Investment Management Review

RETAIL INVESTORS LOSE HEAVILY FROM ETF CHAOS
Safety of ETFs not assured (pp.11,13,14 + editorial)

Plus
THE EROSION OF LISTED EQUITY MARKETS TO WORSEN (p.5)
Golden era for equities ending (p.3)
BLACKROCK ANNOUNCES LINK WITH GOOGLE (p.21)
Investors spend heavily on credit card data (p.24)
Exchange-traded funds (ETFs) were supposed to be safe and reliable in terms of delivering what they said on the tin. Not anymore. The date of 24 August 2015 has all the hallmarks of going down as a ‘black day’ in the history of this young, fast-growing sector.

The redeemability of ETFs at any time during the trading day, and at prices closely reflecting underlying asset value, is taken for granted. But they have failed to deliver on this hitherto sacrosanct promise, with many ETFs trading well below asset value, and some of the big ones falling short of their underlying holdings by something close to 50%. Most importantly, many retail investors have been burnt badly. If their heavy losses on 24 August had been caused by market movements, it would have been acceptable. But the mechanism underlying ETF trading was, in fact, the source of the problem. The key questions are: What went wrong and could it happen again? The answer to the second question is a resounding ‘yes,’ at least for some time to come. Why it happened is a more complex question.

It all apparently started with the early indications of a sharp drop of a few percentage points before trading actually started. The S&P 500 futures contracts reflected this by falling sharply enough to trigger an automatic trading suspension. This event seems to have subsequently played a significant role, as ETF market makers rely on this contract for hedging their own risks.

Confusion reigned in the first hour after official trading began. The key stock market indices fell and rose by up to 5% or so in the short space of an hour. During this time, many ETFs and underlying stocks suffered trading suspensions. Market makers were unable to hedge, or even calculate the real value of the ETFs.

All this mayhem is ascribed to a plethora of rules and trading limits among highly fragmented dealing venues across the US, with some of the new rules having been introduced since the flash crash of 2010.

Regulators and top ETF providers, including BlackRock, the largest of them, have acknowledged that they have not been able to profit, for peculiarly Chinese reasons. The motivation for the gigantic BlackRock’s venture into a sector as small as UK garden centres is not obvious, but there is a clear rationale.

Clearly, the investors will need some time to come up with the answers. In the meantime, it is obvious that ETFs cannot offer the cast-iron guarantee that was previously assumed. True, the sort of market movement that set off the confusion is not likely to be frequent. But, with some dire warnings of a serious equity market setback against the backdrop of interest rates potentially rising and global growth slowing, the possibility of a big market fall that dwarfs what happened last August is not just academic.

There are other structural and regulatory issues to do with ETFs that might pose problems, and exacerbate the risks both for investors and the financial system. Academic research suggests that ETF growth and the very size of the sector is draining liquidity from the underlying markets. Moreover, regulation is perhaps not as effective as it ought to be. There is no clear, well-defined and authoritative distinction between the different types of exchange-traded instruments, such as ETFs and exchange-traded notes.

This sector may not be far behind corporate bonds, which are widely recognised as posing a systemic risk because of potential illiquidity. At least for the time being, perhaps ETFs need to carry a health warning, for investors as well as the authorities concerned about financial stability.

**HEALTH WARNINGS FOR ETFS**

*FROM THE EDITOR:*

**WEAKNESSES CAUSE HEAVY INVESTOR LOSSES**

Aberdeen is no exception. It now faces questions over its survival. Aberdeen has been burnt badly. If their heavy losses on 24 August had been caused by market movements, it would have been acceptable. But the mechanism underlying Aberdeen trading was, in fact, the source of the problem. The key questions are: What went wrong and could it happen again? The answer to the second question is a resounding ‘yes,’ at least for some time to come. Why it happened is a more complex question.

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Arjuna Sittampalam, Chartered MCSI Editor

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**TOP FUND MANAGERS INVESTIGATED FOR AIRLINE PRICE FIXING**

The idea of top fund managers colluding to fix airline ticket prices seems far-fetched, but this is precisely what is being investigated in the US.

**US STYLE PRE-INITIAL PUBLIC OFFERING (IPO) FUNDING TAKING OFF IN EUROPE**

The practice of start-ups going for private funding rather than IPOs is catching on in Europe, after being established in the US with the same potential pitfalls.

**AMUNDI’S SHOCK THREAT TO LEAVE FRANCE**

Amundi’s creditable ambition to climb from its current tenth rank among the world’s biggest fund managers is a silver lining during a bad few months for other leading industry players. But its Chief Executive has made a shock statement about the possibility of it leaving France.

**BANKS CHANGE ATTITUDE TO FUND MANAGERS**

Yet another U-turn by banks on the question of owning fund managers might be superseded by retail customers abandoning them.

**CONTRIBUTIONS FROM INDUSTRY EXPERTS**

**REGULATORY SPOTLIGHT:**

**TIGHTER RULES FOR LIQUIDITY RISK MANAGEMENT AHEAD**

Dr Wolfgang Mansfeld, former President of the European Fund and Asset Management Association (EFAMA), outlines how and why regulators are tightening up to reduce illiquidity dangers among funds run by investment managers.

**CLIMATE RISK AND FINANCE: THE ROAD BEYOND PARIS**

Jag Alexeyev, Founder of Impactvesting and former Head of Global Research at Strategic Insight, explains the growing leadership role in climate change being played by some of the world’s largest institutional investors and global investment banks, and points out why climate awareness will come to the fore in the asset management industry.

**THE RISING POPULARITY OF MULTI-ASSET FUNDS GLOBALLY**

Bryan Liu, Managing Director, Global Research at Strategic Insight, leading global research house and consultancy in mutual funds, analyses the powerful global trend towards the multi-asset approach, with its many different facets in the various investment types and geographic regions.

**INDUSTRY PERSPECTIVES IN FIGURES**

This section provides a statistical perspective on the key trends in important sectors of the asset management industry: mutual funds; pensions; insurance; ETFs; hedge funds; and private equity. Figures in billions and trillions are bandied around. Comparisons put them into perspective.

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**REVIEW OF WHAT OTHERS HAVE SAID**

It is impossible for busy people to read everything that is published about their industry. This section of the magazine includes reviews of some of the more interesting recent outputs from a wide variety of sources, together with editorial comments, as well as our own research. The items included have been selected for their potential long-term significance, in line with the ethos of this magazine.

In cases where the article is attributed to Sage & Hermes Research, the content includes our opinions, understanding and research, but we also draw upon other sources too numerous to be mentioned. We are indebted to a large number of publications in the industry, including the printed and the electronic media, for information.

**GOLDEN ERA FOR EQUITIES ENDING**

The fortunes of western companies are about to experience a substantial downturn, after enjoying a profitable period spanning the past 30 years, according to a report by McKinsey Global Institute (MGI). The report points out that many of the important factors that contributed to the boom years are likely to go into reverse.

Until now, western companies have had it very good. They now extend into all parts of the world, with resources that have not been often equaled. Global corporate profits more than trebled in the 33 years to 2013, and their share of global GDP rose from 7.5% to 10%, according to data from nearly 30,000 firms worldwide. Western companies took a two-thirds share of these profits. On an after-tax basis, the profit of American companies have reached their highest level as a percentage of national income since 1929.

Three long-term forces have been underlying these good times: Firstly, the globalisation of markets has led to the global labour force expanding by over one billion, to a large extent from the emerging economies, leading to a reduction in costs. A real fall in the price of commodities and reduction in corporate taxes by about half have been the other two drivers.

On several counts, conditions are turning for the worse. The multinationals operating now are double the number of those that existed in 1980, creating more competition. Margins are being squeezed. Corporate profits are becoming more volatile as the average variance of the return on capital for North American companies is now 50% higher than it was in the period 1965–1980. MGI’s gloomy prediction is that corporate profits might decrease to 8% of global GDP in about ten years’ time, compared with 10% now.
Germany and David Cameron in focusing on the use of tax loopholes. Moreover, the political environment is turning unfavourable towards the market with the big multinationals, tech giants such as Alibaba, Tencent, well-entrenched markets. Chinese high centres to successfully invade previously companies in this sector are nowadays growth of the high tech sector. The trouble these companies are encountering in their home markets to 26% currently. The 50 largest companies from the emerging countries from just 5% in the period 1980–2000 and capital-intensive industries are being slashed by foreign competition and do not represent the solution. Instead, MGI feels that where western companies can still score is in the realm of ideas. These companies include not just the standard firms in financial services, media and pharmaceuticals, but also businesses in areas such as luxury cars and logistics. The contribution of the ‘ideas sector’ as defined by MGI has increased from 17% in 1999 to 31% now.

MGI’s gloomy prediction is that corporate profits might decrease to 8% of global GDP in about ten years’ time, compared with 10% now

The Economist magazine points out that quite a few of the new powerful groups in the emerging countries and the high-tech sector have dominant owners, who are also their founders. These owners tend to plan for the long term, and not to go for short-term results. In the US, the number of companies in the listed sector has been decreasing, from about 8,000 in 1996 to about 4,000 now. Should western publicly quoted companies diminish in importance, other forms of corporate structure and ownership might come to the fore. Ultimately, the decline of western corporations could be accompanied by capitalism operating in new ways.

Editor’s comment
The share of the economic pie accruing to capital has been increasing at the expense of labour, and this has been widely expected to continue. But the process has to end sometime, and it looks like that time is coming.

These new high tech companies can also provide low cost platforms to small firms with allowing them to compete in the global market with the big multinationals posing more problems for the latter.

McKinsey’s suggestion of focusing on ‘ideas’ is by no means a panacea. Even here, copycats can always encroach. Also note that the likes of Alibaba are creating ideas of their own in financial services and technology. Equity markets are already worrying about the end of quantitative easing, rising interest rates and slowing global growth. A secular downturn in profitability looks like completing a dire picture. The fund management industry is currently in an optimistic frame of mind, but it might soon have to adjust to a very lean era, possibly leading to a severe shakeout.

This is the first of two related articles. Please see the next one on ‘The erosion of listed equity markets to worsen’.

Schumpeter – Death and transfiguration; Schumpeter, The Economist, 18.09.15

The weaknesses of the old type
The ownership and control structure of these established companies has a lot to do with the general discontent felt by governments, investors and other stakeholders, such as employees and customers. Several main problems arise.

Because shareholders are widespread and numerous, they by and large lack sufficient influence over the management. This has given rise to the classic principal-agency problem, whereby management acting as agents tend to follow their own interests rather than those of the underlying owners. Though this issue has been recognised since the 1970s, and subject to phenomena such as Uber, Airbnb and various other internet-based and fast-growing businesses.

Recent attempts to incentivise managers with shares and stock options have actually been counterproductive in many cases

Many listed groups, such as Apple, continue to represent outstanding achievements. They produce talented managers, and turn out innovative products. Society, thereby, benefits from their contribution to the efficient allocation and use of capital. Others evoke widespread unease and disaffection with the way they operate. The new form of start-ups that has been creating all the excitement aims from the very beginning to avoid the management-versus-ownership conundrum of public quoted companies.

In many cases, the underlying shareholders are also preponderantly agents themselves. For example, big financial institutions own 70% of the US Standard & Poor’s 500 index. These are effectively intermediaries acting on behalf of large numbers of end investors. This creates another layer of the principal-agency problem, between ultimate beneficiaries and these financial institutions, many of which are fund managers, insurance companies and pension funds.

The agency problem does not even end here. Between these fund managers and the end owners, there are often several other intermediaries providing various services, which all charge fees. This all adds up to an excessive share of the pie being sliced off by intermediaries. Regulation is another source of disenchantment.
with public listing. Becoming quoted is too onerous and costly, both initially and on an ongoing basis.

All these problems were perhaps not considered too serious during the equity market boom of the past few decades for legal contracts. As changing, as mentioned in the previous article. The profits of the Standard & Poor’s 500 have grown by 8% per annum in the past 30 years, but are now widely believed to be on a falling trend. Family companies, private equity firms, and the likes of Warren Buffett and 3G Capital are already demonstrating a different path from the standard public company approach.

Challenges from the new type

It is in the area of start-ups, however, that a potential revolution is taking place, as described by The Economist magazine. The new form of start-ups that has been creating all the excitement aims from the very beginning to avoid the management-versus-ownership conundrum of public quoted companies. Here, the ambiguity of where rights and responsibilities rest is avoided at the outset by legal contracts between the various parties, including the founders, initial employees and outside investors. The interests of all concerned are thus aligned at the outset, encouraging a culture of hard work and camaraderie that is very distinct from the fuzzy demarcation between owners and investors in public companies. However, these start-ups are not just about legal contracts. They have several other characteristics that provide them with the same advantages possessed by big companies, while also preserving their entrepreneurial energy and freedom without the distractions that beset more traditional start-ups.

In the past, starting up without resources meant operating out of a garage, a shed or even a bedroom. This need no longer be so.

Projective, a similar operation, was host to early versions of the Skype, the well-known online payment system, and Uber. Demand is rocketing for desks that used to be launching pads for currently thriving firms, and various newly fashionable neighbourhoods in the US are filled with start-ups. This approach enables start-ups to avoid the formerly difficult decisions involving the ousting of investing in a property. The same principle comes into play when it comes to all the other services they need, with some of the luckiest even getting help and advice from the very beginning.

In the past, starting up without resources meant operating out of a garage, a shed or even a bedroom. This need no longer be so.

Institutions such as Techstars and Dreamit Ventures are available to help budding entrepreneurs with appealing ideas and dedicated, committed and passionate employees but not much else, such as contacts, business expertise or capital. These two firms get thousands of applications every year and those whom they select receive capital, advice on strategy, marketing, management and leadership, legal help and access to investors, and all the other such functions that large firms can afford, either internally or through much more expensive outsourcing.

The nurturers get small equity stakes. Their successful selections, when boosted properly, can attract investors and also promising corporate youngsters. Start-ups, whether or not they are selected by the nurturing companies as above, can raise money from crowdfunding sites such as Kickstarter, hire programmers from Upwork, rent computer processing from Amazon, find manufacturers on Alibaba and arrange payment systems such as Square. Interestingly, the best-selling brand of TV in America in 2010 was VIZIO, with just 200 employees.

Three objections are often raised to the idea of a revolution by these types of start-ups, but each objection is subject to strong counter-arguments. The first objection is that these start-ups are confined to Silicon Valley-type areas, but this is no longer valid. There are start-ups and potential business disruptors in wide areas of the economy, as demonstrated by the likes of Airbnb and Uber, which have made it big.

