The fund-management industry has done very well—but mainly for itself, says Philip Coggan (interviewed here)

IMAGINE a business in which other people hand you their money to look after and pay you handsomely for doing so. Even better, your fees go up every year, even if you are hopeless at the job. It sounds perfect.

That business exists. It is called fund management. Charley Ellis, a veteran observer, explains that fees in the industry tend to grow at around 15% a year because markets rise by an average of 8% and savings grow by 5-6%. This growth is being maintained despite the industry’s vast size. According to a report by Watson Wyatt, a consultancy, the value of all professionally managed assets at the end of 2006 was $64 trillion (see chart 1).

Under the normal rules of capitalism, any industry that can produce double-digit annual growth should soon be swamped by eager competitors until returns are driven down. But in fund management that does not seem to be happening. The average profit margin of the fund managers that took part in a survey by Boston Consulting Group was a staggering 42%. In part, this is because most fund managers do not compete on price. Instead, they persuade their clients to select their funds on the basis of past performance, even though there is little evidence to show that this is a good predictor of future success. Nor can investors be sure that the intermediaries who sell the funds—brokers, advisers and bankers—will steer them in the right direction. These middlemen often get a cut of the fund managers’ fees, so they have little interest in recommending low-cost alternatives.

Hence the clients get engaged in a costly game of chasing the best performers, even though by definition they are bound, on average, to lose it: after costs, the average manager inevitably underperforms the market. Figures from John Bogle of
Vanguard, an American fund-management group, neatly illustrate the point. Over the 25 years from 1980 to 2005, the S&P 500 index returned an average of 12.3% a year. Over the same period, the average equity mutual fund returned 10% and the average mutual-fund investor (thanks to his regrettable tendency to buy the hottest funds at the top of the market) earned just 7.3%, five percentage points below the index.

But whereas the clients have not always done particularly well out of the industry, the providers have prospered. In recent years the growth of private equity and hedge funds has led to more widespread use of performance fees, creating a new class of billionaires. The balance between the industry and its clients will not be redressed until investors learn that higher fees do not guarantee higher returns. “There’s a huge amount left to do in order to provide a reasonable proposition to the client,” admits Alan Brown, chief investment officer of Schroders, a British fund-management firm.

Even so, fund management is undergoing a revolution of sorts. “The industry is in the process of more change than I’ve seen in the 30-plus years that I’ve been in the business,” says Mr Brown. In part, this reflects the lessons of the 2000-02 equity bear market. Pension funds had been heavily exposed to equities in the 1990s, which allowed the sponsoring companies to take contribution holidays. But when share prices fell, pension funds went into the red, raising doubts over whether equities were the right match for the long-term liability of paying out retirement benefits. Some pension funds switched to bonds; others demanded products that delivered positive returns, regardless of the performance of the equity index. That opened the door to hedge funds, private equity and a whole school of investing known as alternative assets.

The market for retail investors is also changing. These days most fund managers do not deal directly with such clients, but sell their funds to third parties such as brokers, advisers, private banks and pooled portfolios called funds-of-funds. This saves fund managers a lot of marketing expenditure, but it also leaves them at the mercy of the middlemen. They can no longer rely on the inertia of clients who stay with a firm for most of their lives; instead, holdings are churned as the intermediaries seek to generate the highest possible returns and justify their fees.

Call me unpredictable

One of the industry's biggest problems is the markets themselves. Not only do whole asset classes go through dismal periods, but investing styles too go in and out of fashion. A technology manager with a shining reputation in 1999 may have found that by 2002, 90% of his fund value had vanished. Even Bill Miller, the star manager at Legg Mason who beat the S&P 500 index 15 years in a row, has just suffered two years of poor returns. The latest event to ruin fund managers’ performance numbers has been the credit crunch.

A second problem is that, in fund management, size is not necessarily an advantage. True, it can bring an improvement in margins; managing $2 billion does not cost twice as much as managing $1 billion. It also gives managers the marketing clout to build a brand name. Yet size can also be the enemy of investment performance. If a fund becomes too large, trading moves prices against the manager, or the fund starts to resemble the overall market. And star managers may be driven away by bureaucracy or lack of freedom.

So far, fund managers have been remarkably successful in maintaining their high fees, even in the face of lower investment returns in recent years. For more than three decades they have been fighting the challenge from “passive” rivals, which simply track the market through an index such as the S&P 500 or the FTSE 100. But now there are passive versions of other fund-management styles too, even high-charging hedge funds. Asset managers, for so long the Bloomingdales and Harrods of finance, are facing competition from the sector's Wal-Mart in the form of exchange-traded funds (ETFs), a flexible vehicle that gives investors exposure to almost any asset class at low cost.

Yet the industry is also being presented with two great long-term opportunities. In the developed world, populations are ageing and the burden of retirement provision is increasingly falling on the individual. In some countries the state pension offers little more than a subsistence income, and companies are increasingly retreating...
from the expensive final-salary pension promises that they made in the 1970s and 1980s. This gives the asset-management industry an opportunity to step into the breach.

In the developing world, meanwhile, rapid economic growth is creating an immense amount of new wealth. Energy billionaires in Russia and sovereign-wealth funds in China and the Middle East may turn to the asset-management industry to guide their investment decisions.

Although those two huge opportunities are likely to ensure that the industry will survive and prosper, the future of individual companies is far more difficult to predict. Only ten years ago the British pension-fund industry was dominated by four big names; Mercury, Phillips & Drew, Gartmore and Schroders. But competition has blown that cozy oligopoly apart: the first two names on that list no longer exist as separate companies.

Individual managers are having to make a series of choices. Do they emphasise their skill (“alpha” in the jargon) or head down the passive (“beta”) route? Do they stick to traditional asset classes, such as equities and bonds, or branch out into alternative areas such as hedge funds and commodities? Do they stay small, aiming for boutique status and putting the emphasis on performance? Or do they aim big, covering as many areas as possible, and protect themselves against the vicissitudes of the markets? Even more drastically, do they give up the business of investing altogether and concentrate on the relationship with individual clients, selling them other people’s investment products? That, in effect, is what Merrill Lynch did, selling its fund-management business to BlackRock. Citigroup made a similar deal with Legg Mason.

In response, a host of different models is emerging, from tiny specialists with a few hundred million dollars of assets to retail giants such as Fidelity or hybrids such as the Bank of New York Mellon, which has more than $1 trillion of assets spread among a collection of boutique managers. This special report will explain how fund managers make these choices and what is best for the most important people: the individuals who entrust their savings to the fund-management industry.