How boards are overseeing the streamlining of asset managers

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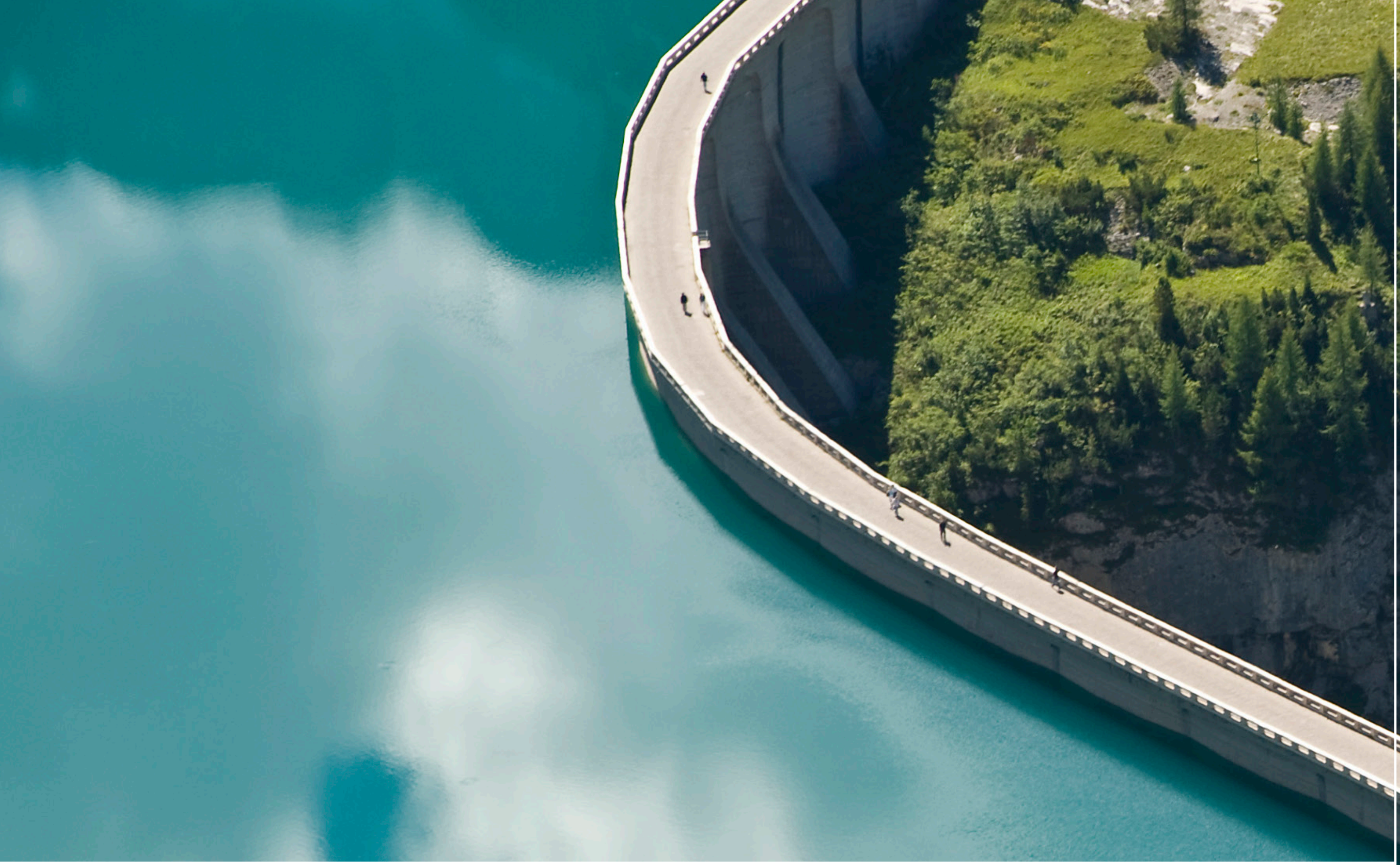
A range of market trends and drivers is forcing profound change within the asset management (AM) and mutual fund industry. Specifically, the combination of downward pressure on fees, rising operational costs and shifting investor demands is causing firms to reassess and refine their business models. Much of that change involves the increased use of third parties and deeper focus on core competencies, including portfolio management and new product development. Some early adopters have embraced smarter sourcing to satisfy intermediate and investor needs, remain competitive, protect market share and grow their assets under management (AUM).