The second major objection to the suggestion of a potential decline or demise of public companies is that the latter are still bought by the start-ups when they eventually want to list or sell themselves to a public company. But this argument is not valid either. An established number is choosing to stay private, and finding it easier to raise funds without resorting to public markets.

The third objection is that public companies give ordinary people a stake in capitalism, whereas the start-ups scene is dominated by venture capitalists and other well-heeled investors with privileged access. In countering this, The Economist magazine points out that ordinary people can use platforms such as SeedInvest, and mutual funds operating in this sector, such as those run by T. Rowe Price.

Another advantage that these start-ups have is that technology, including the internet, enables them to go global very quickly once they have established themselves. The time span of becoming a top global company is shorter than ever before.

Editor’s comment

These new start-ups are not just individuals. They are a part of a new ecosystem of dynamic entities that allows them to benefit from other constituents of the system.

Those who consider the US as having lost its dynamism need to think again. It is difficult to see this complex infrastructure supporting the new type of start-ups coming to life in any other country. Perhaps, once trends are well-established, some imitations might take place.

In Europe, a similar development is not likely. China might have the scale and the entrepreneurs, but not the freedoms and the rule of law that are prerequisites.

This is the second of two related articles. Please see the previous one on ‘Golden era for equities ending’.

Rementing the deal, The Economist, 24.10.15

Rementing the company, The Economist, 24.10.15

SURVIVAL IN DOUBT

ABERDEEN OUTLOOK – SURVIVAL IN DOUBT

Aberdeen Asset Management’s ambition to become one of the largest players at is at least temporarily in tatters, after a drop in its fortunes in 2015. The setback is so substantial that even Aberdeen’s very survival as an independent company is being questioned.

The cause is easy to pinpoint, being the company’s heavy exposure to emerging markets, which are undergoing a torrid time with no early prospect of improvement. This is indeed a massive turnaround in perceptions from 2014, when Aberdeen stood tall and was crowned the largest listed asset manager in Europe. It had to relinquish this crown in the summer of 2015, owing to a massive fall of more than 25% in its share price since the beginning of the year. This reflected not just falling profitability and the loss of assets under management to the tune of £10bn in the three months to end of June, but also worries about worse to come.

The atmosphere in the company as of late 2015 is very bad, with talented staff expected to leave, following likely cuts in bonuses. A few senior departures have already occurred, including that of David Stypniewski, Aberdeen’s Head of Strategy, to become CEO of Robeco, thus this exit might not be related to Aberdeen’s misfortunes.

It is widely rumoured that Martin Gilbert, Aberdeen’s CEO and co-founder in 1983, has made informal approaches to a number of rival fund houses regarding a possible takeover of the group. The authoritative Financial Times has suggested that the talk has come from people in the know. Some believe that a number of US, UK and Asian fund groups may be interested, and that top private equity groups such as KKR, Blackstone and Warburg Pincus are possibly in the frame. Aberdeen, however, strenuously denies that it is talking to any body, and asserts that Martin Gilbert has never talked to anybody about selling Aberdeen, either recently or in the past.

As a counter to the talk of a sale, the investment bankers who have spoken to Financial News have struggled to identify anybody who might be interested in paying the £6bn price that is considered the likely valuation. It is felt in the quarters that the talk may be originating from bankers who are sounding out potential buyers with a view to persuading Gilbert to sell. In this connection, the lack of succession planning is also considered an obstacle.

Apparently, there is nobody who can be identified as wanting to take over the hot potato of Aberdeen’s heavy exposure to emerging market problems, which are widely seen as likely to persist for another three years or so. But Anne Richards, who has a high profile in the financial media and is currently the Chief Investment Officer, is suggested by some as a potential successor.

Gilbert himself has pooh-poohed the idea of there even being a serious crisis, let alone that a sale is being considered. He says that Aberdeen’s current problems should be seen against the perspective of the 2002 crisis that engulfed the company, at the time of the split-level investment trust scandal. In comparison with that disaster, he asserts that there is really no serious problem now.

There may not be a problem in terms of having to sell out, but certainly recent business performance is a cause for concern. While further cost-cutting is expected, it is suggested that the scope for more reductions is small, leaving the group’s profitability vulnerable to further outflows.

It is believed that Aberdeen’s largest shareholder, the Japanese financial services giant Mitsubishi UFJ, with a 17% stake, is in support of Martin Gilbert, according to senior management at Aberdeen. Through a series of small acquisitions in the recent past, following the big one of Scottish Widows Investment Partnership in 2014, Aberdeen has endeavoured to reduce its vulnerability to emerging markets.

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Aberdeen is not the only group to suffer in 2015. Ashmore, another emerging market specialist, has also suffered, albeit with its share price...
only 11% down. This is down to it being focused on emerging markets and debt, rather than the equity to which Aberdeen is exposed, as borne out by the performance of the relevant indices. The MSCI Emerging Markets Index fell by about 10%, while J.P. Morgan’s Emerging Markets Bond Index Plus fell by only about 3.5%. Aberdeen remains very vulnerable. It has not yet gained bond assets from consultancies as had been hoped, and its recent move into multi assets has had little time to make a significant impact.

Editor’s comment

Though Gilbert might be optimistic and taking a long view, confident of riding out the storm, the same cannot be said for either his employees or investors. The share price collapse makes the latter’s opinion very clear. The serious dip in staff morale, if true, at least suggests that Gilbert’s positivity has not percolated down.

Aberdeen and Gilbert have been strenuous in their denial of selling. But of course, they would be. However, much more telling than words are actions, and Gilbert’s recent expansion moves tend to belie the idea of any serious trouble and to indicate that the group is quietly confident.

This is the first of two related articles.

Please see the next one on ‘Aberdeen on the expansion trail despite problems’.

Aberdeen shares fall amid China worries

David Oakley, Financial Times, 22.08.15

‘Asset managers pain is uneven’, Paul J. Davies, The Wall Street Journal, 25.08.15

Aberdeen hosts for sale sign as EM turmoil hits

Chris Newlands and Madison ‘Aberdeen’s crown tarnished as assets expansion trail despite problems’.

The share price might be falling, staff might be leaving and there is talk of the group losing its independence through a sale. But Aberdeen seems to be fairly continuing with expansion plans as if confident of being around for many years to come. On three separate fronts, the company has very successfully undertaken long-term expansion moves, provided of course the pessimists are wrong and it survives the next three years in a reasonable shape.

Why is Aberdeen on the expansion trail despite problems?

Editor’s introduction

Aberdeen is enabled to carry out more proactive marketing to win Chinese customers and to have their own analysts in China who can conduct research locally.

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The 50 other fund companies operating in China have been granted only more limited versions of the same licence that Aberdeen has procured, known as Wholly Foreign Owned Enterprise (WFOE). According to Stephen Baron, Deputy Director of Strategic Solutions at Z-Ben, Aberdeen’s rivals are likely to be put out by the announcement of its success and to change their applications in order to secure the same terms.

Prior to Aberdeen’s achievement, WFOE licence holders were only allowed to give advice on a pool of assets, according to Baron. Z-Ben had been seeking to establish a foothold and are now hastening to try to get the same permission, according to the Shanghai-based leasing consultancy Z-Ben.

Starting from scratch, Aberdeen’s new許诺s? They will enable the company to manage assets directly on behalf of Chinese investors. It will become evident during the following months how the Government implements new rules expected before the end of 2015 that remove the need for foreign firms to intend to join ventures with domestic companies. Under the new regime, Aberdeen is enabled to carry out more proactive marketing to win Chinese customers and to have their own analysts in China who can conduct research locally. In its Shanghai office, it currently has to wait for customers to call, rather than to actually search them out.

According to Aberdeen, the licence will allow it to expand its current office to recruit more Chinese customers, and also enable the local resources, in terms of analysis, to look for good investments for its global investor base.

Aberdeen has achieved a remarkable coup by obtaining a licence to operate in China’s asset management arena that is way ahead of that received by any other foreign fund management group. This success has caused waves among other global asset managers that are working with foreign firms for five years in setting up these licences and has pointed out that Aberdeen’s is the most comprehensive. Previously, for a conduct research observed an earlier version of the licence after registering under the Qualified Domestic Limited Partner programme, which enabled them to protect limited assets from China’s investors.

In March 2015, five fund groups, UBS, Deutsche, Nura, EJF and CBRE Global Investors were given the go-ahead under this programme. Six hedge fund groups had previously been permitted in 2013.

The move will be part of an ongoing trend amongst asset managers in the direction of online sales.

So, what is special about Aberdeen’s new powers? They will enable the company to manage assets directly on behalf of Chinese investors. It will become evident during the following months how the Government implements new rules expected before the end of 2015 that remove the need for foreign firms to intend to join ventures with domestic companies. Under the new regime, Aberdeen is enabled to carry out more proactive marketing to win Chinese customers and to have their own analysts in China who can conduct research locally. In its Shanghai office, it currently has to wait for customers to call, rather than to actually search them out.

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Aberdeen’s move had been unexpected in that Martin Gilbert, Aberdeen’s Chief Executive Officer, had been playing down China opportunities. Aberdeen’s relatively low exposure to China, notwithstanding its overall commitments to emerging markets, previously reflected the difficulties of finding good companies in China, a situation that is now expected to change with the ability to expand its local operation.

Gilbert himself seems to have changed his tune. Whereas he had played down the opportunities earlier, he is now much more positive. He states that, whereas the money from China is not going to come in a flood in the near term, the Chinese achievement will be part of an overall strategy that ensures Aberdeen being well-placed for the next 20 years.

The firm already manages several billion dollars of Chinese money for pension funds and other institutions.

‘Aberdeen’s deal with red dragon awakens green eyed monster’, Madison Mamage, Financial Times, 28.09.15


Aberdeen jumps on the digital bandwagon

Aberdeen Asset Management has moved to enhance its presence in the rapidly growing digital investment arena. It has bought Permision Capital Partners, which gives online advice and manages £1.5bn in fund portfolios for about 900 financial advisers.

Martin Gilbert has been for some time an enthusiast of the digital revolution in asset management. Previously, he had publicly regretted having missed out when Schroders scored the coup of taking a stake in Nutmeg, the internet-based low cost discretionary asset manager in 2014.

In recent months, Gilbert has expressed concern that the asset management industry faces massive disruption from tech giants such as Google over the next decade. Senior Aberdeen management has reportedly met with Google, Facebook and LinkedIn to discuss these disruptive effects.

Permision will allocate funds to Aberdeen’s quantitative strategies and solutions, but will also use other companies’ products. Aberdeen plans to expand this acquisition. The move will be part of an ongoing trend amongst asset managers in the direction of online sales, to replace those achieved through traditional distribution networks, as Schroders has already demonstrated through Nutmeg.

According to Gilbert, this move will render it well-placed for evolving pensions and the changing needs of financial advisers.

The game is no longer about measurement against a benchmark, and that, in order to participate seriously in the new outcome-oriented investment world, a broader armoury of capabilities is required.

Aberdeen taps ‘digital revolution’ with online fund deal, Judith Evans, Financial Times, 09.09.15

More acquisitions by Aberdeen

Apparently unperturbed by what the rest of the world and its own staff think about the group’s emerging market travails, Aberdeen made two acquisitions in early August and September.

On 4 August, Arden Asset Management, the hedge fund group based in New York, was taken over just two weeks after Martin Gilbert had told the Financial News of its intentions to continue with such belt-on deals.

This acquisition marks yet another move in implementing its long-term plans, as explained in an interview to the Financial News by Anne Richards, Chief Investment Officer at Aberdeen, and Andrew McCaffrey, its Global Head of Alternative Analytics. McCaffrey started by emphasising that the group aimed at becoming a universal provider that can cover all types of investment.

Richards added to this by saying that the game is no longer about measurement against a benchmark, and that, in order to participate seriously in the new outcome-oriented investment world, a broader armoury of capabilities is required, including investment types such as private equity, hedge funds and infrastructure.

Arden was attractive on several counts. It has developed a highly successful digital strategy. It is innovative and was one of the first providers of liquid alternative funds in the 40 Act structure of mutual funds. It also has various customised portfolios. Richards admitted that the digital alternative market is somewhat more specialised than global emerging market equities, but it is nevertheless a growing market.
In pursuit of becoming a universal provider, the group has recently purchased Flag Capital Management, a private equity firm. The group has also reportedly considered the fund of funds manager Russell Investments, for which the London Stock Exchange is seeking a buyer.

McCallery concluded by saying that the corporate strategy is to fill gaps in what they have to offer and to diversify both geographically and in terms of business type. They see opportunities in both public and private markets, and feel that many areas are available in infrastructure that can grow organically.

In late September, yet again indicating a lack of too much concern about the outflows arising from the emerging markets downturn, Martin Gilbert confirmed a purchase that actually adds to their emerging market exposure. The group bought Advance Emerging Capital, valued at €409m, which is a manager of two fund of funds vehicles in emerging and frontier markets.

Apparently, Gilbert is getting a bargain in acquiring this company, and the group has said that Advance’s skill in funds of funds could be applied in other sectors. However, it is feared that, while the deal fits in very well with Aberdeen’s current activities, getting further entrenched in emerging markets rather than continuing on its diversifying strategy, increases the risks.

Aberdeen: Arden deal will help
make us a ‘universal provider’

Mark Cobley and Stefanie Eichenbacher, Financial News, 10.08.15

‘Martin Gilbert keeps digging’; Mike Foster, Financial News, 21.09.15

Editor’s comment

It is all too easy to write off emerging markets and to assume that the fashionable paradigm behind their previous popularity will not hold true again. Such a conclusion would be premature. The forces underlying the emerging markets’ take-off prior to the current downturn are still intact to some extent.

It faces the danger of losing its seed corn, its talented fund managers

Ten years ago, the number of top-ranking global companies originating in the emerging markets was much lower than it is now. There is a multiplicity of reasons why emerging markets will continue to develop, and many argue that the word ‘emerging’ is now out of date. There is nevertheless a relatively high exposure to the natural resources sector in some countries, but even in this sector, there is reason to believe that the tide will turn.

The problem for Aberdeen is that it has to weather the downturn and struggle with outflows and loss of profitability. And, worst of all, it faces the danger of losing its seed corn, its talented fund managers. The company and Martin Gilbert are strenuously denying that they are thinking of selling, but these words on their own never mean a thing. What is telling is their actions on the three fronts of China, the digital arena and the pursuit of universal provider status. All these indicate a strong confidence, not just in its survival but also in preparing the ground for much bigger things to come.

Until the emerging market sufferings increased in 2015, a remarkable parallel existed between Aberdeen’s expansion trail and the ascent in recent decades of BlackRock to the world’s number one rank. The latter benefited from the massive bond bull market. Perhaps, Aberdeen’s problem is that it is in the wrong sector at the wrong time. But even the bull market in bonds had its hiccups, and the big question is how long this current emerging market dip will last. Perhaps Aberdeen’s survival, or growth, hinges on the duration of this emerging market downturn.

