing on fee levels. A very low active share does suggest very low risk and if the risks are close to passive then there is a case for charging fees also close to what passive portfolios may be. This is a matter of considerable importance to investors but something regulators need to keep out of.

Editor’s comment

The question of excessive secrecy is even trickier than quantifying closeness to the index. It is interesting that the FCA has not found evidence of deliberate dishonesty. The Italian regulators have also merely responded by asking for literature to be modified, without any further action at this stage.

Much marketing material in many industries uses hyperbole in its advertisements, and few take it seriously. There is a line between

Extract from ‘Closet indexing – the dark art of investment’, Investment Management Review, April 2015

The conflicting results from the various studies indicate that active management can work some of the time but not all the time. When it does not, staying close to the index will be appropriate temporarily, but this process has developed such a bad image that very few people are likely to admit to it.

Hugging the index is perfectly respectable under some circumstances, even on an ongoing basis, if institutions want low risk relative to the index. Consider a portfolio solely with index stocks, for example the FTSE 100 holdings, the portfolio having the same stocks but each of the weightings deviating plus or minus substantially from the index such as 200% or 25%. The active share could be small but if dynamically managed with weightings varied then the process represents active management. This would also be justified by the need to focus research attention on a stable widely covered universe that is easily understood by investors. The active share will be completely misleading.

However, a much larger study of the US equity market from 2004 to 2014 for Nomura, by Joseph Mezrich and Yasushi Ishikawa, came to a different conclusion. They looked at US equity funds with high active shares using data from the Center for Research in Security Prices. The database from which this study was drawn was importantly free of survivor bias, whereas the same perhaps could not be said of some of the other studies. The study indicated that closet trackers outperformed the other groups, including those with higher active shares, in seven of the 11 years from 2004 to 2014. Their conclusion was that active share was not a reliable indicator of fund manager success, at least not over the past decade, and is perhaps overrated as an investment tool.

In rebuttal, Evan-Cook pointed out that the Standard & Poor’s 500 in the US is highly diversified and not easy to beat, whereas in the UK market the index constituents have high proportions in mining, oil and banks, and that active management could therefore bear fruit, in avoiding these sectors at appropriate times. The same is said of small and concentrated markets such as Sweden’s.
exaggeration and misrepresentation that is not always easy to identify. Any errors reflect over-enthusiastic marketing rather than deliberate falsehood. The Italian regulators’ reaction and the FCA not finding any deliberate dishonesty suggests that many of the problems could be dealt with in a light touch manner.

David Schofield uses the word ‘witch-hunt’ to describe some of the more virulent attacks on supposed closet indexers. The anti-closet-index campaign, in demanding that the regulators publish the names of those who might be closet indexers, comes under this witch-hunt category, given that none of them have been proved guilty yet, nor is there any indication that any strong case exists against them.

It is vital that the regulators identify more closely what sort of index hugging justifies the closet index description. Their definition needs to be clear to all concerned.

Why investors go for large-cap portfolios vis-à-vis small-cap ones is very pertinent. The former, consisting of massive, well-established and relatively safe companies, are obviously considered lower risk, and investors going for them are influenced by this. On the other hand, the smaller-cap portfolios tend to be backed by those who want the high returns while accepting the commensurate higher risks. Therefore, it is more natural for large-cap portfolio managers to stay somewhat closer to the index than their smaller-cap counterparts.

David Schofield uses the word ‘witch-hunt’ to describe some of the more virulent attacks on supposedly closet indexers

Furthermore, in the case of the large-cap portfolios, it is more difficult to outperform, except for the highly skilled, as the big companies are so well researched. In addition, the large companies are, by virtue of their size, much more vulnerable to macro-economic shifts than the smaller firms, and betting on these can frequently even be considered speculative. There are many more dud companies in the smaller-cap universe, which are relatively easy to spot and can be excluded, making the task of outperforming a bit simpler than in the case of large-cap groups. So the original paper, mixing the large-cap and small-cap comparisons, is further undermined.

The big fund management institutions do not seem to have commented, or are staying out of the debate, going by the lack of reference to this in the financial media. But they should get involved, and try to stop regulators possibly trespassing on the investment process, apart from stamping down on misleading marketing material.

If not, regulators will have to make judgments and be dragged into supervising investment processes, which could have serious repercussions on the very nature of talented and efficient fund management, with unintended consequences for capital allocation in society.

‘A witch hunt around closet indexers is gaining momentum’, David Schofield, Financial Times, 18.04.16


‘Closet indexing the dark art of investment’, Investment Management Review, April 2015

This is the second of two related articles. Please see the previous one on ‘Closet indexing under regulatory scrutiny’.
NEW INFORMATION POWERHOUSE CHALLENGING BLOOMBERG AND REUTERS

Two data providers, IHS based in the US and Markit in the UK, are combining in a $13bn stock-only deal to establish a new financial and corporate information group that has the prospect of taking on the giants Bloomberg and Thomson Reuters. This deal is the largest in the financial and corporate information sector in two years, amongst many others that have taken place in recognition of the soaring value of market intelligence. The shareholders in IHS will own 57%, while Markit will hold the rest, but the group will shift its domicile to London, where it will benefit from a lower corporate tax rate in the low to mid-20s. Some operations will remain in Colorado in the US. Markit’s founder, Lance Uggla, will take over as Chairman and Chief Executive of the new entity in 2017, on the retirement of the current holder of these roles at IHS, Jerre Stead. Daniel Yergin, the Pulitzer Prize-winning author and well-known researcher, who is currently Vice-Chairman at IHS, will hold the same position in the new group IHS Markit. The new group expects to make $125m of cost savings in three years and hopes to use the cash flow to make further acquisitions. It has promised share buybacks of $1bn in 2017–18.

Markit, which was started up in 2001 by a group of credit derivative traders from a shed in St Albans, UK, has become an important provider of data to Wall Street. It was initially backed by a dozen top banks, including Bank of America, Goldman Sachs, Deutsche Bank and JPMorgan Chase. It was listed in New York in 2014 and has stepped up acquisitions since then. Thirty deals have been done in the last 15 years.

IHS provides analytics to governments and businesses in the corporate sector. It was founded in 1959 and went public in 2005. It is involved in 140 countries and has 9,000 employees in 32 of them. It has also been on an acquisition spree, having done 74 deals in the last decade, buying data providers and rival analytic firms.

The merger is not only a response to the explosion in the demand for information, but also reflects defensiveness. There have been some adverse developments in recent years. Markit was hurt by the European Commission’s investigation into whether it was involved in the credit default swaps collusion, but has faced no charges in the five-year old investigation. Thirteen investment banks were cleared last December for lack of evidence, and Markit insists that it has acted properly and will continue to co-operate fully with the Commission.
The Markit and IHS get-together has huge potential synergies with respect to customer bases, types of data and what is done with the information. The customer bases do not overlap. IHS’s corporate base fits in nicely with Markit’s strengths in the financial services sector, creating the strong likelihood that the services of both components can be provided to each other’s customers. It is considered a superb opportunity to marry corporate and financial data. IHS provides data on various industrial sectors, including aerospace, defence, security and energy, to over 50,000 companies.

**Bloomberg itself started as an interloper, when Reuters ruled the roost decades ago, and it went on to eclipse its main rival in several aspects. IHS Markit will have a tougher job in repeating this feat.**

IHS data is currently largely taken by governments and large companies wanting to know more about particular trends in oil production or other commodities for instance, but does not add too much value to this data.

Markit, on the other hand, gets hands-on with data and creates a lot of valued-added services, such as indices and valuation products. It now has the potential to repeat this process with IHS data and sell it to Markit’s financial customer base, mainly asset managers, hedge funds, banks and insurance companies. IHS’s corporate and government customers will also enable Markit to create extra value added from the IHS data and offer them to the corporate sector.