This "streamlining of the asset manager" was the focus of a recent webinar, hosted by the Mutual Fund Directors Forum (MFDF) and the EY Financial Services Center for Board Matters. More than 80 fund directors attended. The discussion covered the following:

- The historic context of change: During the last several decades, asset managers have shifted from handling everything in-house to engaging asset servicers and other third parties for specific functions and tasks. The objective was to stay ahead of fee and cost pressures and protect margins. Technology, particularly artificial intelligence and the cloud, is a top priority for many.
- The science of achieving economies of scale: A recent EY study of 30 asset managers revealed the importance of economies of scale and the need to approach them "scientifically." Economies of scale are essential to profitability, but most asset managers are challenged to maintain costs as AUM rises.
- Competitive factors in fee-setting: Competition drives fee-setting processes to a greater extent than the actual costs (e.g., technology, human resources) of producing and running a fund. Not every firm wants to be on the low-cost end of the scale, but nearly all are concerned with their competitors' fees. Those who specialize in a particular strategy may find it easier to sustain higher fees, but those with lower fees tend to be split between those that have achieved true economies of scale and those that have made a strategic decision to set low fees.
- Transparency in share class structures: There is increasing demand from investors, regulators and intermediaries for transparency; in our research, a majority of firms rated it as the most important attribute of share class structure, along with simplicity. As fee-based revenue models continue to grow, intermediaries are playing a greater role in how investors pay for services. Revenue share payments based on distribution arrangements are top of mind for asset managers.
- Oversight and due diligence when selecting service partners: Selecting the right service providers is critical to realizing the significant cost savings that outsourcing can deliver. By keeping in mind core business capabilities — and where inefficiencies present the most risk — asset managers can identify the right vendors and realize significant cost reductions. Scalability, transparency and risk mitigation are other areas that must be taken into account when forming these important relationships.



Historical context: generational shifts in business models

Business models of asset managers and advisors have changed considerably in the last few decades. In the 1980s, asset managers wanted to be in control of nearly all of their operations. They served as custodians; hired banks as subcustodians; and oversaw their own technology, compliance, middle-office operations and reporting.

However, as technology advanced and economies of scale became more important, advisors evolved away from owning all of these tasks. They often turned to asset servicers and other third-party providers that could deliver economies of scale because fee and cost pressures constrained their ability to invest in non-strategic capabilities.

There has been a constant assessment of what asset managers should do internally and which services other providers can deliver more efficiently and effectively. For instance, more AMs are asking whether they need an internal tax team or whether they should outsource that function to firms specializing in it. Increasingly, outside of portfolio management, everything appears to be on the table.

In an EY survey of more than 30 global asset management firms:[1]

64%
Plan to achieve their strategic growth priorities by leveraging new technologies (AI, machine learning, cloud-based data management solutions, etc.).

45%
Are considering outsourcing data management and one-third are considering outsourcing foreign exchange and middle-office functions.

40%
Companies that say their number one improvement priority for the IT function is improving client experience and engagement.

However, technology still a challenging area for asset managers, given the difficulties in obtaining and retaining the most in-demand skills. Here again, asset managers are turning to third-party providers and partners to gain access to the technology they need to achieve these goals.

[1] Source: EY Future Consumer Index, Northern Trust Asset Manager Survey, Natixis 2019 Institutional Survey

Economies of scale: how and why they matter

As part of the EY study, we examined fee-setting strategies and the role of economies of scale within the industry. The latter has been a matter of some debate in recent years. The idea of economies of scale would seem to apply rather straightforwardly to asset managers and mutual funds; to the extent that expenses are relatively fixed, asset growth should reduce the ratio of fund expenses to average net assets. Advisors rely, in part, on achieving economies of scale to meet profitability targets.

While achieving economies of scale is a common goal, industry stakeholders recognize that, in reality, the picture is not quite so clear, partly due to differing perspectives of funds and advisors. Advisory fees are based on AUM and paid to fund managers for a range of services, including investment advisory, security research and analysis, trading, reporting and other administrative functions. In theory, costs should not rise as AUM increases, but in practice they do. So the goal for many firms is to ensure costs do not increase as much or as fast as revenue does.

Mutual fund advisors work toward improving operating efficiencies in advisory and administrative processes and by implementing enabling technology and expanding the scale of their operations. However, there are a number of factors that may undermine the reduction in the expense ratio, including active trading strategies that are more expensive to manage and large investor inflows that boost transfer agent and shareholder servicing costs.