Aberdeen’s lustre seems to have dimmed but it still has the potential to become a giant of the future and merits continued watching.

This is the second of two related articles. Please see the previous one on ‘Sharp reversal in Aberdeen outlook – survival in doubt’.

ETF horror story

STRUCTURAL WEAKNESSES CAUSE HEAVY INVESTOR LOSSES

A date that will probably go down in history as a black day in the exchange-traded fund (ETF) sector is 24 August 2015, when a horror story unfolded, causing retail investors massive losses. These were not for understandable market reasons, but due to weaknesses in ETF trading procedures. If this had happened to hedge funds, known to be high risk, then perhaps it would have been less shocking, but ETFs have been billed and sold on the basis of being safe and cheap, and hence the word ‘horror’ is more than justified.

A large number of retail ETF investors incurred unexpected losses when these sell orders became activated during the market collapse

A strong selling point for ETFs is that they are supposed to trade in step with the stocks that they hold, with very little tracking error, so that investors can be confident about realising the underlying asset value when they buy or sell at any time throughout the day. This did not happen on the fateful date, which has also been described as one of the wildest days in the history of the US stock market, let alone just ETFs.

The first few minutes of trading on that day saw the Dow Jones industry average dropping by nearly 1,000 points, and recovering by nearly 600 points just a few minutes later. The Standard & Poor’s 500 index fell by as much as 5.3%, but the S&P100 (Share Core S&P 500 ETF) fell by 26%, approximately 20% points below its underlying asset value. This ETF from BlackRock was not alone. The Vanguard Dividend Appreciation ETF ($18bn assets under management (AUM)) and the SPDR S&P dividend ($12bn AUM) both collapsed by 38%, while the PowerShares S&P 500 Low Volatility ETF saw 46% of its value wiped off. But all these recovered within one hour after the opening of markets.

More than 20% of all US-listed ETFs and products were forced to stop trading after the Dow Jones fell. Many retail investors were badly hit by the saga, leaving them with huge unexpected losses. The New York Stock Exchange reported a fourfold increase in stop-loss orders, which immediately trigger a sale if a stock falls to a certain level. A large number of retail ETF investors incurred unexpected losses when these sell orders became activated during the market collapse.

Many explanations have been put forward in the media, but may not all be consistent.

• According to Vanguard, the world’s second largest fund manager, the problems arose from the fragmented nature of US equity trading, which is spread across 13 exchanges. Joel Dickson, a principal at the group, said “Inconsistencies in how different exchanges matched trading once stock suspensions were lifted also contributed to further problems for ETFs on August 24.” In support of this argument, he pointed out that the US equity ETFs that were listed in Europe and Australia avoided the experience of trading difficulties on 24 August. He argued that the problems, therefore, arose from the different trading rules applicable to ETFs, equities and derivatives in the US.

• The calamitous sequence of events was started by the Standard & Poor’s 500 futures contract falling sharply enough to trigger an automatic trading suspension under the rules in place, before the 9:30am opening bell for stocks. These futures are mostly traded on the Chicago Mercantile Exchange and are resorted to by ETF market makers for hedging purposes. Electronic exchanges had opened in the meantime. In the absence of clarity on futures prices and consistent information about where many stocks might open, ETF spreads between bid and ask prices were quoted at exceptionally wide levels.

• Throughout this period, trading limit rules came into play, requiring suspensions of trading for many individual stocks and ETFs. Called ‘limit up, limit down’, these rules allow trading to continue only when specific price ranges are not exceeded within a particular time period.

In the absence of clarity on futures prices, and consistent information about where many stocks might open, ETF spreads between bid and ask prices were quoted at exceptionally wide levels.

• The hitting of trade limits on individual stocks occurred on such a massive scale that providers were unable to properly price ETFs based on these underlying stocks, causing huge discrepancies between the ETF quotes and their real asset value.
Some of the problems of the day had their roots in the notorious flash crash of 2010, when the stock market gyrated wildly within a very short space of time. Regulations introduced following that crash appear to have contributed towards the confusion of 24 August. Apparently, the interaction of overlapping rules seems to have obscured real time prices in many stocks from the perspective of professional traders, causing a widening of the bid-ask spread in both stocks and ETFs, and these unusually low prices, when transferred into orders, triggered the trading suspensions. In turn, that led to specialised traders, known as “authorised participants,” not engaging in the arbitrage that enables ETF prices to closely track the underlying constituents.

Usually, when an ETF share price falls below the total value of its underlying shares, these authorised participants buy the cheap ETFs and exchange them for the actual underlying shares, and then go on to sell the latter at a profit. This arbitraging process, triggered by the slightest discrepancy, keeps ETF prices reflecting closely underlying stock values. Obviously, when trading was halted in both stocks and ETFs, this process of arbitraging was impossible.

The debacle of 24 August has now raised serious questions about the safety of the ETF mechanism.

**Structural weaknesses of the ETF system**

ETF trading, after the massive growth of the sector in recent decades, now accounts for many substantial proportions of all stock trading in the US, with estimates ranging from a quarter to a third of total equity trading, compared with just 15% a decade ago. The debacle of 24 August has now raised serious questions about the safety of the ETF mechanism. The gyrations in August have justified many prior warnings by critics of the ETF boom. The central issue of ETFs being instantly redeemable at a price very close to the underlying asset's value was also a root of the ETF mechanism. This promise cannot be relied upon.

There is now serious questioning of how ETFs can stand up to periods of extreme stress. Leading ETF players and regulators have now recognised that something needs to be done, though understandably regulators do not have an immediate answer. Even prior to August, back in June, the Securities and Exchange Commission (SEC) had said that it would ask for public comments on ETF pricing and about investors’ understanding of the nature and use of ETFs.

Following the 24 August disaster, Luis Aguilar, a commissioner at the SEC, tabled many questions about ETFs to his fellow regulators in a speech in October. While posing the question of whether trading in ETFs should be halted whenever a significant number of the underlying stocks held by an ETF suffered a trading suspension, he said: “Why did ETFs prove so fragile that (August) morning raises many questions and suggests it may be time to re-examine the entire ETF ecosystem?”

BlackRock, the world’s biggest ETF provider, is reported to be vigorously opposing Aguilar’s suggestion about halting trades in ETFs, but the group acknowledges that work is required to analyse what has gone wrong. Barbara Novick, of BlackRock, and Reggie Brown, of Cantor Fitzgerald, accept that shortcomings in the market structure caused the problems. This is echoed by Mark Wiedman, Global Head of iShares at BlackRock, who stated: “It’s clear this thing has creaks in it that we did not realise. It was a wild anomaly, but one which we must study immediately.”

Regulators will take some time to ... come up with solutions that restore the safety and reliability of ETFs ... until reliable reform guarantees future safety, at the least a health warning needs to be attached to any purchase.

**THE SIZE OF ETFs POSES DANGERS**

The growing size of the exchange-traded fund (ETF) sector is causing dislocations in the stock market as a whole, creating hidden costs for all participants. In addition, it might lead to a dangerous liquidity problem, according to the findings published in a Stanford University Graduate School of Business research paper by three academic authors: Doron Israeli, Charles M.C. Lee, and Suhas A. Sridharan. These issues are distinct from the disaster that hit the ETF sector on 24 August.

One of the main results is that the size of ETFs’ trading in many stocks leads to increasing and ongoing transaction costs, both for these passive funds themselves and, most importantly, for the active managers trying to beat the market. This problem arises from the combination of the buy-and-sell policy of ETFs and the size of their holdings in many companies. Effectively, their purchases lock up the stock and represent a withdrawal of liquidity from the market. The consequence of this reduced liquidity is that bid-ask spreads widen for the companies concerned.

The study looked at the patterns of ETF ownership of US stocks in the ten years between 2001 and 2011. It found that increases of about 6% occurred in the trading cost of the companies widely held by these index matching vehicles. One of the consequences of these increased trading costs, it is argued, is that active managers find it more difficult to beat the market. The performance of these active managers is currently under criticism, leading to a shift towards passive.

The report also finds that, in the cases where ETFs own more than 3% of outstanding equity, the companies share prices tend to be based far more on market movements than on specific company issues, such as expected earnings. Another factor is considered to be the obligation of passive vehicles to buy these companies.

There had been criticism even before this study. In a 2014 paper published by the National Bureau of Economic Research, it was argued that ETF ownership increased a stock’s daily volatility by 16%. Goldman Sachs joined the band of critics in April 2015, when its equity analysis issued a research note pointing out that ETFs’ outsized growth combined with low liquidity “lays the stage for a cocktail of single stock impact that few investors … fully appreciate”.

This impact, in addition to heightened volatility, also includes higher correlations, with a tendency for stocks to rise and fall together, regardless of their underlying specific features. These results are challenged, however, by ETF providers. Joel Dickson, Senior Investment Strategist at Vanguard, claimed that it had investigated ETFs’ impact on volatility and correlation, but found no real effect, emphasising the key difference between correlation and causation. He pointed out that since the global financial crisis, markets have been more correlated, but this is attributable to markets responding in tandem to global macro-economic factors. Dickson also argued that 3% ownership was relatively low compared with other market participants. His view is that more of a lock-up is prevalent in the case of insider ownership and with private equity firms. There are other serious criticisms. According to Michael Axler, Director of Product Design at the index provider ResearchAffiliates, the impact of ETFs’ trading activity costs is implicit, as it is reflected in the index itself. He said that the effect is most pronounced when ETFs track illiquid markets. Charles Lee, one of the co-authors of the Stanford research paper, worries that if the liquidity of underlying stocks continue to decline, then everybody
wanting to sell in a panic could be a huge problem, particularly with less liquid markets. Lee’s findings suggest that ETFs themselves could be the source of this liquidity risk.

Editor’s comment

Active managers suffering from increased costs could, in theory, be setting off a vicious cycle, in that any reduced relative performance could further drive the growth of passive, which in turn could have a bigger impact on trading costs, making it even more difficult for the active investors. But that is theory. In practice, several arguments can counteract this. As argued by Aked, even passive funds experience increased trading costs, albeit not explicitly, and on this count alone, active managers cannot really grumble that they might lose out relatively. Of course, if they trade much more, then there might be an impact, but the best managers tend to be long term and trade less, so it is difficult to quantify how serious the impact is.

As mentioned above, statistical relationships do not imply causation. There are other strong reasons, such as the overall behaviour of markets heavily influenced by central bank policies and regulation, which have been responsible for many of the problems cited. However, the authors’ findings cannot be dismissed if there is a clear difference in the above problems impacting specific stocks, according to whether or not they are largely held by ETFs.

This is the second of a group of related articles. Please see the previous one on ‘ETF horror story – structural weaknesses cause heavy investor losses’ and the next one on ‘Non-standardised ETFs cause regulatory confusion’. Also, see the editorial on the inside cover: ‘Health warnings for ETFs’.

Is there a dark side to exchange-traded funds (ETFs)? An information perspective. Stanford University Graduate School of Business Research Paper, Daron Acemoglu, Charles M.C. Lee, Susha A. Snihur, 26.07.15

‘Dark side of ETFs erode active managers’ outperformance’, Chris Flood, Financial Times, 10.08.15

‘Are ETFs giving the market a hangover?’ Peter Davy, Financial News, 19.10.15

NON-STANDARDISED ETFs CAUSE REGULATORY CONFUSION

Retail investors as well as investment professionals are hampered by insufficient clarity regarding the classification of exchange-traded products (ETPs) under various acronyms: Exchange-traded funds (ETFs), exchange-traded notes (ETNs), exchange-traded commodity pools (ETCs) and ETPs. Deborah Fuhr, the well-known ETF expert, points out that the definition of these terms is important, as the different regulatory structures of the various types affect key investment characteristics, including counterparty exposure and regulatory and tax treatment.

Along with Kathleen Moriarty, a partner at law firm Kaye Scholer (who was known as Spider Woman, following her work on the ‘SPDR S&P 500 Trust’, which was the first ETF to be listed in the US in 1993), Fuhr was among those who responded to the Securities and Exchange Commission’s (SEC) request for comments on ETPs in June 2015. The two of them submitted proposals for the simplification and standardisation of the various products, as advocated by them for more than ten years.

Fuhr outlined an example that supported the case for change. There was a discrepancy between the number of US ETFs (1,664) existing at the end of 2014, according to the SEC, and the figure of 1,662 that ETFGI, an independent research and consultancy firm in the ETF sector, came up with. Fuhr believes that the SEC has wrongly identified two products as ETFs.

The misclassification is attributed to various factors. These include official product statements not mentioning the regulatory structure, and the tax situation rather than the regulatory regime identifying the product. Furthermore, the name ‘ETF’ fails to demarcate what the product is.

Fuhr and her associate asked the SEC to formulate a list of definitions of products and acronyms that will need to be used by all providers of ETFs. The formal product name should be required to include the appropriate acronym. The European Securities and Markets Authority already demands this for undertakings in transferable securities ETFs.

Fuhr and Moriarty have also come up with a new name that they feel should be used for the entire sector: Exchange-traded investments (ETIs), instead of the current ETPs. They do not want the current acronyms, such as the all-important ETFs, to be abandoned, but think that all the different types, ETFs, ETPs, ETCs and ETNs, should come under the umbrella ETFs.

A further measure is suggested by Fuhr and Moriarty, which, if adopted by the SEC, will please those who are concerned about some ETFs venturing into the less safe active territory, rather than being purely passive. They asked for a hierarchy that classifies products as to whether they are index or active in the first instance, further subdivided by benchmark, and then followed by the type of benchmark. Fuhr also added that there is a need for smart beta to be clarified as an index product.

Editor’s comment

It is easy for regulators to demand and enforce that exchange-traded instruments are well-defined according to clearly demarcated acronyms. But a generic umbrella label might be more difficult to enforce, as the investment industry and the media are prone to a loose use of language that cannot be legislated against.

The proposal that there should be an official distinction between active and passive ETFs is very welcome. The general perception that ETFs are passive instruments, as they originally were, has been dented in recent years by the introduction of active types. There is the danger that some of the less informed could confuse the two types and make an investment mistake.

This is the third of a group of related articles. Please see the previous two on ‘ETF horror story – structural weaknesses cause heavy investor losses’ and ‘The size of ETFs poses dangers’. Also, see the editorial on the inside cover: ‘Health warnings for ETFs’.