The US government has been clamping down heavily on the process of tax minimisation, referred to as inversion, whereby large US companies try to escape relatively high tax rates in the US by taking over a foreign company and shifting its domicile overseas.

Several big mergers have floundered recently as a consequence, including the takeover of the Irish drug company Shire, and other blockbuster takeovers. In IHS Markit’s case, it is generally believed that the tax inversion problem will not be a barrier, as there are genuine strategic reasons for the merger, and also because the new company will be driven by Markit’s current head rather than by IHS on an ongoing basis from 2017.

**Editor’s comment**

IHS Markit has a lot going for it in terms of synergies, but there are still potential doubts. Though it has every chance of taking on Bloomberg and Thomson Reuters, this will not be easy. Bloomberg itself started as an interloper, when Reuters ruled the roost decades ago, and it went on to eclipse its main rival in several aspects. IHS Markit will have a tougher job in repeating this feat. When Bloomberg came to the fore, information provision was still not fully out of the pre-IT age, whereas the new group now has to contend with two well-entrenched players and the inertia to changing horses of top decision takers among banks and asset managers. Ferocious competition from the exchanges in their new incarnation as data suppliers will make matters even more difficult.

The entrepreneurial track record and dynamism of Uggla is probably one of the new group’s biggest assets and perhaps increases the chances of it making it big time. The real expansion might be in the corporate sector. This was under-exploited by IHS, and Markit could make waves here. Given that the financial services sector is no longer in an obvious high-growth mode, this might be the real future for IHS Markit.

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important’ is that should they fail it might set off a chain reaction of financial instability. The insurer’s argument was that the life insurance sector did not cause the financial crisis and that existing state regulations in the US were already onerous enough. It pointed out that its core liability, consisting of potential payouts of insurance claims, arises only over long time horizons, in contrast to highly liquid bank deposits, which can be subject to panic withdrawals in the very short term.

Federal Judge Rosemary Collyer reversed the Financial Stability Oversight Council’s (FSOC) decision in 2014 to classify MetLife as a SIFI. The court’s order indicated strong doubts that MetLife collapsing could cause the chaos that regulators fear. Judge Collyer said that the regulators had focused exclusively on the possible advantages to the system of classifying MetLife as a SIFI, ignoring the costs, which was unreasonable. Her explanation suggested that the government had been arbitrary and capricious.

She minced no words in openly criticising the very process of designation, saying “that’s not a risk analysis. That’s assuming the worst of the worst”. Collyer attacked the FSOC for failing to assess MetLife’s vulnerability to serious problems, to explain how it could affect financial stability and to consider how the added cost of regulation could adversely affect the company.

The FSOC’s designation process in general is based on six criteria: size, leverage, interconnectedness, liquidity, maturity mismatch between assets and liabilities, and the regulatory regime already in place for the company.

With $900bn of assets, MetLife’s size is beyond contention. The real debate focuses on how trouble at MetLife would cascade through the financial system. The regulators’ belief is that any problems would ripple through the economy as policy holders wrote down the value of their claims, the group’s access to short-term funding dried up and it was forced to sell assets. As the argument goes, such forced sales could set off havoc among counterparties.

The government is not passively accepting the ruling. The US Treasury Department, in charge of the FSOC, has confirmed that it will appeal. It is felt that the appeal courts might be more sympathetic to the government in view of the liberals added by President Obama to the Court of Appeals.

It is widely believed that the FSOC ... has been weakened as a result

Judge Collyer’s MetLife ruling has already set off repercussions. MetLife had previously said that it would hive off its US retail business, with its $240bn in assets. The immediate implication for the company is that it will not have to do this in order to become smaller. GE Capital had by mid-April filed an official request to be removed from the SIFI list, having already downsized by shedding $200bn of assets. Prudential Financial, another big insurer on the SIFI list, might also appeal, according to some.

The MetLife decision will have much fewer implications for banks, because the Dodd-Frank law unambiguously states that any bank with assets exceeding $500bn will be considered a SIFI. But other insurers could follow MetLife’s lead in rebelling.

The situation governing insurance companies will remain unclear until the judge’s full ruling is issued at a later date. The question has arisen as to whether her judgment has centred more on MetLife’s specific situation or whether it will apply to the insurance sector in general. If the latter, it then opens the door for AIG or Prudential, the two other insurers classified as a SIFI, to challenge the decisions.

The exact rules for non-bank SIFIs have yet to be finalised. A major plank of post crisis regulation has now been put into question. There is much speculation about whether other groups will follow MetLife and try to avoid this classification, with its onerous regulatory burden and possible extra capital requirements.

It is widely believed that the FSOC (which includes representatives of the Treasury, Securities and Exchange Commission (SEC) and Federal Reserve) has been weakened as a result. The ruling is considered a massive embarrassment for the FSOC and raises questions about the regulatory process. It is also believed that it makes it more difficult for regulators to control the increasing risks in asset management and that similar proposals by the Financial Stability Board expected in the summer might lack authority. Regulators are coming under pressure from a resurgent financial sector and a political push for deregulation, and are now on the offensive in both asset management and insurance.

Editor’s comment

Though MetLife has won the day for now, it is not certain that its triumph will endure, given that the Treasury is appealing. At any rate the ruling has brought into focus the exact procedures regulators have adopted. There is room to question whether they have been as systematic as they ought to have been. At the least it’s possible that there has been a communications failure on their part.

Sage and Hermes Research

This is the first of a group of related articles. Please see the next two on ‘BlackRock’s muscle effective against SIFI status’ and ‘Furious controversy surrounds US court ruling against regulators’.
BLACKROCK’S MUSCLE EFFECTIVE AGAINST SIFI STATUS

In contrast with MetLife’s pugnacity in throwing off its ‘systemically important financial institution’ (SIFI) status, BlackRock has achieved the same in a completely different way by making friends and influencing people within the Washington power structures. Rather than suing, it has relied on a more nuanced approach in lobbying through a mix of effective friendly persuasion and aggressiveness.

In the months immediately following the 2008 financial crisis, executives of the group had already started preparations for more federal scrutiny. Barbara Novick, BlackRock’s co-founder, began to oversee the company’s attempts to influence Washington, and in 2009 hired a lobbying firm that provided her with contacts in the government among regulators and politicians. As early as November 2010, Novick and others at BlackRock pointed out to Fed staff that asset managers did not pose similar risk as the banks to the financial system. The fund management industry, including BlackRock, became alarmed in late 2013 when a US Treasury Department’s Office of Financial Research (OFR) asserted that asset management firms were sensitive to shocks and might engage in herding behaviour that could amplify the problems in the financial system.

In rebuttal, BlackRock published a lengthy paper pointing out that, instead of the size of a manager or a fund, the regulators should focus on specific practices, such as leveraging, that might cause risk. The group was alarmed when in 2014 it obtained a copy of a confidential Federal Reserve presentation at a meeting in Madrid that claimed some parts of the BlackRock group were posing the same systemic risks as the big banks. The group's executive responded angrily, shifting to an aggressive note and accusing the Fed of having wrong information in that presentation and being seriously mistaken.

The Financial Stability Oversight Council (FSOC) at the time, responsible for the final decision on the topic, was frustrated by BlackRock wrongly characterising the importance of the document in their recent process, and some have said that the resulting tiff has damaged the group’s reputation within the Obama administration.

While the above was a touch aggressive, BlackRock’s success in fending off SIFI status did not rest on this episode. Its objective was achieved when in late 2014 the FSOC shifted ground, saying that it would focus on products and activities rather than the regulation of individual asset management firms.