Even larger funds with more trades and bigger support teams (including for compliance and regulatory matters) wonder when economies of scale really track to AUM rises. Part of the challenge is difficulties of calculating and allocating expenses to specific funds, given how organizations are structured and operate.

For these reasons, some mutual fund directors wonder if "true" economies of scale exist in asset management. Certainly, gauging their impact is not easy or exact. This is one reason why some stakeholders believe economies of scale are not important for pricing decisions. Most directors believe their reporting addresses economies of scale, as shown in Figure 1 below.

Figure 1: Are economies of scale addressed during the SEC Section 15(c) presentation on advisement profitability for mutual fund products?

- Yes, there is a fairly precise recognition of where economies of scale serve to enhance fund profitability
- Somewhat, economies of scale are implied at the advisor level but not explicitly addressed at the fund level
- No, economies of scale are not discussed within the advisor formula for reporting on fund profitability

Despite the ambiguities, asset managers constantly revisit their operating models in search of efficiency, flexibility and the ability to scale. Increasingly, that means finding cost-effective vendors to take on some operations and functions.

Competitive context in fee-setting: market-based and margin-based factors

In looking at how asset managers set fees for mutual funds, competition often influences as much or more than actual costs (e.g., technology, human resources) of operating the fund. Leadership must ask where it wants to position the fund on the spectrum relative to competitors. It's an important question given wide variability. For example, advisory and administration fees for peer group open-end equity funds can vary from less than 20 basis points to more than 100 basis points.

When setting fees, questions for boards and management to consider include the following:

- Where are competitors setting fees for similar funds and strategies?
- Can we outperform the competition to justify higher fees?
- How will platforms view our pricing vs. competitors?

Concern with competitors' fees doesn't mean every firm seeks to offer the lowest fees. Funds specializing in a particular strategy may find it easier to sustain higher fees. Actively managed funds often seek specific market niches (e.g., emerging markets) to avoid competition with passively managed products. Funds with lower fees include funds that have achieved economies of scale or that have made a strategic decision to set low fees. At both ends of the fee spectrum, the key is to remain in a competitive band with similar products.

It's safe to say low-cost funds are more likely to have gained an edge through outsourcing and successful relationships with asset servicers. Looking more closely at cost structures, our research shows that asset services are focused on those areas where costs are highest for asset managers, such as compensation and benefits, professional services, and technology and communications.

These categories represent the best opportunities for continued outsourcing to achieve economies of scale, and asset servicers are adding capabilities, such as tax, regulatory, compliance and tech expertise to meet the need.

The rise of passively managed funds is having a major impact. The long-predicted demise of mutual funds has never come to pass, because they remain attractive investments thanks largely to their transparency and liquidity. However, the success of index funds and exchange-traded funds (ETFs) have increased the pressure on actively managed funds to deliver superior performance. Advisors' preference for mutual funds is important, both in retail and wealth management channels.

This is not to say that there is no relationship between the price of funds and the cost of providing them. Despite downward pressure on fees, margins across the industry remain strong and boards remain committed to hiring the right people, managing the fund properly and running funds to the highest standards. Add in rising costs and increasingly stringent regulatory requirements and it's no wonder so much board and management attention goes to optimizing the business model and finding the right sourcing relationships.

Share class structures and cost-shifting to advisors

Cost-shifting from asset managers and mutual funds to advisors based on share class structures is another force driving change in the industry, thanks to the confluence of several related trends and developments. While their particular impacts are not completely clear, revenue models for asset managers at the fund level are shifting and advisors are receiving more compensation for various services they provide.