‘Time to redefine the ETF family?’, Deborah Fuhr, Financial News, 21.09.15

ROBO-ADVISER CHALLENGE INTENSIFYING

The shift to the use of robo-advisers by retail customers, already established in the US, is now showing signs of taking off in Europe. More than 200 of these automated robo-adviser platforms now operate in the US (see box 1).


The threat to private bankers from the bottom end of the market comes from what are described as ‘robo-advisers’. This term refers to the automated selection of investment portfolios …

Much of the growth has been in the US, which has 83% of the assets managed by these new players. In Europe, the trend has yet to take off on the same scale. Among the few there, Nutmeg, Moneyfarm.com and Vaamo, in the UK, Italy and Germany respectively, stand out …

Some leading players are already adapting. These include Bank of America and Morgan Stanley in the US, and the UK’s venerable private bank Coutts, which are establishing digital services and platforms. Another big threat is that fund management companies increasingly have the capability to bypass private banks and wealth managers through mobile telephones.
Though the sector is still small, growth is expected to speed up as the baby boom generation gives way to the millennials, most of whom have grown up with technology. Citigroup has forecast that the total assets under management (AUM) might reach $5tn in the next 5–10 years. Parallel’s is made with the exchange-traded funds sector, which started small and then accelerated. It is suggested that robo-advisers might take off even faster.

A survey carried out by the consultancy A.T. Kearney in May 2015 revealed that 3% of customers with bank accounts already use a robo-adviser platform. However, a third of the 4,000 surveyed said that they might use these new companies to manage their investments.

Growth is expected to speed up as the baby boom generation gives way to the millennials, most of whom have grown up with technology.

The newcomers’ 2014 AUM growth rate of 10% per month has halved to 5% in 2015. However, Adam Nash, Head of Wealthfront, dismisses talk of a slowdown by saying that AUM growth partly reflects market levels and is not a good measure. He insisted that the number of customers is growing rapidly. But The Economist responded by pointing out that, while the two top firms, Betterment and Wealthfront, attract $100m each per year, and they really need at least $7–8m per annum, which is nowhere near enough to pay for their 100-plus staff and large marketing budgets.

Their cost base is believed to be in the order of $40–$50bn a year, and they really need at least many tens of billions AUM to be profitable, given their low changes and tiny profit margins.

In the meantime, these automated advisers are threatening the position of the advisory market, according to A.T. Kearney. In five years, this sector is expected to reduce the revenues of traditional advisers by up to $90bn. Already 0.5% of investable assets are with the robo-advisers, and this is likely to become 2.7% by 2018 and then double to 5.6% by 2020 (see box 2).

2. Extract from ‘Dangerous times ahead for wealth managers,’ Investment Management Review, April 2015

The automated portfolios are targeted towards the less affluent, but there is evidence that many of the wealthier also see value for money here and are going for it. This is a serious port. Offerings by the digital upstarts effectively become the new benchmark that the traditional sector has to beat, in terms of performance not of fees. If it fails to deliver on this basis, there is every prospect that the demand for automation might go upmarket on a much bigger scale.

Not only would market share be severely cut, but profitability could also be slashed – as in the UK retail supermarket sector, where Lidl and Aldi are running rings round Tesco and Sainsbury’s. Even if the threat does not intensify, the capital cost of introducing automation and digital facilities cannot be recouped by higher fees, which are already at the top end of what the market can bear, given generally reduced returns.

The upstarts are additionally posing a serious threat to the brokerage arms of the big US banks, which are currently thriving on much higher fees. Some of these brokers are reluctant to go into the digital arena, for fear of cannibalising their more lucrative revenues. But there is talk of links between JPMorgan and Tristc. Bank of the West and SigFig, and Motif Investing and U.S. Bank.

Big established firms are not standing still in the face of danger from the online services. Vanguard has already entered the market, departing from its focus on producing funds (see box 3).

In 2014, Fidelity established partnerships with Betterment and LearnVest. BlackRock has acquired the robo-adviser FutureAdvisor but does not plan to go directly to the consumer. Instead, it will use its purchase to deal with banks, insurance companies and advisers.

The fund management industry has also joined the digital game, recognising the opportunities of reaching customers online. Robeco in the Netherlands and Aberdeen in the UK are intending extensive contact with their customers, in what is known as ‘direct to customers’ (D2C) business. Aberdeen’s intentions are still on the drawing board, apart from its purchase of Parmenon (see the article on ‘Aberdeen on the expansion trail despite problems’, p.8).

However, Robeco can already boast of online success. Anybody who views a Robeco fund on its website a few times, if not invested in the fund, is sent further information automatically. This process leads to an impressive 10% conversion rate of these visitors becoming actual customers.

The question of how the robo-adviser industry will relate to end investors is not settled. Many feel that some human interaction is required, it can always be outsourced or hired separately.

Robo-advisers mark ‘seismic’ shift in industry, Chris Flood, FT/M, 21.09.15

Fund managers face robo-adviser threat, Helen Avery, Euromoney, September 2015

Accept the cookies, skip the ad; Nick Fitzpatrick, Funds Europe, September 2015

Robo-advisers – Does not compute’, The Economist, 3.10.15

3. Extract from ‘Vanguard invading the financial advisory market,’ Investment Management Review, April 2015

It is unprecedented for a top independent fund management house to also take on the advisory role, but Vanguard is doing exactly this. The structure itself is not new. Banks and insurance companies have been doing so for ages. But Vanguard’s prospective entry has some distinctive features that threaten upheavals in the advisory sector. The company is aiming to devise a method of providing simple but effective guidance to US savers, while charging just 0.3% of assets annually, a fraction of the 1% that the average financial adviser levies. Bill McNabb, Vanguard’s Chief Executive, is confident of supplying very good quality advice cheaply on a very large scale, and in the process, radically changing the advisory industry. It will mainly utilise online tools, including webcams for chats with advisers, and avoid the expensive overheads of existing advisory groups.

That computerised services will evolve in the direction of increased personalisation. Jet Lali, Head of Digital at Alpha FMC, suggests that automated solutions will eventually be almost like a fingerprint, giving a complete perspective of clients’ finances, embracing matters such as borrowings, tax status and valued collections.

These automated advisers are threatening the position of the advisory market, according to A.T. Kearney. In five years, this sector is expected to reduce the revenues of traditional advisers by up to $90bn.

Editor’s comment

Notwithstanding heady growth projections, online advisers are not secure, given their need for high volume in order to become profitable. However, only a few can achieve the necessary scale, so there are too many of them at present. The situation cries out for consolidation.

The part of the robo-adviser sector that is purely automated represents a classic commoditised industry, with low entry barriers. Large players with deep pockets are likely to eventually dominate. If any human interface is required, it can always be outsourced or hired separately.

Share prices often react sharply, positively or negatively, to enforced departures of chief executive officers. The factors that cause these dismissals are, therefore, of abiding interest, and are the subject of an academic paper in the Journal of Finance. The authors begin by pointing out that the decision to keep or fire a CEO after bad share price or company results is one of the most important decisions that confront corporate boards.

Standard theory demands that, in evaluating a CEO, components of firm performance outside his/her control should be ignored. Though previous studies found evidence of this good practice, the authors have come up with opposite results, using a larger data set over a more recent, and therefore more relevant, time period, as well as better methodology. The essential finding is that there is a significantly higher chance of CEOs being fired in the wake of negative results or shocks in their peer industry group.

The data set covered around 2,490 voluntary and 875 forced CEO turnover events in 3,042 firms in the period 1993–2009. It is shown that low share price returns in the industry, as well as low market returns to a lesser extent, increase the frequency of forced CEO turnovers.

When the industry contributes to a company performance drops from the positive 90th percentile to the abysmal 10th percentile, the probability of a sackings doubles. So, the traditional sector that boards take extraneous factors into account in the decisions on whether or not to retain CEOs.

In theory, CEO quality should be independent of the business cycle,
implying that efficient boards do not force out more CEOs in bad times than in good times. The authors strongly reject this proposition on the basis of their empirical results.

More CEOs tend to be fired when their peer group is not doing well, and one of the reasons is that boards misattribute exogenous performance to the CEO. Peer performance has not much effect on underperforming CEOs, but large effects on underperforming ones.

More CEOs tend to be fired when their peer group is not doing well, and one of the reasons is that boards misattribute exogenous performance to the CEO.

The authors suggest a possibility that boards mistakenly credit or blame CEOs for exogenous performance, with underperforming CEOs being more frequently dismissed in a recession than during booms, while underperforming CEOs are unaffected. The argument is that the latter can always point out that competitors are performing worse.

Underperforming CEOs, on the other hand, are less able to defend themselves against external performance attribution in recessions, but are happy to exploit good industry and market performance in boom times. This asymmetry between out- and underperformers is evidenced in the data.

The authors end by pointing out the need for more research in identifying the effect of peer performance on CEO turnover. Their results in this paper are consistent with boards mistakenly attributing to CEOs factors beyond their control, but also suggest that more is revealed about CEO quality in recessions than during booms.

Editor’s comment
This research is not just about CEOs or their quality. It says much about the professionalism of boards which clearly do not measure up to recognised standards in their decision making, with respect to CEOs.

Chinese Government Turns Active Stock Picker
The Chinese Government embarked in the summer on not just supporting the equity market, but also engaging in active stock picking, much to the fascination of stock market students and China watchers. Investors familiar with the idea of monitoring Warren Buffett’s and Fidelity’s stock picking might have hoped for similar piggy backing on the back of Chinese Government stock selection. Unfortunately, this has not been possible for peculiarly Chinese reasons.

At least two dozen companies in which CSRC became one of the top ten shareholders, according to official data, had performed remarkably well.

Immediately after the June crash, the hitherto obscure Securities Finance Corporation, run by an academic and bureaucrat Nie Qinger, was given S$4.83bn to spend on some stocks. The amount of discretion given to Nie was not disclosed. He and his 70 staff started blue chip buying on 6 July and followed it up with mid-sized and smaller companies on 8 July.

Based on information issued by the China Securities Regulatory Commission (CSRC), Nie’s program had little impact on the market as a whole. After 6 July, stock volatility reached a 20-year high. On 27 July alone, the Shanghai Composite Index fell by a dramatic 8.5%, and the index was down a stunning 30% between its 12 June peak and 3 August. It has been a different matter with individual stocks. Meyyan, founded in 1993 as a maker of equipment for the hydro-power industry in the Guangdong province in southern China, reported a total loss of €106mn in the six month period to March 2015. Despite this, its shares outperformed the market before its Ju ne crash, more than quadrupling in the 12 months to 12 June and reaching ¥8.96 a share, before collapsing by 63% to ¥3.32 by 8 July. Subsequently, following support by Nie’s team, the shares reached a record ¥9.85 on 17 August, having increased by the daily maximum of 10% on nine of the first ten trading sessions after the share support.

At least two dozen companies in which CSRC became one of the top ten shareholders, according to official data, had performed remarkably well.

In the US, investors who monitor the stock picks of Warren Buffett and Fidelity, do so in the hopes of profiting by copying them. But in China, government rules not allowing rapid day trading have eliminated this possibility. While most big investors try to be secretive about their trading to avoid piggy backing, the Chinese Government has made no such effort, but the rules have still precluded any profiting.

It has also been noted that government buying has been focused on the afternoons. So, if it had been possible, a purchase of the relevant stocks in the morning (10:30am being the best time), and sale at the close of dealing after government activity had moved up the share price, would have hypothetically yielded big profits in some stocks. For instance, over the period from early July to early September, day trading in Industrial and Commercial Bank of China, the country’s biggest bank, would have led to a profit of 40%. But such profits are purely academic, given the prohibition of this type of short-term dealing.

Editor’s comment
Hedge fund arbitrageurs worldwide need not kick themselves thinking they have missed out on a massive moneymaking opportunity, since they would not have been allowed to profit.

The Chinese Government picking a stock or two more broadly supporting the market might have unintended consequences. Exiting from these holdings could be a negative move for the markets. It is also possible that these favoured few companies could benefit materially from the benign oversight of their new shareholder.

This is the first of two related articles. Please see the next one on ‘Disturbing connections between China’s and Japan’s market interventions’.

The mission to save China’s stock market, Bloom berg Businessweek, 10.08.15
‘Beijing is China’s stock picker in chief’, The Wall Street Journal, 21.08.15
‘If only you could piggy back on China share buying’, Jacky Wang, The Wall Street Journal, 15.09.15

Disturbing Connections Between China and Japan’s Market Interventions
Gillian Tett, the well-known Financial Times columnist, has identified disturbing similarities between the Japanese Government’s stock market manipulations of about a quarter of a century ago and recent Chinese Government action. What is worrying is that the subsequent adverse effects were then contained mainly within Japan itself, but this time around, serious reverberations could ensue on an ongoing basis worldwide in due course.

Conditions in the years and decades preceding the stock market movements in both countries were remarkably similar
Japan did the same in the decades following World War II, though controlling the financial system in a more subtle way. Then, in the 1970s, the country changed tack, with the industrial companies needing less cheap credit from banks and investors becoming wealthier. The country started to liberalise the financial system, but in a patchy way that led to asset price bubbles. Fluctuations in monetary policy and exchange rates made matters worse.

At the end of the 1980s, stock and land prices had boomed, a situation replicated in China in the past few years, accompanied here too with patchy liberalisation.

According to Tett, what is most important is the action taken by the Japanese Government to respond to the above excesses, bubbles and distortions.
After hitting a peak of nearly 35,000 in December 1989, the Nikkei Share Index fell by 60% in the next two years. Initially, the Government assumed that this was just temporary, but as prices continued falling it started to intervene, propping up asset prices, sometimes with actual purchases but more often through more subtle methods. For instance, banks kept rolling over bad loans and big companies kept supporting each other’s share price. This approach seemed to work for a few years, and by the mid-1990s, the stock market appeared to have stabilised at lower levels. But in 1997, as it became known that banks had massive unrecognised losses, a financial crisis was the consequence, with asset prices falling again. By then, the financial system had become subject to a corrosive lack of trust.

It has been suggested that a similar erosion of trust is underway in China. Faith in the omnipotence of the Government would have been shaken somewhat by its failure to shore up the Chinese stock market in 2015.

It has been suggested that a similar erosion of trust is underway in China. Before the crash, the Chinese population reposed massive confidence in their Government’s ability to control events in general and the stock market in particular. This faith in the omnipotence of the Government would have been shaken somewhat by its failure to shore up the Chinese stock market in 2015.

Going back to Japan, by the late 1990s, ten years of ineffective market intervention had created a loss of confidence amongst investors in officials’ power. Neither did they trust market prices, since they knew that these were artificially propped up. Thus, according to Tett, the traditional pillars of faith that once supported asset values have collapsed without an alternative source. Under these conditions, it was not possible to gauge the unfettered ‘clearing prices’ of assets, and the psychology was the consequence, with asset prices falling again. By then, the financial system had become subject to a corrosive lack of trust.