The general lobbying effort by BlackRock has exploded since the financial crisis

Though BlackRock has made the efforts, other giant fund management houses, such as Fidelity and Vanguard, who have also resisted SIFI status, will benefit. But BlackRock has stood out with its endeavours in influencing government officials. It has used a blend of public comments and documents as well as private lobbying of politicians.

The general lobbying effort by BlackRock has exploded since the financial crisis. In 2008 it did not spend anything on lobbying at all. Even by the end of 2009 it had registered only a single in-house lobbyist in Washington. But since then it has spent over $14m on lobbying, compared with $13m on the part of Vanguard and $23m by Fidelity, according to the Center for Responsive Politics. It is now considered one of the US capital’s most powerful and prominent financial firms, with its top ranked executives being on first name terms with the treasury secretary, the banking regulator and the staff of many congress members.

Editor’s comment
BlackRock has several advantages in comparison with MetLife. It is understandable why the insurer had to go to court to ventilate its arguments. On the other hand, the strong personal connections between those at the top in BlackRock and senior politicians and officials in the government is clearly no disadvantage in getting a respectful hearing and being treated as authoritative.

On a practical level, at the onset of the crisis BlackRock was closely involved in advising the US government in dealing with several aspects of the problems that were highlighted. All this meant that it had a head start in persuading the authorities.

Furthermore, the fund management industry is very different from the insurance industry, and the former as a whole has got its point across that it’s not size but other issues that matter. In the case of insurance companies, size seems to remain a big factor. Related issues are examined in the article that follows.

BlackRock succeeding where Metlife failed through persuasion says much for the effect of lobbying on regulators. This is not always positive and prone to misuse. In Europe, regulators are being criticised for being too influenced by the big banks to the detriment of retail customers.


This is the second of a group of related articles. Please see the previous one on ‘Too big to fail – US court castigates regulators’ and the next one on ‘Furious controversy surrounds the US court ruling against regulators’.
FURIOUS CONTROVERSY SURROUNDS US COURT RULING AGAINST REGULATORS

The US court’s verdict against the government is not yet a done deal as the Treasury is appealing against it. In the meantime, however, it has attracted furious debate on both sides of the argument, with respected and authoritative commentators weighing in. There is also the danger of the controversy becoming a political football, given its intrinsic nature in part due to the interaction between political power and the very top of the judiciary in the US.

Jacob Lew, the US Treasury Secretary, attacked the court decision in support of MetLife as mistaken and, writing in The Wall Street Journal in some detail, says that, despite cheers to the contrary by opponents of financial reform, efforts to depict the decision as a positive are dangerous.

Jenkins felt that the judge had previously shown “barely disguised disdain” for Obama’s Government

Lew claims that the Financial Stability Oversight Council (FSOC) has worked carefully and judicially and has so far identified only four non-bank financial companies that could pose a threat to the system should they become distressed and that therefore need heightened supervision. Lew asserts that the FSOC’s non-bank designation authority is an important tool that the authorities will continue to defend.

Products and activities in the asset management industry are being examined, as it is a fast-growing sector with increasing importance. Two main risks as well as leverage have been identified by the FSOC: liquidity and redemption risk. With respect to liquidity redemption risk, the FSOC has identified a requirement for strong risk management practices, to avoid inability to meet redemptions, as well as a need for clearer guidelines on the extent to which illiquid or limited liquidity holdings should be invested in. Lew pointed out that enhanced reporting and disclosure of mutual funds would help.

On the leverage front, the risks are concentrated among the larger hedge funds, but data is lacking for the understanding of such risks. Another area highlighted by the update concerned the use by asset
managers of one of a small group of service providers for important functions, such as data collection and securities lending activities.

In criticising Collyer’s judgment, the Financial Times columnist Patrick Jenkins referred to a bias against the Obama Administration. Jenkins felt that the judge had previously shown “barely disguised disdain” for Obama’s Government. Apparently, in a lawsuit in May 2015 relating to the Obama Care Plan for a medical insurance system, she had asked one witness whether impeachment was an option. Clearly, Jenkins was taking the side of the regulators and considered that Collyer, as a George Bush appointee, was swiping at the President and not just against the Government’s landmark SIFI reforms. Jenkins felt that the FSOC, with its expert mandate and responsibility for financial stability, was being “torpedoed by an inexpert judge”.

Another attack on the ruling was made by Mark Whitehouse, an editorial commentator on economics and finance at Bloomberg, who has won a Pulitzer prize as part of a team. He feels that the ruling has damaged reforms meant to protect the American public and that the Government must try to reverse it. According to him, the FSOC does not interpret systemic importance as needing to assess a company’s vulnerability; it only needs to analyse their systemic consequences should trouble occur. He also feels that calculating potential losses is not relevant. His conclusion is assuming that a crisis could affect insurers is not out of court and cited the disaster that nearly brought down AIG, the US insurer, along with the banking system, owing to derivatives losses.

The opposing stances taken by The Wall Street Journal and Pollock of R. Street Institute on the one hand and Patrick Jenkins of the Financial Times points to the Metlife judgment having in part become a political football. The situation arises from the US judiciary system not being fully independent of the political system in that the top judges are appointed by the President with their ideological bent being a criterion.

Judge Collyer’s opinion that the regulators should have looked at the costs as well as benefits of the SIFI classification is a powerful remark that also needs to be considered in a wider context. Many of the rules introduced worldwide since the financial crisis have a whiff of either panic or undue political pressure about them, and perhaps also of insufficient thought being given to unintended consequences in terms of wider damage to the economy, particularly in the long term. The issue of wider costs being ignored has been highlighted many times by industry leaders.


This is the third of a group of related articles. Please see the previous two on ‘Too big to fail – US court castigates regulators’ and Blackrock’s muscle effective against SIFI status’

Editor’s comment

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The Wall Street Journal in its editorial columns came down on the side of Collyer, saying that although she was appointed by President George Bush, she is a respected moderate among the appointees of former Republican Presidents. The journal’s opinion is that Collyer has ruled on an issue where the FSOC “looked like a rookie” and was exposed for sloppy mistakes of administrative procedure, making claims about a company that it did not have the evidence to support.

Jenkins’ opinion was also attacked by Alex J Pollock, a distinguished senior fellow of the R Street Institute in Washington and former CEO of the Federal Home Loan Bank of Chicago. He said that Jenkins believes that bureaucratic agencies should not be checked because they know best how to control systemic risk, and he goes on to claim that there is little evidence for this latter ability, with the agencies all failing to foresee the major crises of not only this century but also the 1930s, ’70s and ’80s. His opinion is that governments themselves are the main sources of systemic risk.

Backing forestry is appealing from a variety of different perspectives. Aesthetically, everybody likes greenery. Forestry is a hedge against inflation and has a low correlation with other asset classes. But what is most appealing and distinguishes it from most other investments is the inbuilt biological growth, reassuringly visible year by year. According to Maurice Ryan, Timber Marketing Manager at the Irish forestry-management company Green Belt, the long-term organic growth of the trees allows investors to ride out the low points and to wait for the highs. These investments are also less volatile than other asset classes as a result.

Nils von Schmidt, Timber Fund Manager at Aquila Capital, warned that the inflation hedging and low correlation characteristics only apply if investments are in pure forestry, excluding processing facilities. This alternative investment firm runs two retail and two institutional funds and can invest between 10-30% in...
processing facilities. Other funds can invest more. Some retail funds do not invest directly in timber, including the Pictet Timber Fund, a sub-fund of a Société d’Investissement À Capital Variable (SICAV) vehicle domiciled in Luxemburg. It also invests in the shares of timber management companies and any volatility of equity markets feeds through into the fund, according to its Co-Manager, Gabriel Micheli.