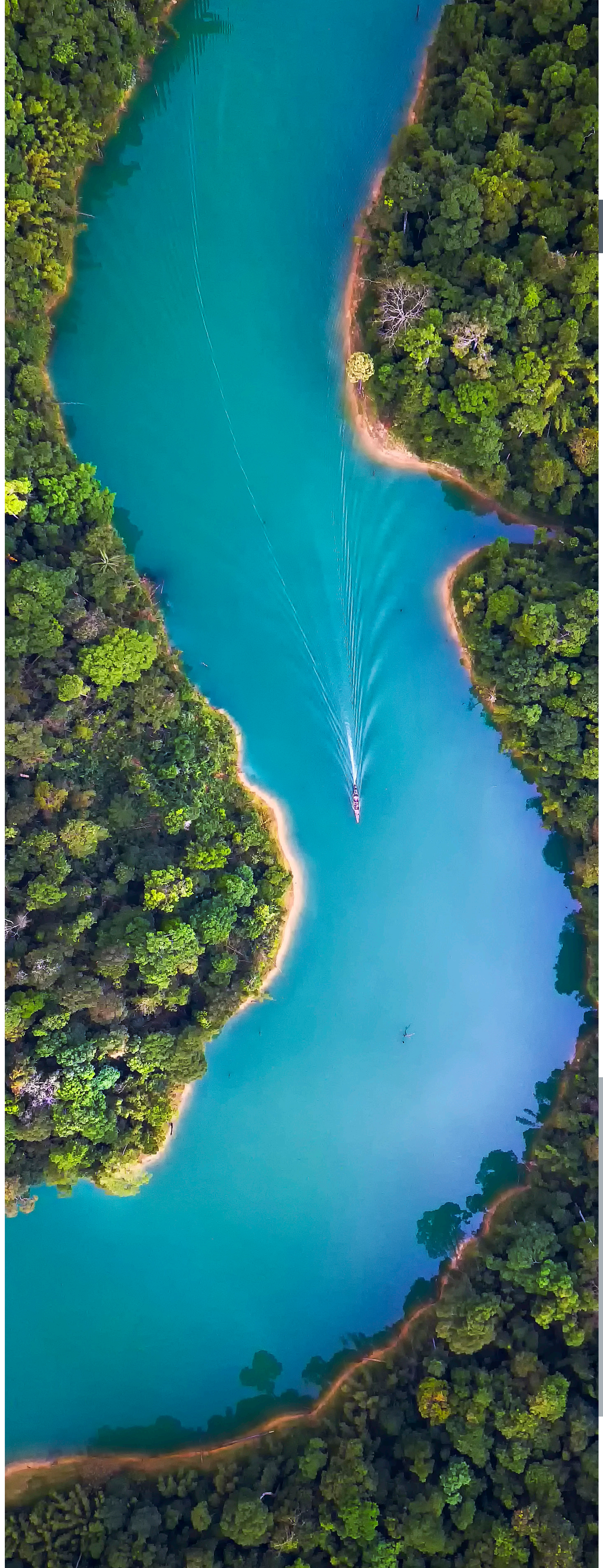
Increased demand for transparency and clarity is the primary impetus for change. In the recent past, it was difficult for intermediaries and end investors to know which share class was most appropriate. Today, however, plan sponsors, regulators and intermediaries are demanding transparency of fees and clarity in eligibility and minimums. The overwhelming majority of firms rate simplicity and transparency as the most important attributes of fund companies' share class structures.

Simplicity of share class and transparency of fees for each share class provide several benefits. Firstly, they reduce operational complexity. Secondly, they make it easier for end investors and intermediaries to understand the best share class for intermediary compensation and the services being performed.

The role of intermediaries is increasing in terms of how investors pay for services. The advent of omnibus accounting, the increasingly common "rep as PM" role, the focus on wealth management, and the increased cost of reporting and record-keeping have given intermediaries more to do. It's safe to say that intermediaries feel that they spend a lot of money to service shareholders and are looking for more compensation. Specifically, intermediaries feel that currently, they are not being compensated for the operational and technology support they provide to investors.

Regulators have been closely examining the use of revenue share and investor payments via share class. The goal must be to offer investors clear explanations of what's embedded in the share class and where fees offset service and operational costs. Thus, funds must avoid the perception that revenue sharing payments are meant to push one fund over another. Further, as regulatory scrutiny increases into how investors pay via share classes, plan sponsors will move toward cleaner share classes, less revenue sharing, and less offset of record-keeping and other costs.

While fund performance is the primary consideration in fund selection, there is strong and growing preference among investors, plan sponsors and intermediaries alike for the lowest-cost share classes available for a given product or platform. Of course, intermediaries still expect to be compensated for record-keeping costs.



A closer look at revenue sharing

Revenue sharing has become a more important strategy as the intermediary channel has grown more prominent during the last 10 years. The SEC defines revenue sharing as "payments made by advisors or other affiliated entities out of their 'legitimate' profits to intermediaries to compensate them for their distribution effort."

Intermediaries generally feel that fees do not fully compensate for their management of investor relationships and the Intermediaries they provide at the level of particular funds. Funds should look at the picture holistically – the overall strength and performance of funds and the cost to end investors – and ask if current fees are enough to support intermediaries on that platform. Such perspective is necessary in light of new costs of business that have emerged in the last three years, including:

- **Platform access:** additional payments prescribed at the selling agreement (e.g., making up 12b-1 fees to 40 basis points for a fund's inclusion in a "fund supermarket" platform)
- **Sponsorship:** support of education programs and events offered to advisors
- **Data:** delivery of more detailed data on where managers' assets are sold as well as data analytics

Ownership of and insight into customer relationships are other dynamics in this constantly evolving landscape. Intermediaries are focused on their relationships with end investors. At the same time, AMs want to know who is investing in their funds – what's selling where, to whom and why. Some intermediaries have begun charging AMs for access to that data, which adds another pressure point on asset managers' costs.