While some Chinese officials express a keenness to avoid Japan’s mistakes, Tett points out that the historical echoes to date are very strong. In spite of the authorities throwing large sums of money at the market and intimidating investors from selling, the markets still fell by about 40% from the peak. Once again there is a potential limbo, as in Japan. The trust in both officials and the market has already been undermined, and Tett hopes that Beijing remembers the potential dangers.

Editor’s comment

If China continues to follow the path trodden by Japan, the repercussions could be global. When Japan declined in the Nineties, the West was still prospering, with a long-term bull market trend underway in stocks and bonds. If China’s stock market problems are affected by a more negative psychology on an ongoing basis, there could be a serious impact on the economy at large. An already weakened West may be more adversely affected. So, Tett’s salutary warnings need to be heeded not just in China but also elsewhere.

This is the second of two related articles. Please see the previous one on ‘Chinese Government turns active stock picker’. China risks repeating the errors of Japan, Gillian Tett, Financial Times, 04.09.15

BLACKROCK FORAY INTO GARDEN CENTRES

It is difficult to imagine the gigantic BlackRock, with its $3 trillion-plus of assets, spending time and effort going into such a tiny investment type as garden centres in the UK. But this is exactly what it has done in buying a portfolio of eight garden centres in the UK for $171m. What is the rationale behind this?

Garden centres have strong investment attractions. These centres fit into a bigger picture of a much wider class of exotic properties that BlackRock is backing.

BlackRock seems to have bothered on two counts. Firstly, garden centres have strong investment attractions. Secondly, these centres fit into a bigger picture of a much wider class of exotic properties that BlackRock is backing. This sector brings together several investment themes. The centres tend to be patronised by the older generation, whose numbers are growing fast. The customers are also typically home owners, another relatively affluent category. Finally, garden centres are not just about gardening. They also have cafes and restaurants, which make them important leisure destinations, once again for the more prosperous.

The investment figures seal the case for buying these assets. The centres bought by BlackRock have an unexpired lease term of 29 years with the initial yield at 9.25%, which compares favourably with bonds as well as mainstream equities.

These sectors would have been thought too small prior to the era of low interest rates, but are now receiving fast growing attention.

The portfolio was bought from the US property investment firm LaSalle Investment Management, which had put together the portfolio for the LaSalle Garden Centre Fund. The sale was obligatory on account of this fund’s tenure having ended. Six of the units are let to Wyevale Garden Centres, the largest UK operator of these centres, which is owned by the well-known private equity firm Terra Firma.

Overall, BlackRock’s exposure to real estate exceeded $21bn. The amount invested in these garden centres might look relatively miniscule, but these garden outlets are not the only type of exotic alternative property investment held by BlackRock.

Conventional property has gone up in price in response to low interest rates, and there is a rapidly increasing number of alternative investment types which asset management firms such as BlackRock are going into for the higher yield. The giant investment firm has also backed doctors’ offices, student housing, parking garages, cinemas and gas stations.

Other large global investors are doing the same. In March 2015, the Canada Pension Plan Investment Board purchased a student housing portfolio for around $1.6bn. In June, Brookfield Property Partners purchased Center Parcs, which operates five family vacation resorts in the UK, from the mammoth private equity group Blackstone. In the UK in particular, the volume of deals in these alternative sectors reached approximately $1.3bn in the first six months of 2015, compared with just $78m in the corresponding period of the previous year, according to the property agent JLL.

Top investors applying artificial intelligence to big data

BlackRock, the world’s largest investment house, is in talks with a Google company in the UK about exploiting AI in big data.

Pierre Sarraz, Chief Investment Officer of Multi-Asset Strategies at BlackRock, referred to this tie-up as a very exciting joint venture, but did not specify which Google company he was talking about. It is believed that the company is DeepMind, a company specialising in AI and bought by Google in 2014.

BLACKROCK ANNOUNCES GOOGLE TIE-UP

Editor’s introduction

BlackRock is taking the initiative in marrying the two exciting and much talked about concepts of big data and artificial intelligence (AI). The key question is whether this approach will lead to good investment returns.

Machine learning techniques would enable the spotting of ‘correlations and patterns that cannot be observed manually or even with traditional analytical techniques that require significant human guidance’.

DeepMind was founded in 2010 by Demis Hassabis and his team, who are currently exploring the best of machine learning and systems neuroscience, in order to create powerful learning algorithms. BlackRock is already using machine learning in many investment decisions to analyze big data. To this end, it had hired Bill MacCarty, a former Google scientist, to assist in using machine learning techniques in investment strategies.

BlackRock is not the only top investment house trying to analyse huge volumes of data. Other top asset managers are also interested, including Amundi, BNY Mellon, State Street and NN Investment Partners. BNY Mellon published a paper in May 2015, which observed that machine learning techniques would enable the spotting of correlations and patterns that cannot be observed manually or even with traditional analytical techniques that require significant human guidance. The paper also pointed out that the data needs to be analysed initially by machines before any humans get involved.

A prolific source of big data is social media, which asset managers are exploiting on an increasing scale.

In a survey of 90 German institution investors, more than 60% have predicted that more use of AI will be made for fund management-making, and over 15% believed the same for medium-term investment. A majority of them claimed that AI is already taking the place of active managers. This survey was carried out at a conference in October held by Universal Investment, which has £260bn assets under management. According to Markus Neubauer, Managing Director of Universal Investment, AI is capable of accurately assessing emotional aspects, such as greed or fear.

A prolific source of big data is social media, which asset managers are exploiting on an increasing scale. BlackRock stated in October 2015 that both Google and Twitter information was being used for an increasing scale.

Google and Twitter information are exploited on an increasing scale. BlackRock, for instance, uses data from Google to exploit big data, and exploit big data was underlined by a top executive in an article published in Investment & Pensions Europe (IPE) magazine. Peter Nielsen, Head of Institutional Business for Continental Europe at BlackRock, pointed out that, according to IA economists, 90% of the data in the world had been created in the past two years. After referring to the mass amount of active data surrounding big data, he addressed the questions of how specifically investment houses could benefit.

The case for big data in investment research is made but also to their huge investments in operations arms (see box).

Extract from ‘Big data: A growing need for asset managers’, Investment Management Review, April 2014

What is it in for asset managers? A primary force driving their need to understand and utilise data is increased regulatory demands for transparency. The authorities need to be satisfied that the financial services companies’ business models are sufficiently robust for survival. They want to be reassured that the firms themselves understand and cater for all that is going on in their operations, and this means a better fix on their data. There are other incentives for asset managers. Abridge, owned by BNY Mellon, offers services that enable asset managers to enhance their business by using their data on three fronts. These are:

- monitoring relationships with sub-advisers
- identifying and analysing trends in asset flows and transactions, for spotting opportunities
- assessing the profitability of products, advisers and clients.

BNY Mellon is not alone. As a custodial bank, it naturally has access to plenty of asset management data. State Street is … enabling institutional investors to use client data for risk assessment and portfolio efficiency monitoring. However, opinion amongst fund managers is not unanimously in favour of the big data approach to investment research. For example, Nick Thomas, a partner at the Edinburgh based fund firm Baillie Gifford, has expressed serious doubts to FTfm. Given his firm’s long-term orientation towards investments, he felt that applying big data to its own decision-making will be very difficult.

BlackRock and Google in talks over joint venture: ‘Artim Williams, Financial Times, 19.10.15

‘Actives face more competition from artificial intelligence’, funds-europe.com

The case for big data in investment research is made but also to their huge investments in operations arms (see box).

BlackRock’s interest in the use of AI to exploit big data was underlined by a top executive in an article published in Investment & Pensions Europe (IPE) magazine. Peter Nielsen, Head of Institutional Business for Continental Europe at BlackRock, pointed out that, according to IA economists, 90% of the data in the world had been created in the past two years. After referring to the mass amount of active data surrounding big data, he addressed the questions of how specifically investment houses could benefit.

There is a race to build the tools necessary for acquiring the data, and to find the talents needed for the next generation of quant insights.

He claimed that big data is simultaneously overhyped and underappreciated. He dismissed the exaggerated notion that human beings will become redundant in the foreseeable future, but also pointed out that the mass volume of big data is not fully appreciated by the investment management industry. Creating alpha is now increasingly difficult, and he believes that fund managers are turning to big data for an edge in both generating and forecasting.

Such an edge is not easy to find. There is a race to build the tools necessary for acquiring the data, and to find the talents needed for the next generation of quant insights. However, these insights lose value when widely adopted. Therefore, Nielsen emphasised that not only is a large commitment required to exploit big data in the long term, but also constant innovation is a must.

A large volume of data stems from new technologies and approaches, such as smartphones, social media and internet searches. Identifiable signals from the massive volume of noise emanating from these sources is not easy. The techniques of natural language processing, social data visualisation and distributed computing are of considerable value. Over a long period, fund managers have relied on analysts for information sources. But huge worldwide exploitation in broker reports, currently averaging 4,000 per day, makes advanced analysis absolutely essential for asset managers.

Given the difficulties of separating valuable signals from the noise, this analysis requires new thinking. Nielsen expects that postulating a hypothesis and using data to test it is a good way of going forward.

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To illustrate big data’s potential, Nielsen referred to a 2010 paper published in the Journal of Financial Economics. Alex Edmans, a professor at the University of Pennsylvania’s Wharton School of Business, investigated a link between employee satisfaction and company profitability. He found that, over a 25-year period, a value-weighted investment portfolio of Fortune 500 companies performing above the median on the employee satisfaction survey would outperform the median by 2% per annum. Nielsen claims that by using big data techniques, the same study could be replicated on a wider scale and also in a more timely way with better accuracy.

‘Finding big alpha in big data’, Peter Nielsen, Investment & Pensions Europe, October 2015

Editor’s comment

Baille Gifford’s Nick Thomas makes an extremely important point about the long term. The big question concerns the shelf life of the big data that might be considered useful for investment research. In addition to much of the information being just noise, even the valuable signals could be valid only in the extreme short term, without much lasting value. True, even long-term oriented investment managers do benefit from timing their purchase and sales, but here too, they need to assess how reliable the signals are compared with their own observations. It need not be the case that all the

signals point in the same direction, and the general signal could signal could be a problem in itself.

There is also the difficulty that the asset manager making the decision could be far removed from the original source of the data, not making it easy to assess their value relative to other information which the manager has.

Too much, perhaps, should not be read into German institutional investors predicting the greater use of AI. It seems unlikely that any of them on their own will have the resources that BlackRock can bring to bear to the approach. The survey merely records opinions which may not always be well-founded. The claim that greed and fear can be predicted deserves some scepticism, as these emotions are not easy to predict far ahead.

Furthermore, investment forecasting over the medium to long term has to allow for the possibility of shocks and black swans. All AI can do in spite of the hype is to implement guidelines and company profitability. There is also the difficulty that the

big data in all sectors and companies becomes beautiful in asset management. If BlackRock is right, big becomes beautiful in asset management, with yet another entry barrier for smaller groups.

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Giant such as BlackRock, Amundi and State Street might have the money to throw at big data without any perceptible impact on their bottom line, but the same is not true of most other companies. So, if BlackRock is right, big becomes beautiful in asset management, yet with another entry barrier for smaller groups. The jury is still out and one can only wait and see.

The likes of BlackRock need a pat on the back for attempting to extend the frontiers of investment research and decision making through use of advanced techniques involving AI to exploit big data. Whether it will actually become useful is another matter, but they deserve plaudits for trying.

BlackRock’s garden centre venture (see ‘BlackRock foray into garden centres’, p.20), seems much more practicable and more in keeping with the new outcome-

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BlackRock’s garden centre venture (see ‘BlackRock foray into garden centres’, p.20), seems much more practicable and more in keeping with the new outcome-oriented investment world. All this big data crunching is perhaps more suited to high-frequency short-term traders.

This is the first of two related articles. ‘Please see the next one on ‘Investors making a mint from credit card data’.

Extract from ‘Big data looming large for asset managers’, Investment Management Review, April 2014

Editor’s comment

At the end of the day, crunching and analysing big data is not enough, and

Other questions concern investment research based on big data. Will it cover all industry sectors or all companies, or will there be some kind of a selection process?

The game is still at its early stage and is not clear yet. For instance, notwithstanding, machine learning. Researching big data in all sectors and companies would seem to be a monumental task. It might involve sourcing the necessary information by blanketing the entire planet in all areas of economic activity by blanket the entire planet in all areas of economic activity.
INVESTORS MAKING A MINT FROM CREDIT CARD DATA

Yodlee Inc, based in Redwood City, California, is a fast growing business that exploits credit and debit card data by selling it to investment managers who pay huge sums for this service.

Yodlee’s main business consists of supplying online personal finance tools to 11 of the 20 largest US banks in terms of assets. Banks and other financial institutions pay Yodlee a fee on each occasion that one of its customers uses a tool supplied by the company. The banks that use this facility have 100 million customers. Some of the world’s most sophisticated investors analyse location data from mobile phone carriers, cargo ship movements and construction permits. These pools of data can cost huge sums per annum, even up to $4m.

Yodlee does not stop there. Every time an individual customer of the bank uses their credit or debit card to access a service, Yodlee is able to collect this information and sell it on to investment research firms that can then mine the data for company trends that might impact share prices.

Based on this data, Yodlee gets information on, for example, the total water bill of 25,000 citizens of San Francisco, or the daily spending in McDonald’s throughout the country. As Peter Hazlehurst, Yodlee’s former Chief Product Officer said. Some investment firms pay more than $2m a year to Yodlee for this research, according to people familiar with the matter. Important buyers of this service include Point72 Asset Management and Tiger Global Management. The first of these was previously known as SAC Capital Advisors, which pleaded guilty to insider trading in 2013, paid nearly $2bn in fines and agreed to stop managing money for outside clients. It now has $11bn in assets under management, while the illustrious hedge fund Tiger Global Management runs $28bn.

This mining of data is not unique to Yodlee. Some of the world’s most sophisticated investors analyse location data from mobile phone carriers, cargo ship movements and construction permits. These pools of data can cost huge sums per annum, even up to $4m. The above activities are part of an arms race between investors who are trying to profit from such data. Yodlee does not publicly admit to having sold data to investment firms. Before an initial public offering (IPO) in 2014, it merely said that it provides data for research. It will not identify its data-buying clients either. All Yodlee has said on this account is that it has a very limited number of strategic partners to develop sophisticated analysis.