A mix of trees is considered an end in itself and is very good for sustainability

The low correlation advantage has lessened in the last four to five years, with timber having become more correlated with other asset classes, according to Bob Flynn, a director at Risi, an information provider on the industry. However, the quoted sector has the advantage of liquidity lacked by direct investment, allowing many retail investors to access it, in particular, small investors without the money to invest directly. According to Micheli, there are often good deals to be had on the listed market, often allowing them to buy high quality timber land on better terms than private equity investors.

Timber is a long-term investment, and pension funds invest either through a similar account or pooled products for a typical fixed 8–15 year time horizon, and sell after that. According to Flynn, some are currently trying to develop more long-lasting (evergreen) funds, but the secondary market is still at an early stage, which might be an inhibition. Few retail investors, however, will be happy with the really long term. For pension funds, a timberland investment management organisation (TIMO) is a common route for pension funds.

Risk management is another important feature, as the right kind of forest can diversify the risks. For instance, Aquila Capital is pursuing this approach in a 3,100-hectare forest in three units at different locations in Scotland. The process involved amalgamating the three units to form a model forest. Ideally, young trees exhibiting vibrant growth and appreciating in value are combined with cash flow from harvesting mature trees. Scale is vital, in order to diversify among different types of trees.

The US housing market is the largest user of wood worldwide

A mix of trees is considered an end in itself and is very good for sustainability. Conifers are the most heavily traded, constituting usually a large proportion of a typical forestry portfolio, and Aquila Capital has 70% in conifers. It is also good to have a mix of conifers and deciduous trees, with different end products. Typically, the deciduous variety is used for furniture that has a fashion element, and Von Schmidt suggests that visiting a kitchen showroom might be a revelation. Last year’s UN climate conference in Paris helped to promote biomass fuel, and in both Ireland and the UK there is pressure to use more renewables.

Perhaps surprisingly, clothes are another form of usage. Some semi-synthetics are partly made from wood and are more environmentally friendly than synthetics. Some 7% of clothes are derived from wood and the proportion is set to increase, according to Micheli. Plastics also can be sourced from wood, and these will decompose better. New engineered wood products are also increasingly used in building, and it is expected that some nano products will also be based on wood.

The demand from the US and Asia is likely to increase because of construction in housing. The US housing market is the largest user of wood worldwide. Here the recovery phase is currently sub-normal and expected to increase, according to Micheli. China and India do not have much forest, and need to create it as they urbanise. Market practices worldwide are different and many do not have the same standards as in developing counties. Proper due diligence and time spent in every jurisdiction is vital. Potential problems embrace provenance of title in South America and land tenure issues in Africa.

Timber does not travel very well and is sold only locally. So local knowledge is vital for investors. In central and eastern Europe, forestry is very similar to that...
in western Europe, but the communist legacy results in very different ownership and management problems.

According to Von Schmidt, the main risk in timber, even with the best forestry, is management. Biology is not just a plus in terms of inbuilt growth. Investors focus on biological risks such as fire and disease, and these are controllable by the right management. Overall risks vary around the world, ranging from high return in many emerging markets to low risk investment in Scotland.

Editor’s comment
Forestry shares with sectors such as infrastructure the characteristics of inflation hedging, low volatility and low correlation with other asset classes. Yet these properties have not insulated infrastructure investments from price fluctuations during the post crisis years, in contrast to the long-term stability enjoyed and expected when they first grabbed the attention of big investors.

The underlying reasons are twofold. First, as investors everywhere started chasing these safe returns, following the onset of the financial crisis everything was bid up until rates of return became similar to those available elsewhere, just as water reaches the same level if connected. Second, the entry of private equity investors and listed vehicles introduced a significant short-term element, which produced short-term price volatility. As yet, forestry does not seem to have the same cachet and the widespread interest as that enjoyed by infrastructure, and it may remain insulated from these negative influences.

Contrary to general understanding, forest-based products are not all bad, as in the West and other developed countries they tend to come from renewable and sustainable timber enterprises. The bad name comes from less developed parts of the world, such as the Amazon, Indonesia and the highly valued Carpathian Mountains (described as the last natural outpost in Europe). Sustainable forestry can make a strong positive contribution to the climate change issue as more trees on the planet alleviate global warming. Perhaps it should be classified as an impact investment with very good returns on top.

‘The future is wooden’, Fiona Rintoul, Funds Europe, February 2016

CO-INVESTMENT MAKING INROADS INTO TRADITIONAL PRIVATE EQUITY
Co-investment is changing the way in which institutions back private equity investments. The traditional model of clients, the limited partners (LPs) entrusting their money to the general partners (GPs), the owners of private equity firms, is now giving way to alternative ways of investing privately. The biggest institutions can consider investing directly in private equity. But the more common approach is for institutions to co-invest alongside the GPs in specific projects.

The principle of co-investment applies to institutions, not only partnering with private equity firms, but also clubbing together to invest privately, bypassing the buyout firms.

This has inevitably given rise to protests of unfairness, and many private equity firms respond by having a rationing system to avert accusations of arbitrariness. Some allocate the available co-investment opportunities on a pro rata basis. But this is not practicable if large numbers of clients want to co-invest.

For instance, Christian Marriott, a Partner at Equistone, said that...
capital it has available for syndicating through co-investment is typically €10m–€20m. Sharing this amongst all their clients (LPs) would be infeasible. However, not all do and in practice private equity firms often find that only the bigger clients want to co-invest. A variety of different systems are used. Another method is to identify a pool of, say ten, large investors who have the size and the desire to co-invest, and then to rotate amongst them as each co-investment opportunity arises. Often the selection is confined to those who are able to commit to the deal in a short time.

LPs who invest in the main private equity fund at the outset are often granted the right to co-invest as suitable opportunities arise. Some clients try to insist on this, but the firm may disagree on the grounds that it is unfair. Many clients do get such rights, however, and the largest ones sign up to sweetheart deals and negotiate preferential side letters. Some firms offer co-investments as a carrot during the original fundraising, as a way of differentiating themselves from competitors.

However, co-investment does not always lead to good results. There is a danger that the private equity firms make only the less attractive deals available for co-investment. According to a recent report from Preqin, the private equity data provider, half of LPs are looking for co-investment opportunities. There is concern that many of them will end up with lemons as they are allowed access to only the less profitable investments. Richard Howell, partner at Paris-based PAI Partners, said that it was scary that investors paid more attention to co-investment allocation than fund performance. Some peer review studies show that co-investment with GPs underperforms fund investing as well as direct investing, but other studies suggest that it outperforms fund returns.

Co-investment does not always lead to good results

The problem of getting bad apples can be avoided if the co-investing LP builds up a strong relationship based on mutual trust with the GP, but many institutional investors do not fully understand the need for building such deep relationships with other organisations, and do not have the capability of managing these relationships themselves.

Regulators are getting worried. The Securities and Exchange Commission (SEC) in the US is increasingly concerned about co-investment transparency. Marc Wyatt, Acting Director, Office of Compliance Inspections & Examinations, said in May 2015 that the SEC had detected several cases of investors in a fund not having been aware of others receiving co-investment rights. He said that disclosure is important, as these rights have economic value. Accordingly, many firms are moving to making the process more transparent.

The SEC in the US is increasingly concerned about co-investment transparency

Editor’s comment

The giant Canadian pension fund, Ontario Teachers’ Pension Plan, has made a name for itself as a pioneering co-investor worldwide, particularly in infrastructure, but it has built up the requisite teams over many years. Very few of the largest institutions have the patience and wherewithal to do this. The practice of co-investment has both positives and negatives. On the positive side, it is an effective way of cutting what are increasingly considered exorbitant GP fees, levied both directly from the LPs and indirectly through the charges they extract from the underlying portfolio investments, the profitability of which is naturally affected. On the negative side, the possibility of getting the less attractive deals is a real risk and only the favoured few who take the trouble to be selective can benefit. Much depends on the strength of the relationship between the co-investor and the private equity firm. Different institutions collaborating to bypass the private equity sector is an option, but then they have to collectively build a common private equity team or incur individual costs of in-house expertise. Neither of these is an easy option.