Platform access is especially important due to limited space. As the intermediary channel has become more important than direct channels, fund performance remains the most critical factor for gaining a place on platforms. However, asset managers must assess how easy they are to do business with, in terms of selling agreements, support and infrastructure, revenue sharing and other factors. Other considerations have emerged, such as diversity and inclusion (D&I) and environmental, social and governance (ESG) factors, which can be deciding factors when everything else is equal.[2] It's worth noting that D&I and ESG are both areas where regulators will be looking for increased transparency.

Recent trends suggest that revenue sharing and distribution arrangements will continue to be top of mind for regulators, asset managers, intermediaries and investors.

The following are among the revenue sharing issues that boards must keep their eyes on:

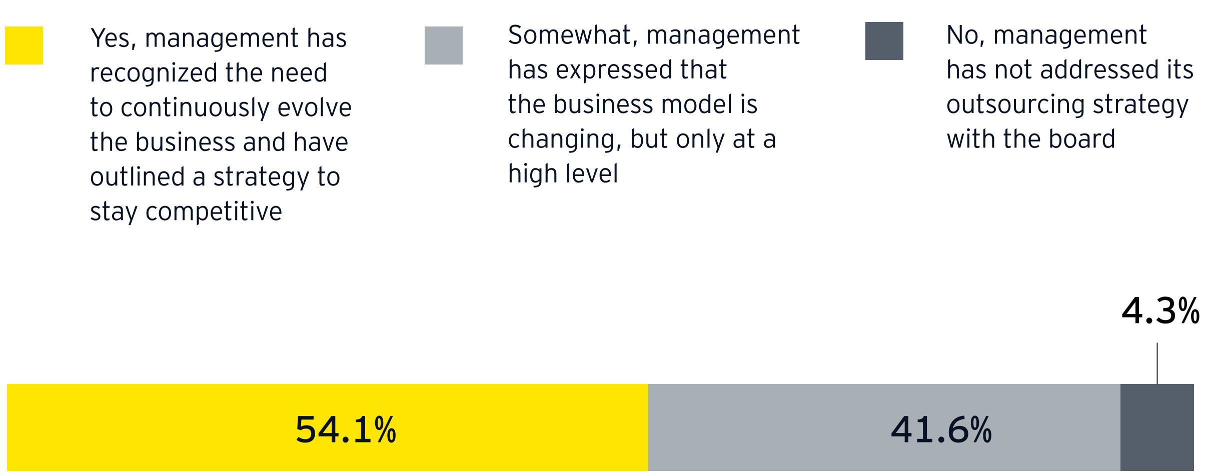
- Intermediaries: renewed revenue sharing focus in an effort to renegotiate agreements with asset managers to make up for lost trade commission revenues
- Asset managers: growth in zero-revenue share classes, including triple zero-revenue shares that exclude distribution fees, sub-TA fees and revenue sharing
- Regulators: continued SEC focus on share class disclosure requiring investment advisors (intermediaries) to disclose and settle violations of 12b-1 fee and share class selection rules
- Investors: a 401(k) record-keeper is being sued by a plan participant for allegedly accepting undisclosed platform fees from asset managers

[2]ESG: how mutual fund boards can manage risks and seize opportunities | EY - US

The asset management business model: toward a leaner future

From the perspective of boards and senior management, there are varying degrees of awareness and preparation regarding the evolution of business models. When polled in our session, mutual fund directors highlighted expected changes in business model of some kind, as seen in Figure 2.

Figure 2: Have fund advisors communicated to mutual fund board members how they are planning to address rising fee and cost pressure?



In our experience, the performance of current service providers and new outsourcing opportunities and strategies are often on boards' agendas. There is much discussion around new products and new competitive strategies with existing funds. Given where we are today, it's almost certain that the dialogue will turn to more tangible action in the relatively near future.

Optimizing their use of service providers is likely to be a priority. The first step is to carefully assess the costs and benefits of services provided and then design and implement an effective vendor management framework.