Preserving the privacy of individual bank customers whose data is accessed by Yodlee is an important issue. The company insists that it maintains strict privacy standards to ensure that transaction data supplied to its investment research customers remains anonymous, and does not make it possible to identify the individuals concerned. The strategic partners to which it sells the research are forbidden from reselling, sharing or providing it to any third party. They are also forbidden to re-identify the people involved.

But some researchers maintain they have achieved re-identification. A group from Massachusetts Institute of Technology have claimed that they could identify approximately 90% of the people from the database of credit card transactions, using four pieces of information, including data and location, supplied by another company. For instance, if somebody purchased something at a retail outlet and then had dinner at a restaurant the next night, they could work out who he was. But Yodlee rebuts this possibility by saying that it has technical measures in place to reduce this risk, as recommended by regulators. Peter Swire, a privacy expert at the Georgia Institute of Technology hired by Yodlee, points out that investment firms that buy the research have no reason to identify the individual sources.

Some of the biggest banks involved, which are the sources of Yodlee’s information, assert that it is not possible for their individual customers to be identified. For instance, Bank of America, which generated nearly 14% of Yodlee’s revenue in 2014, asserted that customer data was protected by all third party vendors. Yodlee’s prospects are such that some big names have invested in its shares. These include Fidelity, the private equity firm Warburg Pincus, Bank of America and Tiger Global.

The biggest use appears to relate to research on retail companies, particularly publicly traded restaurants, theme park operators such as Sea World, and clothing companies. The share prices of these companies react to quarterly revenue announcements, with surprises causing large price swings, so information received in advance can lead to big profits.

At Yodlee, the business of analysing the data is in such demand that the company has subcontracted the analysis of such information. The Earnest Research Company, a New York-based start-up, analyses data from Yodlee on behalf of some hedge funds, according to people familiar with the situation. Earnest supplies weekly reports on sales and transactions at more than 70 retail companies, from Urban Outfitters to McDonald’s, as pointed out by these same sources. Neither Yodlee nor Earnest have commented.

Editor’s comment

Yodlee’s links with 11 of the top 20 banks and 100 million customers indicate that the company has arrived in terms of taking a big share of the US market. It is unsurprising that regulators have already entered the scene, with recommendations for Yodlee to observe. But the question of privacy remains a huge potential pitfall.

BlackRock exploiting big data with artificial intelligence (AI) and profiting from credit card data provides a study in contrast. Credit card information is just one aspect of big data, but the path to profits in this particular area is both practical and clear-cut. The use of AI in the wider realms of big data appears to be more conceptual. Not much authoritative and convincing information seems to be widely available on the methodology used for predicting performance or related research.

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It is interesting that so far the players researching credit card information are short-term-oriented hedge funds, bearing out the argument that the information gained is good just for the very short term. Furthermore, the main area for exploitation seems to be retail outlets, such as restaurants. Interestingly, BlackRock and other giant mainstream asset managers are not so far involved with Yodlee. Thus, there is a case for questioning the shelf life of much of the big data relevant to fund management.

This is the second of two related articles. Please see the previous one on ‘BlackRock announces Google tie-up’. 'Company tracks bank cards and sells data to investors', Bradley Hope, The Wall Street Journal, 10.08.15.
The DOJ antitrust inquiry confirmed same industry, not just airlines. Shares in different companies when a group of large investors hold possible loss of competitiveness was part of the agenda. On a wider shareholders where industry capacity between the airlines and the major managers brought into this investigation are those holding more than 2% of the shares of at four largest airlines in the US, and is looking into price fixing by the largest investors important ramifications for the investment process could ensue. If the competitors are likely to be in the same stock market index, and if an investor generally wants exposure to a sector to spread the holding within it, either because of uncertainty or to avoid too large a holding in a single company, then any constraint could have a severe impact. This issue applies even more to index funds which are obliged to hold the different shares. Such potential unintended consequences should make authorities think twice before coming to hasty conclusions.

Who’s really at the control?, David McGlaughlin and Mary Schlangenstein with Michael Sass, Bloomberg Businessweek, 28.09.15

BlackRock, pointed out that most of their investments are in index and exchange-traded funds that are not actively managed. While refusing to comment on the DOJ investigation, he asserted that BlackRock expects fair and ethical competition between the companies it invests in.

Editor’s comment
The relationship between common ownership and ticket prices is fascinating. It is difficult to imagine the fund managers participating in any secret collusion, as they have too much to lose if it comes out. However, some indirect and inadvertent pressure cannot be ruled out.

For instance, if an industry is subject to an oligopoly, with just a few large players, it is in their interests not to compete on pricing. It would only be a losers’ zero-sum game, where all that would be achieved would be a lower general level of prices and profitability, leaving all the participants worse off. If the airlines really wanted to collude, they would not need the fund managers as intermediaries. On the other hand, it is not likely that they would be influenced by a 2% holding to engage in an illegal practice. What is possible is that the fund managers, concerned about the profitability of such a cyclical industry, may have mentioned opinions that price cutting by any of the companies would be futile since the others would follow. Expressing such a view would not be illegal. Should the authorities move towards limiting common ownership of different companies, without taking antitrust considerations into account. Professor Maurice Stucke, a law professor at the University of Tennessee, looked at common ownership and ticket prices is fascinating. It is difficult to imagine the fund managers participating in any secret collusion, as they have too much to lose if it comes out. However, some indirect and inadvertent pressure cannot be ruled out.

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put down the trend of pre-IPO funding to the growth of family offices, owing to the increasing number of wealthy European families. These family offices, having become disenchanted with the unsatisfactory performance and high fees of private equity funds, find the pre-IPO business attractive. Previously, these families did not have the capability to evaluate companies at this early stage, but this is now changing. They particularly like pre-IPOs where the seekers of money are families like themselves, so that they have something in common.

On the other side of the coin, some of the companies, aiming to raise funds, find family offices useful, not just for the money they are providing but also because of comfort factors. Some emerging US tech companies like the idea of a close relationship with an independent family, so that a market can be opened up in countries such as Germany, France and Spain by somebody they know.

Editor’s comment
It is not certain that this new trend will survive in an equity bear market (see box 2).

2. Extract from ‘Privileged investors squeezing out initial public offerings’, Investment Management Review, October 2015

Editor’s comment
The early stage privileged investors are taking on risk as well as potential reward, and in some cases the investments have gone sour. Given the inflated valuations some of the tech groups trade at, big losses and handsome profits are equally likely, depending on the overall tenor of the market. While strong bull market conditions continue, these early stage investors could do well on the basis that others will buy from them at even higher prices.

What happens when the music stops? Then, these wealthy backers could well take a nasty hit. This phenomenon of rushing to back companies before they float could just be a bull market feature. The next downturn is most likely to end this practice.

Family offices, having become disenchanted with the unsatisfactory performance and high fees of private equity funds, find the pre-IPO business particularly attractive. Some start-ups will go on to become huge successes regardless of whether the markets are in a bull or bear phase. But, as venture capitalists know, such instances are not common and finding them is not easy. The majority of pre-IPOs are likely to produce losses in a downturn, leading to a sharp fall in this type of funding.

Companies uncouling new funding

Privileged investors squeezing out initial public offerings, Investment Management Review, October 2015

A POPULAR INVESTMENT TECHNIQUE BLAMED FOR DESTABILISING MARKETS

The risk parity technique has long been considered a powerful method of asset allocation that has produced good results in the last couple of decades. During the market turmoil of last August, however, it received a lot of bad press for having exacerbated the turbulence at the time, although its proponents have vigorously refuted this charge.

What does risk parity seek to achieve, how did it perform so well, and how well-founded are the accusations?

The robustness and consistent performance of risk parity funds, particularly since the financial crisis broke, has led to an expansion in the size and number of such funds. The technique is strongly supported by some of the leading asset managers in the world. Providers of risk parity funds include BlackRock, Pimco, Investco, AllianceBernstein, J.P. Morgan, the world’s largest hedge fund group, Bridgewater Associates and AQR Capital Management, another hedge fund founded and run by Clifford Asness, a former star trader at Goldman Sachs.

So what exactly is risk parity? In theory, it is a passive form of asset allocation based on risk that needs rebalancing from time to time, the frequency of which varies between funds. A risk parity portfolio invests in a variety of asset classes chosen not by their expected return but according to their riskiness. The idea is to assign weights to the various asset classes so that each contributes equally to the portfolio risk, with risk being defined here as volatility. This is a departure from the traditional rule-of-thumb method of having 60% in equities and 40% in bonds. Because bonds are much less volatile than equities, they are assigned a higher weight, so that the contribution to risk from bonds equals that of equities.

The actual market fire power is much higher, with up to $1.4tn being under the control of the risk parity funds, because of leverage which is estimated at 355%.

The same approach is adopted towards other asset classes, such as commodities. Unfortunately, with this approach in good times the higher bond weighting can drag down performance. This problem is mitigated or avoided by leveraging the bond exposure or by using derivatives or other debt or derivatives. The idea is that the higher bond holding will provide ballast in bad times, while the portfolio will not suffer from holding the safe bonds in good times, because of the leverage. As with many other asset allocation techniques, algorithms are used to manage the portfolio and restore the equal weighting. The frequency of rebalancing is a decision for each fund and underlies the furious destabilising debate.

Bridgewater Associates has established the ‘All Weather Fund’, dedicated to risk parity, which has accumulated $300bn, and its popularity has helped to attract more funds to back this technique. It is now estimated that $400–600bn of assets under management (AUM) have been assigned to risk parity. This total does not take into account risk parity funds managed internally by institutional investors. But, according to AllianceBernstein, the actual market firepower is much higher, with up to $1.4tn being under the control of risk parity funds, because of leverage which is estimated at 355%. This $1.4tn is significant, considering that the total estimated funds run by money managers is in the region of $60tn.

Ray Dalio, the founder of Bridgewater Associates, is credited with inventing the risk parity concept. He traces this idea to McDonald’s ‘Chicken McNuggets’, the introduction of which was instigated by him.

Leon Cooperman, the manager of the hedge fund firm Omega Advisors, blames risk parity funds using automatic trading algorithms. Furthermore, even AllianceBernstein, a supporter of the technique, weighed in by saying that there could be a marked impact on the stock market because of risk parity dealings. These accusations were ridiculed by Dalio, who pointed out that they did not rebalance during the crisis and their adjustments only take place infrequently. Secondly, he dismissed the idea of risk parity funds having a substantial impact on markets, as the total volume in the sector is not big enough to justify the accusation. In fact, the accusations do not take account of short-term changes in volatility, and therefore they would be buyers and not sellers of assets that have fallen.

This was echoed by Michael Mendelson at AQR Capital Management and several other leading fund managers, including Yazzon Romali, Head of Quantitative Strategies at J.P. Morgan Asset Management.

Future Prospects
What causes most concern amongst those who have supported risk parity is the future outlook. Some pension funds are backing away from the technique, though by and large most are still staying with it. The worry is that risk parity has benefited from Market instability
The strong criticism of the risk parity technique for having contributed substantially to market turbulence last August centred on its methodology. This implies rebalancing when an asset type falls in value, accompanied by increased volatility (risk). Such an increase in risk requires further reductions in its exposure. Thus, risk parity is considered a pro-cyclical technique.

Ray Dalio, the founder of Bridgewater Associates, is credited with inventing the risk parity concept. He traces this idea to McDonald’s ‘Chicken McNuggets’, the introduction of which was instigated by him.
benign market conditions over the past 30 years. In the coming period of rising interest rates and poorly performing bonds, both leveraging and risk parity’s higher exposure to bonds could see the portfolios using this technique in trouble. But Daleo has countered by saying the whole idea of risk parity is based on it doing well under different conditions because of its weighting approach.

Editor’s comment

The problems with the above arguments and counter arguments is that quite a few participating in the debate could be biased either in favour or against. The accusations of causing market turbulence do not seem to be very strong. Risk parity portfolios are not the only ones that are pro-cyclical. Moreover, only a fraction of the assets backing this technique would have been traded last August.

The performance argument is a different matter. There is no unique risk parity portfolio, and claims for or against the technique need to be tested by impartial academics. It is feared by some that a bond bear market could see risk parity portfolios doing badly. This argument ignores the possibility that equities could do even worse under the same scenario. In this event, risk parity could shine.

Financial Times – ‘Whatever the weather?’, Henry Sender and Robin Wigglesworth, 24.08.15; ‘Risk parity strategy blamed for fragile markets’, Robin Wigglesworth, 24.08.15; ‘Risk parity fund given bogus treatment’, Robin Wigglesworth, 03.09.15; ‘Risk parity industry defends strategy’, Robin Wigglesworth, 09.09.15; ‘Bridgewater defends risk parity strategy’, Robin Wigglesworth, 17.09.15; ‘Risk parity strategies prepare for headwinds’, Robin Wigglesworth, 29.09.15


‘Bridgewater’s “risk parity” marque fails to weather the financial storm’, Rob Copeland and Timothy W Martin, Financial News, 21.09.15

‘Risk parity investment survey’, Chief Investment Office, October 2015

AMUNDI’S SHOCK THREAT TO LEAVE FRANCE

Editor’s Introduction

The world’s leading asset managers suffered an unpleasant third quarter in 2015, reflecting the global equity downturn. While this hit many of them, particularly affected was Franklin Templeton, who is not far off the top ten by assets under management (AUM). On the positive side, the French giant Amundi is proceeding with expansion plans. But its Chief Executive’s statement on the company departing from France, if needed, may not be just an idle threat.

• Top players lose heavily. Seven of the world’s largest fund managers suffered a fall in AUM of more than $700bn, representing 4–11% of assets in the third quarter. BlackRock; J.P. Morgan; T. Rowe Price; Franklin Templeton; and the investment arms of BNY Mellon, Bank of America Merrill Lynch and State Street. BlackRock alone lost $215bn. These results followed a first half which was good for most of them. The losses inflicted balance sheet stress on the asset managers, already under pressure because of regulatory costs and price wars on fees. Their profitability was directly hit, with BlackRock down 8% in the third quarter compared with the same period in 2014.

 Swedish pension reforms condemned; Chris Newlands, Financial Times, 26.10.15

‘Fund houses lose $700bn in “brutal” Q3’, Attracta Mooney, FTfm, 26.10.15

In a shock statement, Yves Perrier, the Chief Executive, points out that Europe’s planned financial transaction tax would… force him to move operations out of France

• Franklin Templeton worst hit. This top emerging market player did not suffer from just a bad third quarter. While it lost $3.9bn in August alone, outflows in 2015 up to September totalled $6.4bn. Franklin’s global equity business suffered 16 consecutive months of negative flows prior to August, while the Templeton Global Bond Fund suffered from more withdrawals that month than in any previously.