’surge for co-investments leaves some in the cold’, Dawn Lim, Financial News, 08.02.2016


’Who gets to share? The opaque world of co-investment deals’, Yolanda Bobeldijk, Financial News, 02.05.2016
A NEW FASHION IN IMPACT INVESTING

Editor’s introduction

Impact investing, which aims to provide a social benefit as well as an investment return, is becoming more popular, but there are still major hurdles. A new approach to overcoming one of these hurdles has become fashionable. Pure social investing is still very much in its infancy, but there are hopes that this sub-sector will also expand.

A cocktail of public, private and charitable funding

Impact investing is increasingly pursued by leading financial institutions, but the overall amounts provided here are still just a drop in the ocean in terms of what is required. The United Nation’s sustainable development goals need investments of $2.5tn per year, in areas such as healthcare and education for the poorest, as stated by the UN agency UNCTAD. An additional $13.5tn will be needed by 2030 to implement what was agreed at the Paris Climate Change Conference, according to the International Energy Agency.

Unfortunately, not enough public money is available and charitable sources are inadequate. The private sector needs to back projects in a big way for impact investing to really take off on the scale required. The problem is that the risks are either too big or not calculable. To cope with this, a newly fashionable concept is the idea of blended finance. This has gained currency adherence at the International Monetary Fund (IMF), the World Bank, and the World Economic Forum (WEF) in Davos. Public projects attracting private investment is not a new idea, but making it effective on a large scale is what is now being talked about.

For instance, the construction of rural roads or vaccination drives in Africa can potentially lead to enormous investment returns. But private investors are scared off by the risks. So the new idea of blended finance is to kick off the investment with a small amount of public and charitable money in projects that the private sector on its own has stayed cleared of. According to a WEF survey of 14 blended finance vehicles, this method is producing results. Every dollar of public money draws in more, often much more, of private sector investment.

A newly fashionable concept is the idea of blended finance

In Thailand, an entrepreneur hoping to build solar farms found commercial lenders unwilling to face the dangers. In 2011, IFC, part of the World Bank, together with a low-interest loan from CTF, a climate investment fund that is backed by several governments, provided loans of $12m. Three local banks subsequently lent a further $14m and by 2015 the company had attracted $800m, almost all of it provided by the private sector.

Another example points to an even more powerful structure. The Africa Agriculture and Trade Investment Fund (AATIF), a $146m fund investing in sustainable agriculture in Africa, has different levels of shareholders. The German Ministry of Development, KfW Development Bank owned by the German government and Deutsche Bank, which also runs the fund, will absorb any losses before the third tier of shareholders, the private investors, get affected. Losses have to exceed more than 50% of the funds’ net asset value before the last group gets hit.

Similarly, GaurantCo, backed by aid agencies, takes all the trickiest risks in infrastructure in poor countries and attracts $13.50 in private backing for every dollar it puts up. The Gates Foundation has put aside $1bn for loan subsidies, guarantees and other attractions for nervous private creditors.

Blended finance is still a niche. Recently, two global platforms came into being to match investors with projects. One of them, Convergence, has made 150 blended transactions in a database with a total value of $40bn, but the list is not complete.

Editor’s comment

Increasing pressure from socially conscious clients, including many pension funds and high-net-worth individuals, particularly the millennials, is a force for more impact investment by fund managers. But it is not clear how many have merely a token approach to the sector or are intent on putting in serious money. Perhaps governments need to consider fiscal incentives to encourage them more in this direction.

On the supply side as well, opportunities with acceptable risk are thin on the ground. The real value of the blended finance approach is not just the leveraging effect but also the risk reduction offered.


This is the first of a group of related articles. Please see the next two on ‘Social impact bonds growing’ and ‘Powerful pushes for green investment’.
SOCIAL IMPACT BONDS GROWING

Unlike other fixed-income impact bonds, a relatively new type of impact investment, the social impact bond, does not provide a predetermined return. The payback to investors is structured according to a Payment by Result (PbR) system, whereby the bonds pay out only if specific social goals are met. An example is payments linked to unemployment levels of migrants increasing faster than in a predetermined control group.

The growth in this sector has been pushed by the Social Impact Investment Taskforce, under the UK presidency of the G8 group of leading industrialised countries in 2014. Only 0.2% were PbR out of $60bn in assets among a group of impact investors in a survey by J.P. Morgan and the Global Impact Investing Network. This indicates that the sector still accounts for only a tiny fraction of the impact investment universe.

Various Nordic countries are also involved. Projects include those aimed at reducing homelessness and shortage of housing in Nigeria. The hope is that the need for private sector capital will lead to sensible frameworks that will encourage private investment, rather than just rhetoric.

Editor’s comment

The total currently invested in social investment bonds is miniscule. In part this is because they are new. It is also likely that payment by results is a strange idea to mainstream financial services institutions. Just putting money into projects will never be enough on its own, as socially conscious individuals are needed to run or supervise the projects. The question is whether there will be a sufficient number of such workers for this sector to grow to a significant size.


This is the second of a group of related articles. Please see the previous one on ‘A new fashion in impact investing’ and the next one on ‘Powerful pushes for green investment’.
EDITOR'S INTRODUCTION

While green investment has been catching on worldwide, it has still to reach serious levels. Two new developments have the potential to change matters.

Massive global impact from Chinese green bonds

China is turning to green bonds to help its five-year policy drive to clean up pollution. This will potentially provide a lift-off to a market that hardly existed just a few years ago. The country has begun to build a domestic green bond market. This is expected to bring in ¥1.5tn (about $230bn) for dealing with renewable energy and the environment. Accordingly, two Chinese banks raised a total of ¥30bn from green bond sales in January: Shanghai Pudong Development Bank ¥20bn and Industrial Bank Company ¥10bn.

In the period to 2020, the market might account for ¥300bn per annum, according to Xu Nan, Senior Political Analyst at the Climate and Energy Finance research centre under the Central University of Finance and Economics. This figure will comprise a substantial addition to the ¥46bn in green bonds sold worldwide in 2015, as provided by Bloomberg New Energy Finance. It has estimated the value of deals to have doubled in the past two years. The total of outstanding bonds might possibly double in 2016 to ¥1.58bn compared with the previous year, according to HSBC Holdings. Under these circumstances, China could become one of the largest green bond issuers globally.

“China will be the main battlefield for future energy saving and emission reduction with rising demand for green financing”, said Lu Zhengwei, Chief Economist of the Industrial Bank Company on 2 February. It also “means that China’s efforts to protect the environment and cut emissions are put under the international supervision of investors who buy the bonds”.

China’s green plans will also do its economy plenty of good, refuting the widely held notion that greenness conflicts with growth

According to the report, public funding should play a leveraging role and facilitate the entry of large private fundings in the low carbon development of Chinese cities.

“The financial sector should establish a system to differentiate potential projects based on the environmental benefits, so that green finance can effectively direct funding to low carbon urbanisation.”

Chinese companies started to access the global green bond market last year. In July, the country’s first dollar-denominated bond, which had a maturity of three years, was issued by Xinjiang Goldwind Science and Technology, which raised $300m. Then, the Agricultural Bank of China
raised ¥600m of two-year green bonds, which were heavily oversubscribed.

Hitherto, bank lending has been the major source of finance for environmental projects in China. According to the China Banking Association, 21 major Chinese banks had lent more than ¥6tn yuan by the end of 2014 on this account, representing about 10% of their total lending activity.