Fee structures: Regulatory costs continue to rise for asset managers. The latest regulations require mutual fund and ETF managers to develop solutions to meet N-PORT and N-CEN filings. Compliance will necessitate a lot of work. Asset servicers will either include these filings in an increased flat fee or bill for these services separately.

Close partnership and communication between asset servicers and asset managers will be more important to managing the cost and effort for compliance. As new financial reporting requirements arise, asset servicers will be asking if they can facilitate accurate and efficient compliance. If so, asset managers will be freed from the necessity to develop their own teams and technology to meet these requirements.

Current approaches to reporting vary across the industry. In some cases, fund administration includes standardized processes (e.g., 13F reporting) that are "off-the-shelf" offerings by service providers in order to allocate appropriate costs related to standard business flows. In other cases, reporting is broken out separately and customized. Asset managers should aim for "apples to apples" comparisons in terms of fees paid for services. Asset managers should seek to identify fund-by-fund expense ratios.

Service relationships: Asset managers are paying more attention to asset servicers, including boutique firms with targeted or niche offerings (e.g., market data). There are clearly more third-party options for asset managers to off-load tasks and activities than they used to manage internally.

Asset managers are more carefully and holistically assessing their overall business relationships with service providers. Certainly they are validating the value of services relative to associated costs. Risk mitigation is another consideration; those working with only one provider are evaluating secondary or backup options, while those with three or more providers are looking to rationalize. Service quality is yet another issue, especially relative to the risks presented by staff turnover and the impact of time zone differences when outsourcing to low-cost locations.

Enhanced vendor oversight: Collectively, these steps add up to more robust oversight. Asset managers and asset servicers are working to more clearly define the roles and responsibilities and points of escalation as their relationships evolve. More robust performance management is becoming more common, based on closer monitoring of terms and conditions, service level agreements and key performance indicators. Some asset managers have adopted periodic reporting on quality standards, including both qualitative and quantitative trend analysis.

The success of these efforts often comes down to the quality of shared information and collaborations to ensure there is no duplication of efforts among asset managers and their service providers. Increased visibility and transparency are important goals. Increasingly, asset managers want real-time visibility into the technology and processes to see that controls are being performed, rather than waiting for "end of the night" to check. Through analytics, data and dashboards, asset managers have visibility into how funds are being managed and how open questions are being resolved. The traditional, manual back-and-forth approach to solving problems has been replaced by a more streamlined process.

Optimization is an ongoing process, from the perspective of asset managers. The balance between cost advantage and risk mitigation is a delicate one. Among the key questions directors and leadership should ask are the following:

- "Should I have two service providers from a business continuity and strategy angle?"
- "Can I combine my providers and get better pricing through the scale of my business?"

Forward-looking asset managers are moving away from micromanaging and toward more holistic and strategic oversight. Such an approach requires getting the right tools, infrastructure and data streams in place. That's especially true in the parts of the business where strategic insights offer the greatest payoff, including the client experience, attribution relative to performance and the competitive landscape.

Of course, the lockdown in the wake of the COVID-19 pandemic has created new challenges for managing third-party relationships. In response, fund administration teams are taking more purposeful action in validating that appropriate controls are being performed. Given the high cost of perfection relative to controls and risk management, there are increasing conversations around finding the right level of risk tolerance and precision in monitoring. Boards and management are asking, "how perfect do we need to be in risk and third-party management?" and balancing the need for precision with the critical cost savings that can come with effective outsourcing agreements.

The bottom line: sourcing as a strategy for success

Strategic sourcing is proving to be an essential strategy for asset managers seeking to deal with increasing fee and margin pressures, increasing regulatory requirements, rising investor and intermediary expectations and technology disruption. Tomorrow's winners are likely to be those firms that most effectively assess and optimize their current service relationships today and identify the best new firms to plug into their ever-evolving business models. The outcomes — from stronger capabilities to lower costs — will provide a foundation for future success.

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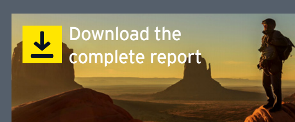
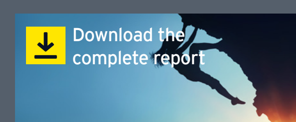
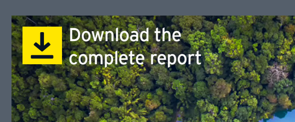


How fund boards oversee how their advisors navigate the now, next and beyond



How to govern changing business, operating and distribution models in asset management



The ESG potential - how mutual fund boards can manage risks and seize opportunities

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