Half of Franklin’s $6.8bn in AUM are wholly or mostly outside the US. Its focus on emerging markets and heavy reliance on retail investors, who tend to be more volatile, has made the group very vulnerable. These problems were reflected in a near 30% fall in the first three quarters of 2015, while the rest of the fund management sector was down by only half that.

Franklin Templeton hit by record fund outflows; Stephen Foley, Financial Times, 14.09.15

Editor’s comment

Franklin Templeton’s problems are similar to those of Aberdeen, but the circumstances of the two are very different. Aberdeen has clearly been on an expansionary path, while Franklin Templeton has a history of being close to the top, with its main strengths of fixed income from its Franklin roots and its emerging market emphasis coming from the Templeton side. These exposures might result in serious problems on an ongoing basis, with no acquisition strategy obviously in place, unlike at Aberdeen.

• Amundi on target in growth plans but shock statement about possible exit from France. Disregarding market turmoil and any outflows suffered, this company continues serenely with its expansionary ambitions, as reflected in the initial public offering (IPO) targeted for the end of 2015. It registered this IPO flotation with French authorities in early October, planning to go public in December, which will effectively provide it with some independence from its parents Crédit Agricole and Société Générale.

Some key strategic issues have been identified from its IPO filing by the Financial News. It has the ambition of making Europe its domestic market, not just France, with recent offices opened in the Netherlands, Sweden and Switzerland. It hopes to build on joint ventures in Asia. It currently has links with the Agricultural Bank of China and the State Bank of India. The group also hopes to grab outsourced insurance business on the back of its experience of managing insurance money on behalf of its parents.

In a shock statement as reported by the Financial Times, Yves Perrier, the Chief Executive, points out that Europe’s planned financial transaction tax would be a disaster for Europe and force him to move operations out of France. He implied that it would be easy to leave, as Amundi already has a presence in the UK and Luxembourg.

Franklin Templeton hit by record fund outflows; Stephen Foley, Financial Times, 14.09.15

‘France’s Amundi eyes Asia push after IPO’; Michael Stothard, Financial Times, 08.10.15

Amundi maps out post- IPO targets; five key points to take away; Andrew Pearce, Financial News, 12.10.15

Amundi aims to grow distribution after IPO; Mike Foster, Financial News, 02.11.15

Editor’s comment

Amundi is making all the right plans to propel itself upwards from its number ten rank in the list of the biggest global fund managers, but there are difficulties on the way. Its insurance ambitions resemble those of Standard Life in the UK, but this is a crowded market. Making headway in Asia is easier said than done. But on paper Amundi has everything going for it, and could certainly challenge the US heavyweights.

Given that Amundi is aiming to make Europe, not just France, its domestic market, its Chief Executive’s threat to move from France, if necessary, sounds quite credible.
Editor’s introduction
Yet another U-turn by banks on the question of owning fund managers might be superseded by retail customers abandoning them.

Banks changed tack on owning fund managers
Banks are rediscovering the advantages of being involved in asset management and forgetting the negatives that impelled them to divest their operations in this arena. In recent years, following the credit crisis, the main motivation for divestment had been one of necessity, a direct result of the financial crisis that led to stronger balance sheet requirements from banks. But the banks had never totally lost their interest. It was only dormant. Now that hard times seem to have gone, banks are renewing their fascination with owning fund management companies.

Fund management not requiring a large amount of capital has always been a draw for banks. In addition, new developments provide more reason for getting back into asset management. This industry is now seen as a good route to offer financial services, at both retail and wholesale level. Marketing funds to retail customers might become easier because of technological changes and the digital revolution.

One of the recent examples of banks moving into asset management was Mediobanca’s purchase of London-based asset manager Cairn Capital from the Royal Bank of Scotland, emphasising its global ambitions in the process. The Swiss private bank Vontobel bought 60% of 24 Asset Management in 2015, and is now looking to buy a bond manager based on renminbi. Brazil’s BTG Pactual bought BSIE, one of the oldest Swiss private banks, last September. Credit Suisse Asset Management, having sold out to Aberdeen a few years ago, is now re-expanding in the business, with talk of the group shifting more towards wealth management, following its main Swiss rival, UBS.

It is now suggested that Barclays might also reverse in the direction of fund management, having disposed of Barclays Global Investors to BlackRock back in 2009 in order to raise capital. There is the problem that big acquisitions might impose a balance sheet strain in the write-offs of goodwill, and that only the bigger banks might be able to withstand it. But even the smaller ones can consider growing organically, having fund management teams or making small niche acquisitions.

Barclays might also reverse in the direction of fund management, having disposed of Barclays Global Investors to BlackRock back in 2009 in order to raise capital

Jes Staley is appointed Chief Executive, given his former role as Chief Executive of J.P. Morgan’s Asset and Wealth Management Division for eight years. ‘Banks rekindle love affair with fund management,’ Mike Foster, Financial News, 19.10.15

Banks losing their retail following
In the past, banks had an unsailable position with respect to their retail customers. They benefited from brand loyalty that was reinforced by the difficulties of customers switching accounts, as well as the physical advantages of having branches everywhere. These advantages are now being eroded on three counts.

Firstly, there is no shortage of fintech upstarts taking on banks, with much success already. Secondly, the advent of internet banking allows everybody to get their own personal information in a very convenient digital form, which they can share with third parties.

Finaly, new regulation and the rise of upstarts are forcing banks to share their customers’ data with other groups.

It seems likely that in the future, banks will be considered merely as utilities for holding money, with the actual management of it taken elsewhere by their customers.

‘Cracking the vault,’ Mike Foster, The Economist, 24.10.15

Editor’s comment
Banks have other reasons, apart from the need for capital, not to get too involved in asset management. The problem is that many banks in the past, particularly in Europe, did not make too good a fist of operating their investment arms. There is a major structural reason for this. Their bureaucratic culture as well as pay structure do not sit very well with the talents, creativity and flair needed in investment management. This has been a vicious circle in the past, in that the cultural differences discourage the really talented from staying or joining, leading to indiffent investment performance.

Another issue is that banks’ customer-facing distribution arms always had a conflict of interest in trying to promote the in-house products coming from their internal fund managers, while implicitly claiming to recommend the best available in the open market.

To a lesser extent, this might also apply to investment banks that have cultural attributes which are different from those of retail banks. Investment banks tend to be short-termist and transaction orientated, the antithesis of what a good fund manager requires: a long-term outlook and a solution-based approach.

This is not to say that banks can never make it. Some investment banks that suffer lesser cultural problems are able to cope better, and perhaps some private banks too. The level of autonomy is the key.

The potential loss of banks’ retail followers for functions other than depositing money will have a serious impact. Retail banks’ very survival in the long term, in anything like their current shape, size and dominance, is very much a matter for debate at the least. They then stand to lose one of the main attractions they have to offer fund management houses to join them, namely their retail customer base.

Only about $2tn of the $11–12tn of Asian institutional assets are managed by external fund managers. This proportion of under 20% is much less than the corresponding 80% in the US.

Even where banks do not explicitly co-operate, many customers enable other companies to access their bank data by giving them the passwords to their accounts. However, this trend is currently more prevalent with the less creditworthy, who are passing on data in order to obtain credit. Hitherto, peer-to-peer lending groups have relied on various credit bureaus for their credit checks, but data from the banks is far superior, and they, too, will have better access to such data.

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Tighter Rules for Liquidity Risk Management Ahead

Dr Wolfgang Mansfield

The open-ended, daily redeemable type of fund is the model for retail investment funds in the US and Europe. Rightly or wrongly, the daily redeemability of fund units is regarded as a cornerstone of investor protection. With the extension of investment instruments and techniques used by funds, it became evident that their investments would not automatically be as liquid as the fund units. Investment funds engage, strictly speaking, in the use of illiquid instruments and techniques used by institutional investors. But in the open-end fund, the manager is in charge of assessing liquidity risk, classifying instruments accordingly and deciding on liquidity buffers. He is obliged to assess portfolio liquidity and ultimately the ability of the fund to pay out on redemption requests. In addition, regulation may require the manager to implement certain policies and procedures relating to the process of liquidity risk management. As a result, current regulation gives the fund manager a significant level of discretion to determine how to measure and manage liquidity risk. Not surprisingly, regulators have observed that different fund managers may apply liquidity risk management standards with differing degrees of rigour. It is evident that the pressure to deliver performance may create incentives and pressures on managers to compromise on liquidity risk. So, conflicts of interest clearly exist.

Ensuring that funds remain liquid continues to be an issue of concern for regulation. Doubts persist as to whether the current principles-based approach is strict enough. These concerns are exacerbated by recent industry and markets trends:

- Funds in less liquid instruments have increased (see box)
- Exchange-traded funds (ETFs) are gaining ground, where the process of issuing and redeeming fund units is more complex
- Concerns over bond market liquidity are growing: the ability of bank and broker-dealers to provide liquidity for the fixed income markets has been reduced, and execution risk has, therefore, increasingly shifted to the asset owner.

The new Securities and Exchange Commission (SEC) approach

The discussion about liquidity risk management has intensified. It is remarkable that a first important contribution has come from within the fund industry. BlackRock issued in 2015 a valuable and comprehensive analysis including a number of proposed measures.3

Very recently, the SEC has proposed amendments to the US investment Company regulation regarding liquidity risk management that would be more detailed and prescriptive than the current regimes for either US investment companies or UCITS. The proposals would require each registered open-end fund, including ETFs but not money market funds, to establish a liquidity risk management programme comprising the following elements:

- classification of the liquidity of each of the fund’s positions in a portfolio asset
- assessment and periodic review of the fund’s liquidity risk
- management of the fund’s liquidity risk, including the holding of a minimum proportion of net assets in investments that the fund believes are easily convertible to cash
- board oversight provisions related to the liquidity risk management programme requirement

Can redemption policies help?

This programme sounds reasonable. It should reduce the probability of suspensions. However, it can’t rule them out. The SEC may be recognising this, and, therefore, also considering the proposal of rules that would explicitly allow the suspension of redemptions in a defined process. Beyond straight suspensions, other forms of redemption restrictions – in particular so-called gates and side pockets, or temporary imposition of longer notice periods for redemptions – may be considered. Such procedures are today permitted in principle under UCITS, but only in very limited cases under the Investment Company Act.

Suspensions and redemption restrictions are often used for funds utilised by institutional investors. But in the case of retail funds, the situation is different and more difficult, as practical evidence has shown. It is certainly helpful to define principles regarding the suspension of redemptions, in order to handle such a process as properly as possible. I would, therefore, welcome this element of the SEC proposals. The International Organization of Securities Commissions (IOSCO) has shown in a valuable report what such principles could look like.4

But whether an ‘orderly’ process of suspending redemptions and re-introducing them will work in practice is anything but sure. For retail investors, suspensions will almost always be a negative surprise, if not a shock, even if this possibility is laid down in the funds’ prospectus. As a result, severe losses of trust among investors will occur. There is here a potential spillover to the broader markets: investors in comparable funds may suspect that these funds will follow and may ‘rush to the door’, causing exactly the situation that the regulators want to avoid. And, while a fund is (temporarily) closed, investors and their advisers may conclude that they should redeem as soon as the fund re-opens, which, as a result, might actually make such redemptions impossible.

In my eyes, suspensions and restrictions remain a rather theoretical option with a high risk of frictions. As BlackRock rightly notes, “it is impossible to legislate the behaviour of free markets during periods of stress”.

Start of a discussion

The approach of the SEC is reasonable and timely. Whether it is sufficient to make funds ‘structurally more resilient’ against suspensions, as BlackRock postulates, remains to be seen.

There are policy options which the SEC obviously did not consider. One would be the introduction of mandatory liquidity stress tests, combined with limits. Another would be to challenge the mantra of daily redeemability. This requirement is, as John Kay notes, far in excess of anything really required by savers. The new European long-term fund could become a first step in that direction.

At least, the SEC proposals will open a serious discussion which had already started. It will hopefully lead to conclusions while it is still not too late.

1. For example, the UCITS Directive defines ‘transferable securities’ that are listed on a regulated market as the main investment instrument for UCITS. In practice, however, many instruments that are listed are not regularly traded on exchanges but over the counter, which par for means that liquidity may depend on one or a few counterparties and may, therefore, be limited.


Dr Wolfgang Mansfield, 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 BFI (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.
CLIMATE RISK AND FINANCE: THE ROAD BEYOND PARIS

Jag Alexeyev

Looking back 20 years from now, the Paris climate conference in December 2015 will be seen as a pivotal moment for investment management. Regardless of its successes or failures, the conference will be associated with the point in history that climate change became a major issue for asset owners and managers, influencing risk management and portfolio allocations.

Several asset owners and financial institutions announced that they will expand their climate-related initiatives, including greater financing for renewable energy projects, reducing carbon footprints, phasing out coal and other fossil fuel investments, and setting an internal price on carbon for financing decisions.

Asset owners set targets for carbon reduction and renewable investment

The UK’s £2.9bn Environment Agency Pension Fund (EAPF) has been among the leaders in setting climate investment goals. It recently said that it will ensure that its portfolio and processes are compatible with keeping the rise in global temperatures below 2°C relative to pre-industrial levels, in line with international government agreements. EAPF aims to achieve this objective through a combination of positive investment in the low-carbon economy, continued decarbonisation, and shareholder engagement. It has set three targets for 2020:

• invest 15% of the fund in low-carbon, energy-efficient and other climate-mitigation opportunities;
• decarbonise the equity portfolio, reducing the fund’s exposure to ‘future emissions’ by 90% for coal and 50% for oil and gas;
• support progress towards an ‘orderly transition to a low carbon economy’ by working with asset owners, fund managers, companies, academia, policy makers and others in the investment industry.

Several asset owners and financial institutions announced that they will expand their climate-related initiatives.

EAPF has already reduced its carbon footprint by 44% since 2008, and has changed its benchmark for its global equities allocation – amounting to around £260bn – to the MSCI Low Carbon Target World Index. It has also invested 26% of the fund in clean and sustainable companies.

Goldman Sachs, BNP Paribas, Société Générale, Bank of America and Allianz, are also stepping up their commitments.

Goldman Sachs will target $150bn in clean energy financing and investments by 2025, expanding the existing $40bn target set in 2012. Goldman Sachs expects to become the first US investment bank to be ‘carbon neutral’ across its operations and business travel. The firm will also target $2bn in green operational investments and seek to source 100% renewable power for its global electricity needs by 2020.

Since 2006, Goldman Sachs has invested and financed $65bn in clean energy across the world, structured over $14bn in weather-related catastrophe bonds, and invested $3.3bn in green operational investments, with over 50% of its global office portfolio now green building certified.