It is considered that green bonds may actually be cheaper than traditional bank finance. The Shanghai Pudong issue will pay 2.95% annually on its three-year bond, compared with over 3% for financial bonds issued by commercial banks and the central bank's benchmark rate of near to 5% for loans up to five years.

Fund management houses are under increasing pressure to consider green investments ... Hitherto, asset owners and asset managers were hampered by the lack of a general definition of what is green

Editor's comment

Compared with the massive investment universe globally ($100tn plus), and with what the planet needs, the size of the green bond market is still tiny. But the trillions of dollars that China plans to raise will make this market much more significant in global terms. In fact, it might catalyse the rest of the world to follow suit, leading to green bonds becoming a substantial global asset class in its own right.

China's green plans will also do its economy plenty of good, refuting the widely held notion that greenness conflicts with growth. China cleaning up on the scale planned will actually lead to much of it spent on the ground, boosting employment and possibly averting social instability. China badly needs to change the emphasis from manufacturing exports to domestic consumption, a feat, if it brings it off, that will keep the economy going in a less lopsided, safer way.

Furthermore, consumption triggered by the green bonds will be of the best possible type: not short-term goods, but a long-term reduction of Chinese pollution consequently leading to increases in productivity.


‘China’s cities need $1tn green finance to cut pollution’, Bloomberg, 07.06.2016

Top index provider facilitates global green investment

Increasing pressure on investment institutions to consider greenness is hampered by the lack of suitable data. FTSE Russell has now come up with a data model and an index series based on it, which it claims will allow indexers to measure the impact of the global transition to a green economy on their portfolios. The highlights of the data model and the related series include:

- The launch of a ground-breaking green revenues (LCE) data model that captures the shift in the revenue mix of companies that generate revenues from green goods, products and services.
- For the first time, indexers can identify and support their investment in the world's transition to a green economy.
- More than 2,400 of 13,400 public companies already generate green revenues.
- Aggregate value of green revenues is $2.9tn, not much lower than the $3.5tn market cap of the emerging markets.
- The Green Revenue Index series based on the new LCE data model is designed to provide investors with indices that reflect exposures to companies engaged in the transition on a country, regional or global basis.
- FTSE Russell's framework provides a first complete picture of the scale and velocity of the structural shift to a green economy across public companies.
- The model provides the missing dimension of the green transition, by providing portfolio managers, research analysts and product managers with consistent transparent data to track green-revenue exposure and support their investment in companies that stand to benefit from the increasing shift in the global economy.

Christiana Figueres, Executive Secretary of the UN Framework Convention on Climate Change (UNFCCC), said that 'FTSE Russell’s index series and data model offers a unique and potentially powerful new way of assisting investors switch capital towards companies walking the talk in terms of green products among goods and services. Indices like this can, if widely used, play a real role in assisting asset managers and owners to accelerate the necessary transition to a green economy'.

Editor’s comment

Issues to do with how the word 'green' is defined are still to be resolved and could hold back the development of this vehicle. So far, the issuers have been well-known and highly reputed names, but, if the market continues to grow, investors will demand reassurance that 'green' really does mean 'green'. Several definitions of the word subsist in different industries, such as transport, waste management and land use. The consultants and investors subscribe to different shades of this colour.

The Climate Board Initiative has its own concept of 'green'. It wants a single standard, but accepts that it is currently difficult to impose one.

Hitherto, asset owners and asset managers were hampered by the lack of a general definition of what is green and how that can be measured (see box), FTSE Russell removes the second part of this problem, but the problem of definition remains. Short of in-depth investigation of each company, the index provider probably has to depend on each company’s own assessment of the green definition. This and the lack of standardisation might still be obstacles.

‘New green revenues model from FTSE Russell tracks global transition to a green economy’, press release – FTSE Russell, 06.06.2016

This is the third of a group of related articles. Please see the previous two on ‘A new fashion in impact investing’ and ‘Social impact bonds growing’.
REGULATORY SPOTLIGHT

NO BREAKTHROUGH FOR OPEN ARCHITECTURE

Dr Wolfgang Mansfeld

The regulation of fund distribution has a strong impact on the fund industry. In this context, two issues are of particular importance.

The first issue regards commission payments. Should distributors be permitted to receive commissions from providers of the products they sell?

The second issue regards the so-called distribution architecture. Should distributors who are part of a financial group offering own funds be permitted to restrict investment advice and fund sales to just in-house products (integrated architecture)? Or should they be required to offer a broader range of funds, including third-party products (open architecture)?

Both issues have a strong effect on the market strategies and business interests of the industry. They are also important for consumer protection. Not surprisingly, both issues are highly controversial, and their regulation has been subject to intensive discussions for at least a decade.

In Europe, the Markets in Financial Instruments Directive (MiFID) sets the framework for investment advice and distribution of financial products. In 2014, a revision of MiFID came into force (known as MiFID II). The new directive has been completed very recently by so-called Commission Directives – regulations of the EU Commission specifying provisions of the directive.

With these steps, the regulatory framework has been amended and a new regime has been established for both sales commissions and distribution architecture.

Commission payments restricted but not completely banned

The regulations confirm that under MiFID II, sales commissions are subject to tighter restrictions, but not completely banned. Only investment firms that provide “independent” advice will be forbidden to accept payments by product providers, and hence will have to be paid for by the client directly.
For non-independent advisors, commission payments remain permitted if certain conditions are met, in particular the “quality enhancement requirement”. MiFID II states that commissions have to be designed in such a way that they enhance the quality of advice.

Excerpt from Regulatory Spotlight, Investment Management Review, September 2014

In the discussions preceding MiFID, some regulators, consumer organisations and independent experts raised doubts whether accepting rebates could ever fit together with advising in the best interest of clients. But the European legislator concluded that commission payments could be accepted, provided that (1) they are disclosed to the client, (2) they do not impair the advisors’ duty to act in the best interest of the client and (3) they are designed to enhance the quality of the advisory service.

The Commission regulations clarify – to some extent – the controversial issue of what constitutes a quality enhancement. The regulations state that a non-independent advisor is permitted to receive a sales commission if a clearly defined additional level of service is provided, representing a tangible benefit for the client. Furthermore, the commission must not lead to biased or distorted advice.

Commission payments can be therefore expected to survive in the non-independent distribution channel, which is the dominant one in most European countries.

Open architecture an option, not an obligation

This brings us to the issue of distribution architecture. Until 2014, the MiFID directive was neutral with regard to architecture. Investment advice could concentrate on in-house products, provided that the suitability requirement was met.

MiFID II, in contrast, imposes some rules and restrictions with regard to distribution architecture:

- The first is the so-called agency status disclosure. Investment firms have to provide detailed information to clients whether investment advice is provided on an independent basis or not. Furthermore, they have to explain how broad or restricted the product range that they offer is, and whether in-house products are on offer. Ideally, the client should understand the different types of product and advice on offer, to enable a considered choice between a more open or more integrated architecture.

- Independent advisors have to apply an open architecture. According to MiFID, advice is provided independently if the advisor offers a broad range of financial instruments beyond proprietary products.

- Non-independent advisors who want to continue to receive commission payments have to offer some added value to their client, according to the “quality enhancement requirement”. Switching to an open architecture is one option to comply with this requirement. But it is not the only option – as advocates of open architecture may have hoped. Another option – mentioned explicitly by the Commission regulation – is to provide an ongoing portfolio check or asset allocation service for the client.

Banking networks in Europe that regard the application of an integrated distribution architecture as strategically important may therefore continue to concentrate investment advice on in-house products. All they have to do is:

- abstain from using the label ‘independent advice’
- offer a value-added service other than open architecture to the client in order to comply with the quality enhancement requirement, if commission payments are received.

It remains to be seen how fund distributors respond to these new rules. Personally, I do not believe that MiFID II will create any major structural change in fund distribution.

The benefits of open versus integrated architecture

Does this mean that MiFID II, because it permits integrated architecture, fails to deliver appropriate investor protection standards?

First of all, there may be some evidence that, since the financial crisis, banking networks have concentrated more on selling proprietary funds. However, a completely integrated architecture is in practice hardly to be found in Europe. For some time now, banking networks have partially opened their fund offer (‘guided architecture’), responding to competition and customer demand.

Second, the relationship between distribution architecture and client benefits requires a careful analysis. Advocates of open architecture argue that only an open architecture will offer ‘best’ solutions for investors, by giving them access to the ‘best’ products in the market.

For me, this argument is not convincing. What is the best product? Most academic studies on fund rankings and outperformance have concluded that the level of persistence of top rankings and outperformance is rather low. In other words: good performers in the past are not likely to be good performers in the future. It will be difficult to forecast which fund will outperform its peers in the future, and so it will be difficult to recommend the best fund and provide the best advice.

Integrated architecture will, of course, provide good results only if certain conditions are met. In particular, the banking networks’ asset manager has to have the necessary expertise and experience to handle a broad fund range across many asset classes.

But open architecture has evident weaknesses. Commission payments, which are to stay under MiFID II, carry risks for the quality of advice. Open architecture will not mitigate these risks, but rather increase them. For instance, organisations offering open architecture with commission payments allowed could be tempted to recommend the products that either pay them the highest commission or offer other incentives.

Dr Wolfgang Mansfeld, from 2002 to 2005, was the President of EFAMA. Until June 2011, he was on the Executive Board of Union Asset Management Holding, the holding company of Union Investment Group, Frankfurt am Main. From 2007 to 2010, Dr Mansfeld was the President of BVI (German Investment Funds Association). From 2004 to 2011, he was a member of ESMA (European Securities and Markets Authority) Consultative Working Group on Investment Management.
The €200bn Sub-Advisory Opportunity in Europe

Jag Alexeyev

Investment managers are taking a closer look at sub-advisory opportunities in Europe, which could grow meaningfully as a result of regulatory changes and market forces. Net inflows to sub-advised funds approached €130bn during the past five years, making it an important source of new business for many firms. Yet at least another €200bn could migrate into such funds by 2020 (see chart).

Regulatory changes such as the Retail Distribution Review (RDR) in the UK and the revised Markets in Financial Instruments Directive (MiFID II) across the region are reshaping the economics of investment distribution in Europe, supporting demand for sub-advisory. The industry is moving away from the use of retrocessions from fund management fees to pay for distribution, towards unbundled fee models with direct charging for advice and wrap-fee programs. However, the resulting pressure on margins has encouraged distributors to explore sub-advised solutions as a way to recapture revenue streams.

Up to now, the sub-advised fund market in Europe has been among the most difficult to assess, with large gaps in coverage. But new research from Impactvesting has mapped more than 1,200 funds, 75% of which previously were not identified as sub-advised by some of the largest global data providers.

This new and comprehensive research gives valuable insights to managers seeking to expand their sub-advisory distribution in the region:

- **At least €200bn of net flows could migrate to funds sub-advised by external managers in Europe over the next five years, helping assets under management in the sector to expand to around €660bn by 2020.**

- **An increasingly diverse group of financial institutions are using sub-advisors. They include domestic banks, co-operative credit institutions, financial advisor networks, pension providers, insurance companies, and emerging wealth managers.** Firms such as Omnis, Heptagon, and OP Financial Group are joining the ranks of better known providers like St James’s Place, Nordea, and Mediolanum.

- **Sub-advised fund assets have grown 17% per year since 2010, compared to 13% annually for the entire European fund industry.** Yet the pace should accelerate. Undertakings for Collective Investment in Transferable Securities (UCITS) and other long-term funds will attract around €1.8tn of net flows in the next five years, with sub-advised funds accounting for 10% to 12% of the total.

- **Higher reliance on sub-advised solutions will coincide with continued strong demand for funds in the region.** An environment of low and negative interest rates will push assets from bank deposits into higher yielding managed investments, including non-traditional and unconstrained income strategies, multi-asset yield substitutes, dividend equity, and alternatives with income potential.
• Multi-asset demand is growing, with allocation funds increasing their share of sub-advised assets from 13% in 2010 to 19% today. This reflects broader use of outcome oriented solutions, risk based programs, and dynamic allocation strategies for volatility reduction. While specialists that provide building blocks to allocation solutions can play a role, managers with multi-asset, absolute return, and unconstrained investment capabilities also will see gains.

• Changes in demand and investment packaging raise the bar for traditional sub-advisors. Growing use of model portfolios and risk-graded solutions, often with passive underlying funds, means that active managers must deliver higher value, better service, competitive pricing, stronger risk management, and more distinctive outcomes.

• Manager replacement opportunities will expand as cost pressures and rising competition encourage sponsors to review underperforming products. However, only 18% of sub-advised funds have below average risk-adjusted returns. With a limited universe of replacement targets, intelligent targeting of opportunities and long-term relationship building will be critical in achieving results.

New sub-advised funds introduced during 2015 reached €7bn in assets by year end. Of these, 21 funds surpassed €100m each and together accounted for 65% of new sub-advised fund assets raised during the year. Mediolanum, ABN AMRO, and Generali were among the more active product developers. Some of the highlights include the following:

• Mediolanum introduced Best Brands Equilibrium, an asset allocation fund sub-advised 70% by AXA and 30% by Principal Global Investors, which ended 2015 with more than €400m. The group also brought a Financial Income Strategy product to market, advised by Algebris and Principal. Socially responsible and real estate funds were also launched.

• ABN AMRO added seven sub-advised funds to its AA MMF range in 2015. The largest was a European Equity strategy advised by Henderson that ended the year with €388m. The funds advised by Investec, Insight, Verrazzano, and William Blair all surpassed €100m in assets. In addition, a global emerging market equity strategy advised by Numeric Investors (Man Group) introduced last year reached €88m as of March 2016.

• Generali Group introduced six sub-advised funds through its IS and MPS umbrellas, with total assets in these products reaching €740m by the end of the year. Sub-advisers include Finisterre, Income Partners, BlackRock and BNP Paribas IP. Assets grew rapidly during Q1 2016 for a few of these. Generali launched another eight funds via its BG SICAV and BG Selection ranges, raising €205m.

Many sub-advisory programs in Europe actively highlight the brands of the sub-advisors, at times in the name of the fund itself. Thus, such relationships frequently go beyond a simple sub-contracting or private labeling arrangement, and reflect the industry trend towards stronger and longer strategic partnerships.

Impactvesting’s new 80-page report, Opportunities in European sub-advisory, provides more detail on this growing marketplace, with in-depth profiles of 28 financial institutions expanding their use of sub-advisors.

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.

Net flows into sub-advised funds in Europe, €bn

Source: Impactvesting LLC

Jag Alexeyev
During 2015, stock, bond, multi-asset and other long-term mutual funds attracted over $103bn in net flows in Japan. Importantly, 18 out of the 30 highest cash flow funds in Japan last year were sub-advised by international fund companies.

Local Japanese managers nowadays co-operate with foreign firms in order to utilise their expertise, not only in regions or asset classes outside Japan, but also in domestic assets. For instance, Nissay JPX Nikkei 400 Active Premium Open and DaiwaSB Japan Equity Alpha Quartet are both sub-advised by Credit Suisse. They employ the same investment strategy to achieve extra returns through currency trading and option trading.