BNP Paribas increased its commitment to the transition to a low-carbon economy by more than doubling the financing resources allocated to the renewable energy sector, from €6.9bn in 2014 to €11bn in 2020.

In addition, BNP Paribas will strengthen its carbon-risk management policies and will:
• continue to promote green bonds to institutional investors;
• no longer finance coal mining activities, unless companies have put in place an energy diversification strategy;
• invest €100m by 2020 in start-ups working to develop solutions to climate change, which revolved around sustainable growth driven by (i) climate finance for developing countries, (ii) a price on carbon, (iii) energy-efficiency investments, and (iv) impact investments. Closer co-operation between public and private parties aiming to create a stable investment environment is needed, in their view, to boost impact investing and climate finance.

Countries; and a further 25% reductions in its carbon footprint. It is also supporting the development of ‘positive impact financing’ under the aegis of the United Nations Environment Programme Finance Initiative (UNEP Fi) – Société Générale has granted nearly €1bn in positive impact financing and is considering the issuance of the first ‘Positive Impact’ bond.

In July 2015, Bank of America pledged to increase its current environmental business initiative from $50bn to $125bn in low-carbon business by 2025 through lending, investing, capital raising, advisory services and the development of financing solutions. Bank of America has provided more than $39bn in finance for low-carbon activities since 2007, including $12bn in 2014 alone.

Allianz will provide transparency across its entire investment portfolio against 37 environmental, social and corporate governance (ESG) criteria, including greenhouse gas emissions and energy efficiency. The group will also stop financing coal-based businesses, offer greater climate insurance in developing countries, and double its financing for a low-carbon economy.

Just the beginning of a long-term trend

These commitments from asset owners and managers represent just the start of a longer-term transition towards climate-aware investing. Combined with additional efforts by governments, regulators, corporations across diverse industries, and individual investors, the economic and financial landscape of the world will transform in coming years. The challenge as always will be to identify the winners and losers in this process, and to appropriately time the transition while optimising risk-adjusted portfolio returns.

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.
Investment management review

Investment management review

Over $500bn, in balanced FoFs.

Retirement through variable annuities

Addition, US investments targeted for

Assets under management (AUM) as

Funds (FoFs)) with roughly $2.2tn in

Multi-asset funds (including funds of

MF database tracks nearly 1,700

Contributed to the rising popularity

This reality, paired with uncertainty

Ultra low interest rate environment.

Investors have consistently pursued

After the 2008–2009 financial crisis,

Flexibility to rebalance investments

95%. Fund managers, preferring the

Funds, but still allows mixed funds to

Stocks from 60% to 80% for equity

Regulatory Commission in 2014

In Asia, the Chinese Securities

Total multi-asset fund AUM, while the

Represent roughly two thirds of inflows to all long-term funds. However, the

Nature of demand for multi-asset funds varied within the region. In the UK,

Absolute return multi-asset funds were the leaders, with six such funds among

UK’s top 15 sellers in the multi-

Asset space over the past 12 months.

In continental Europe, investors prefer conservative asset allocation products, partly

Because they are considered substitutes for bank deposits and other guaranteed products, and partly

Because traditional bond funds offer

Conservative asset allocation products, for asset allocation, income and risk

Exterior FoFs, broadly defined by Strategic Insight as those having at least 20% of their assets invested in

Funds of external managers, attracted

Quarter of the total contributions year-to-date through September 2015 in Europe. Excluding

Institutional activities, it is estimated that FoFs account for more than 50% of the retail fund flows in certain markets

Such as Spain, where, interestingly, some Spanish managers and advisers have increased the use of exchange-

Traded funds as part of their core asset allocation. Nevertheless, the majority of

Multi-asset funds are increasingly used by both individual and institutional investors around the globe to preserve and/or grow their wealth, amid rising volatility in both equity and bond markets. Multi-asset approaches can be very flexible and targeted, based on investors’ assets, liabilities, investment objectives, risk tolerance, age and family profile and geographic location. They are also among the solutions for broad asset allocation strategies. The importance of the expanding asset allocation mindset for investors globally is broader than the multi-asset fund phenomenon, with equity and bond funds increasingly ‘wrapped’ with balanced portfolios. Japan, for example, is experiencing a rapid shift towards wrapped models of fund distribution.

Recent months have provided a reality check to investors worldwide. The global mutual fund industry is likely to benefit from $1tn plus of new investment flows in most future years. Two themes are expected to be in the forefront: firstly, the increasing use of mutual fund investments to address the world’s shortfall in retirement savings; and secondly, the growing dominance of asset allocation in investment solutions. These solutions will suit affluent investors who will always be too busy to construct their own investment portfolios. How well funds fit within such a solution (stock and bond funds, local and global, traditional and liquid ‘alts’, active and passive) will increasingly map the path to success.

The rising popularity of multi-asset funds globally

Bryan Liu

After the 2008–2009 financial crisis, investors have consistently pursued stability along with yields against an ultra low interest rate environment. This reality, paired with uncertainty regarding bond and stock markets, has contributed to the rising popularity of multi-asset funds in the US, Europe and globally, and a growing asset allocation mindset among investors.

In the US, Strategic Insight’s Simfund MF database tracks nearly 1,700 multi-asset funds (including funds of funds (FoFs)) with roughly $2.2tn in assets under management (AUM) as of September 2015, representing an increase of 64% since year end 2010. In addition, UK investors targeted for retirement through variable annuities have nearly a third of their assets, over $150bn, in balanced FoFs.

Outside the US, multi-asset funds in Europe, cross-border, and Asia have seen their AUM increase by 50% since year end 2010 to reach a similar $2.2tn as of September 2015. Locally registered and sold European funds accounted for nearly 60% of total multi-asset fund AUM, while the remaining asset was almost evenly split between cross-border and local Asia.

In Asia, the Chinese Securities Regulatory Commission in 2014 increased the minimum holdings of stocks from 60% to 80% for equity funds, but still allows mixed funds to hold any asset class between 0% and 95%. Fund managers, preferring the flexibility to rebalance investments in the face of volatile stock markets, thus focused on launching new mixed asset funds. Meanwhile, many existing equity funds switched their investment objectives to be reclassified as mixed funds in order to better adapt to the fast changing markets.

In European and cross-border markets, multi-asset funds continue to stand out. They attracted $238bn ($44bn in the third quarter of 2015) of net flows year-to-date through September 2015, and represent roughly two thirds of inflows to all long-term funds. However, the nature of demand for multi-asset funds varied within the region. In the UK, absolute return multi-asset funds were the leaders, with six such funds among the UK’s top 15 sellers in the multi-asset space over the past 12 months. In continental Europe, investors prefer conservative asset allocation products, partly because they are considered substitutes for bank deposits and other guaranteed products, and partly because traditional bond funds offer unattractive yields. In the cross-border space, income-focused funds were noticeable, with a moderately higher risk tolerance.

In the UK, multi-asset fund assets have grown by over 80% since 2010 and exceeded £338bn, accounting for nearly 30% of the UK long-term fund industry. Since the implementation of the retail distribution review at the beginning of 2013, most independent financial advisers (IFAs) have offered multi-asset funds as one of their key investment propositions.

We observe other distinctions between investors’ preferences in Asia and Europe regarding fund yield, risk, currency, and choices of share classes, as well as income distribution frequency. The preference of local Asian investors for receiving regular income has spread from Japan to Taiwan, Hong Kong and Singapore. These investors play an increasingly important role in how asset managers design and market fund products in the region.

In addition, FoFs have returned to Europe and become a part of the packaged solutions that meet the need for asset allocation, income and risk diversification in the wake of increasing market uncertainty and volatility. External FoFs, broadly defined by Strategic Insight as those having at least 20% of their assets invested in funds of external managers, attracted nearly €76bn, a quarter of the total contributions year-to-date through September 2015 in Europe. Excluding institutional activities, it is estimated that FoFs account for more than 50% of the retail fund flows in certain markets such as Spain, where, interestingly, some Spanish managers and advisers have increased the use of exchange-traded funds as part of their core asset allocation. Nevertheless, the majority of managers and advisers in Europe take a more active and flexible investment approach towards FoFs, marketing them as multi-asset products that can adapt to changing market conditions.

Diversification and growth, but they were more equity- and growth-biased products. After the financial crisis, many pension schemes paid more attention to risk controls, benefiting absolute return multi-asset funds, such as Standard Life’s Global Absolute Return Strategies Fund (GARS).

With ongoing pension reforms, DGFs could see further shifts towards income generating assets, both traditional and non-traditional, to meet UK retirees’ income needs. Other multi-asset approaches could include more US style lifecycle funds.

Since the implementation of the retail distribution review at the beginning of 2013, most independent financial advisers (IFAs) have offered multi-asset funds as one of their key investment propositions.

We observe other distinctions between investors’ preferences in Asia and Europe regarding fund yield, risk, currency, and choices of share classes, as well as income distribution frequency. The preference of local Asian investors for receiving regular income has spread from Japan to Taiwan, Hong Kong and Singapore. These investors play an increasingly important role in how asset managers design and market fund products in the region.

In addition, FoFs have returned to Europe and become a part of the packaged solutions that meet the need for asset allocation, income and risk diversification in the wake of increasing market uncertainty and volatility. External FoFs, broadly defined by Strategic Insight as those having at least 20% of their assets invested in funds of external managers, attracted nearly €76bn, a quarter of the total contributions year-to-date through September 2015 in Europe. Excluding institutional activities, it is estimated that FoFs account for more than 50% of the retail fund flows in certain markets such as Spain, where, interestingly, some Spanish managers and advisers have increased the use of exchange-traded funds as part of their core asset allocation. Nevertheless, the majority of managers and advisers in Europe take a more active and flexible investment approach towards FoFs, marketing them as multi-asset products that can adapt to changing market conditions.

Multi-asset funds are increasingly used by both individual and institutional investors around the globe to preserve and/or grow their wealth, amid rising volatility in both equity and bond markets. Multi-asset approaches can be very flexible and targeted, based on investors’ assets, liabilities, investment objectives, risk tolerance, age and family profile and geographic location. They are also among the solutions for broad asset allocation strategies. The importance of the expanding asset allocation mindset for investors globally is broader than the multi-asset fund phenomenon, with equity and bond funds increasingly ‘wrapped’ with balanced portfolios. Japan, for example, is experiencing a rapid shift towards wrapped models of fund distribution.

Recent months have provided a reality check to investors worldwide. The global mutual fund industry is likely to benefit from $1tn plus of new investment flows in most future years. Two themes are expected to be in the forefront: firstly, the increasing use of mutual fund investments to address the world’s shortfall in retirement savings; and secondly, the growing dominance of asset allocation in investment solutions. These solutions will suit affluent investors who will always be too busy to construct their own investment portfolios. How well funds fit within such a solution (stock and bond funds, local and global, traditional and liquid ‘alts’, active and passive) will increasingly map the path to success.
INVESTMENT MANAGEMENT REVIEW

INDUSTRY PERSPECTIVES IN FIGURES

The following tables provide a statistical perspective on the key trends in important sectors of the asset management industry.

Global managed assets

In isolation, it is difficult to interpret what amounts and growth rates mean. Figures in billions and trillions are banded around and it is useful to assess how the numbers for each sector relate to the whole.

Although hedge 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 - less than 10% of the world's total financial assets in every case. The other big asset pools include pension funds, insurance and sovereign wealth funds.

Estimated global managed assets at end 2014 exceeded the threshold of $100tn for the first time. They amounted to $103.3tn, representing an increase of 7%, compared to the whole.

Mutual funds maintained a significant level of inflows of more than $1tn globally in 2014. Equity funds received the strongest inflows. Mutual fund assets were $31.4tn at the end of 2014, exceeding the end 2013 level by 4.5%.

In 2014, the growth of the ETP industry remained strong, with net inflows into ETPs of $331bn, about 40% more than in 2013. Total assets increased to $2.8tn.

Mutual funds

<table>
<thead>
<tr>
<th>Net flows ($bn)</th>
<th>Assets ($tn)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2013</td>
<td>2014</td>
</tr>
<tr>
<td>Global industry</td>
<td>888</td>
</tr>
<tr>
<td>USA</td>
<td>356</td>
</tr>
<tr>
<td>Europe</td>
<td>299</td>
</tr>
<tr>
<td>Asia-Pacific</td>
<td>100</td>
</tr>
<tr>
<td>Fund categories</td>
<td></td>
</tr>
<tr>
<td>Equity</td>
<td>411</td>
</tr>
<tr>
<td>Bond</td>
<td>176</td>
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<tr>
<td>Money market</td>
<td>-67</td>
</tr>
<tr>
<td>Balanced</td>
<td>301</td>
</tr>
</tbody>
</table>


Notes

IMR calculated the statistical figures based on publications of the following institutions: ICI, EFAMA, BlackRock International, Eurekahedge, 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. These figures are a repeat of those published in the October edition, because the full data for 2015 comes out in February.

Investment Management Review (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.

Pension and insurance assets

Assets of pension funds grew in 2014 to $26.2tn. Assets of insurance undertakings exceeded those of pension funds, with $30.9tn in total.

Alternative funds

Growth of the global hedge fund industry, which has slowed since 2012, was also weak in 2014 due to poor inflows and moderate performance. Fund assets increased to $2.1tn at the end of 2013, according to Eurekahedge research.

Private equity fundraising was remarkably strong in 2014, with more than $600bn of capital raised and assets reaching $3.8tn mid 2014, according to Preqin research.

Top ten asset managers

<table>
<thead>
<tr>
<th>Rank</th>
<th>Manager</th>
<th>Total assets ($tn)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>BlackRock</td>
<td>4.7</td>
</tr>
<tr>
<td>2</td>
<td>Vanguard Asset Management</td>
<td>3.1</td>
</tr>
<tr>
<td>3</td>
<td>State Street Global Advisors</td>
<td>2.5</td>
</tr>
<tr>
<td>4</td>
<td>Fidelity Investments</td>
<td>1.9</td>
</tr>
<tr>
<td>5</td>
<td>BNY Mellon Invest. Advisors</td>
<td>1.7</td>
</tr>
<tr>
<td>6</td>
<td>J.P. Morgan Asset Management</td>
<td>1.5</td>
</tr>
<tr>
<td>7</td>
<td>Capital Group</td>
<td>1.4</td>
</tr>
<tr>
<td>8</td>
<td>PRINC</td>
<td>1.4</td>
</tr>
<tr>
<td>9</td>
<td>Pramerica Investment Management</td>
<td>1.2</td>
</tr>
<tr>
<td>10</td>
<td>Amundi</td>
<td>1.1</td>
</tr>
</tbody>
</table>


Notes

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