The shift from a transaction based commission model to assets under management (AUM) based ‘fee-for-service’ models and asset allocation ‘wraps’ brings more sub-advisory opportunities. In addition to existing large Nomura Fund Wrap and Daiwa Fund Wrap funds, new wrap products launched in 2015 were also good examples: Shinsei World Wrap Fund series, which currently consists of three products with two investment styles each (growth and stable), and together garnered $140m of net new money since their inceptions. Structured as fund of funds (FoFs), they invest in Credit Suisse Universal Trust (Cayman) Ill-Shinsei World Wrap Fund, which is managed by Allianz Global Investors Japan.

The total AUM of wrap accounts (mutual funds accounted for over 80% of wrap AUM) grew around 80% during full year 2015 to nearly $47bn, while the number of wrap accounts increased by over 100%, though the growth rate has slowed down amid market volatility. During 2015, the amount of investment made through NISA reached $53bn ($6.4tn) in 9.6 million NISA accounts (raised from ¥1m since January 2016) per year and within the program all dividends and capital gains are tax-free for a period of five years.

Since its introduction in 2014, the NISA program has been attracting investment money constantly. Total investments made through NISA reached $53bn ($6.4tn) in 9.6 million NISA accounts as of December 2015, according to the preliminary data released by the Financial Services Agency of Japan. During 2015, the amount of investment through NISA increased by over 100%, though the growth rate has slowed down amid market volatility. Starting from 2016, the tax-exempt contribution amount for NISA increases from ¥1m to ¥1.2m per year. The Junior NISA program, which allows resident individuals under age 20 to open a tax-exempt NISA account, aims to promote long-term investment for the child’s future, and is also open for application.

On the other hand, NISA is also facing various challenges. According to a survey conducted by the Investment Trust Association of Japan in September 2015, while 31.7% of the respondents have opened NISA accounts, only 19.5% of the respondents have invested through NISA. Additionally, regional banks located outside Tokyo are having difficulties in implementing the Junior NISA program due to lack of human resources and budget.

Nevertheless, more opportunities are still lying ahead for NISA given its importance. Japanese regulators, industry associations, asset managers and fund distributors are continuing to actively promote the NISA program. For example, each year February 13 is set up as ‘the Day of NISA’. In addition to regular seminars and promotions, special events will be held by these institutions on this day to further educate investors. The FSA, for instance, has co-operated with Nikkei to organise special NISA seminars for two consecutive years. Fund managers are also expected to benefit from growing NISA assets. As noted in the above-mentioned survey, 55.9% of those who have opened NISA account are investing in mutual funds.
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.

Estimated global managed assets at end-2015 reached $105.5tn, representing an increase of 1%, compared with the corresponding end-2014 figure.

Although hedge funds, exchange-traded funds (ETFs) 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.

Two new categories appear in the table on the left and elsewhere in this section: Regulated open end funds and private capital. The first category includes mutual funds and ETFs. The second is a broader category of private close end funds with the actual figures very close to private equity (please see notes 2 for details of these changes).

Regulated open-end funds achieved inflows of almost $2tn globally in 2015. Regulated open-end fund assets were $37.2tn at the end of 2015, slightly above the end-2015 level.

Exchange-traded products (ETPs)

In 2015, the growth of the ETP industry remained strong, with net inflows into ETPs of $351bn. Total assets increased to $2.96tn.

Pension and insurance assets

In 2015, the growth of the ETP industry remained strong, with net inflows into ETPs of $351bn. Total assets increased to $2.96tn.
Assets of pension funds decreased by 0.9% in 2015, according to Towers Watson estimates. Assets of insurance undertakings exceeded those of pensions funds, with $28.1tn in total.

**Alternative funds**

<table>
<thead>
<tr>
<th>Rank</th>
<th>Manager</th>
<th>Total assets ($tn)</th>
<th>2015</th>
<th>2014</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>BlackRock</td>
<td>4.8</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2</td>
<td>Vanguard Asset Management</td>
<td>3.4</td>
<td></td>
<td></td>
</tr>
<tr>
<td>3</td>
<td>State Street Global Investors</td>
<td>2.3</td>
<td></td>
<td></td>
</tr>
<tr>
<td>4</td>
<td>Fidelity Investments</td>
<td>2.0</td>
<td></td>
<td></td>
</tr>
<tr>
<td>5</td>
<td>BNY Mellon Investment Management</td>
<td>1.6</td>
<td></td>
<td></td>
</tr>
<tr>
<td>6</td>
<td>J.P. Morgan Asset Management</td>
<td>1.5</td>
<td></td>
<td></td>
</tr>
<tr>
<td>7</td>
<td>Pimco</td>
<td>1.4</td>
<td></td>
<td></td>
</tr>
<tr>
<td>8</td>
<td>Capital Goup</td>
<td>1.4</td>
<td></td>
<td></td>
</tr>
<tr>
<td>9</td>
<td>Prudential Financial</td>
<td>1.2</td>
<td></td>
<td></td>
</tr>
<tr>
<td>10</td>
<td>Legal &amp; General</td>
<td>1.1</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Top ten asset managers**

Growth of the global hedge fund industry amounted to 3.6% in 2015 due to moderate inflows and performance. Fund assets increased to $2.9tn at the end of 2015, according to Hedge Fund Research.

Private capital fundraising was again strong in 2015, although below the 2014 level, with more than $550bn of capital raised and assets reaching $4.2tn mid 2015, according to Preqin research.

**Notes 1**

IMR calculated the statistical figures based on publications of the following institutions: ICI, EFAMA, BlackRock International, Hedge Fund Research, IPE, OECD, Preqin, Statista and Towers Watson.

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.

**Notes 2 (Changes in the asset management perspectives, IMR April 2016)**

The ‘Perspectives’ column for IMR April 2016 contains some changes in the categories, figures and sources for the statistics.

**Mutual funds**

The mutual fund statistics are based on the statistics of ICI, EFAMA and IIFA (which among them are consistent).

Since 2015, these statistics have been broadened. They include now all substantively regulated, open end investment funds. The broadened coverage has been applied backdated, starting with the first quarter 2014.

The figures in IMR April 2016 reflect the new format, also for the 2014 figures. Therefore, the 2014 figures in IMR April 2016 are not the same as the 2014 figures in the previous IMR issues.

Furthermore, the category has been renamed from ‘Mutual funds’ to ‘Regulated open end investment funds’. The new category comprises the total of exchange-traded funds (which was not the case before).

A detailed description of the new collection can be found in EFAMA’s *International statistical release* 2015, Q1, p.8.

The first table in this section – titled ‘Global managed assets’, is an estimation. The official end 2015 figure, based on the official IIFA statistics, will be published in IMR July 2016.

**Hedge funds**

So far the hedge fund statistics had been based on monthly public press releases by Eurekahedge. In the course of 2015, Eurekahedge has stopped the press releases in the usual format.

Therefore, IMR has switched to Hedge Fund Research (HFR) as a source. HFR is the leading provider of hedge fund analysis worldwide.

HFR issued press releases on 20 January 2015 and 20 January 2016, which contain figures both for investor net inflows of the year before, and the AUM year end.

The figures in IMR April 2016 and IMR July 2016 for 2014 are higher than the 2014 figures in previous issues, because HFR covers a broader fund universe than Eurekahedge does.

**Private equity**

Private equity (PE) figures have been based on Preqin press releases or free publications for years.

Preqin has now announced an “updated terminology” for the fund categories covered. From now on:

- ‘Private equity’ will be narrowed and refer to buyout and VC only.
- A new broader category – ‘Private capital’ – will refer to a broader spectrum of private closed-end funds, including PE, Private Real Estate, Infrastructure and Natural Resources.

Figures are also published for 2014, according to the updated classification.

The new category ‘Private capital’ is, with reference to the figures, very close to the former PE category. Therefore IMR decided not to stick with the PE category – which would have meant to work with much lower figures from now on – but to apply the new ‘Private capital’ category. Figures for this new category are available for 2014 and 2015, and there is little change regarding the 2014 figures used to now.
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