Boutiques and behemoths isolate the middlemen

'The financial crisis hit asset management like an asteroid in 2008,' James Dilworth, chief executive of Allianz Global Investors Europe, told FTfm Bloomberg

Overview

Chris Newlands looks at whether the middle will go the way of the dinosaur or rise to phoenix-like splendour

Boutiques or behemoths – popular wisdom suggests asset managers have to be either one or the other in order to survive in the investment management game.

The much-visited idea that midsized groups will be squeezed out of existence by the so-called "barbell effect" will not be new to the bulk of fund management professionals, but many now agree the crunch on those in the middle has intensified and become more of a concern since the 2008 financial crisis.

Indeed, last month the argument became less theoretical, and subsequently more interesting, after a number of asset managers from Europe, Latin America and Asia launched a self-help group to fight back against the increasing dominance of "powerful, well-resourced, global players".

The 12 houses behind the alliance fear midsized groups are being crushed by an environment in which the big providers get bigger, the boutiques flourish, and the medium-sized fund companies struggle to compete.

José Luis Jiménez, chief executive of March Gestión de Fondos, the asset management arm of Banca March, and one of the main drivers behind the new alliance, recognises the problem has worsened since 2008. His hope is the newly formed group can help stave off the impact of that.

But the numbers are hard to dispute. The top 10 global players in terms of funds under management run almost a third of all assets, and this percentage has grown steadily year on year.

At the same time, figures from McKinsey, the consultancy, show that despite a recovery in assets and revenues since 2008, asset management profits remain more than 20 per cent below pre-crisis levels due to increased costs, reduced productivity and lower pricing.

"The financial crisis hit asset management like an asteroid in 2008," James Dilworth, chief executive of Allianz Global Investors Europe, told FTfm.

"The coming years will determine whether active fund managers go the way of the dinosaur or are able to dust off the ashes of the crisis and rise again in phoenix-like splendour."

Con Keating, head of research for BrightonRock, the pensions indemnity assurer, however, has hope for those stuck in the middle. "Will the midsize survive? Yes, if the world doesn't change too much. But they will become increasingly marginal," he says.

> 'Some midsize companies should still be able to sell the sizzle of short-term performance and survive'
>
> **Con Keating, BrightonRock**

He suggests the "cost economies of scale" of the large fund outfits will matter even more in future. However, he is quick to point out that these cost economies have "never translated within active management businesses".

"As a result, some midsize companies should still be able to sell the sizzle of short-term performance and survive," he says.

His belief – and that of others – is that asset managers have the capacity to forge their own destiny. For McKinsey this means a shift in focus for asset managers, from selling products to delivering what the consultancy rather uninterestingly calls "outcomes" or "solutions". These two rather dry terms describe income-generating and capital-guarantee products.

"Traditional ways of achieving growth – namely beating a benchmark – are no longer proving sufficient," says Salim Ramji, co-head of the asset management group at McKinsey.

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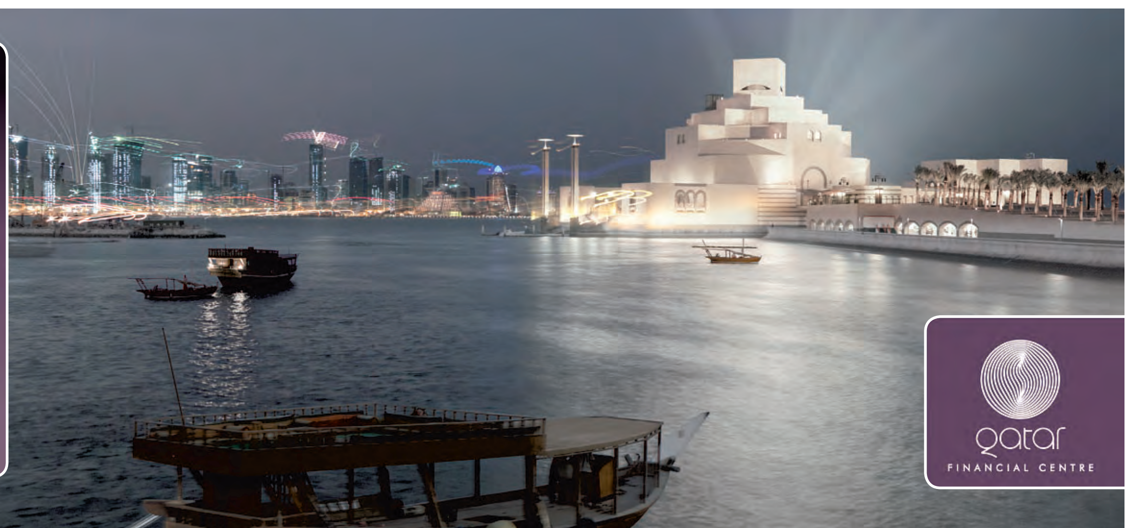

* References the 2008 Forbes Tax Misery & Reform Index

Exchange traded droids march on active managers

ETFs

Solutions might stem passive funds' invasion, writes **Joe Morris**

Not unlike the sole survivors of a robot uprising, traditional fund managers recognise the best hope against exchange traded funds lies in exploiting their mental edge over mindless trackers.

The droids are on the march. This year, exchange traded products breached the $2tn asset mark globally, and in Europe the compound annual growth rate for passive fund assets has been more than double that of active funds in each of the past four years.

Active managers have tried to assimilate. Pictet Asset Management has taken the lead in launching tracker funds, and Julius Baer pioneered active ETFs. Yet the fate of their compatriots at Credit Suisse Asset Management, which is selling its ETF unit to BlackRock, suggests such ventures stand little chance of cracking elite ETF ranks.

Turning back the ETF insurgency requires the opposite of assimilation, says Diana Mackay, chief executive of London-based consultancy Mackay Williams. "There is plenty of room for these guys, but they have to differentiate themselves," she says.

Alpha is just the beginning. Ms Mackay says active managers can also stand out by designing products that redefine performance in terms of "solutions", such as payouts or downside protection – targets tougher for ETFs to hit.

Sales data suggest active solutions are indeed helping to stem the ETF tide. Among bond funds, AllianceBernstein's American Income Portfolio was Europe's best seller last year, with €8.2bn in inflows, while M&G Investments' Global Dividend-led equity funds, taking in €2.7bn, and Standard Life Investments' Global Absolute Return Strategies outsold all mixed-asset funds, attracting €5.5bn, according to Lipper data.

As a group, European multi-asset fund assets have grown 152 per cent since the end of 2008, to €201.9bn, while the number of such funds has grown 47 per cent, to 1,894, Cerulli Associates research shows.

The financial crisis hangover and subsequent bouts of market volatility are fuelling the demand, says Sze Yoon Ng, associate director at Cerulli Associates in London. "In a tough market, in a very solutions-driven market, it's almost the best time for fund managers to prove their worth, because it's the time where you need to be quite specific about strategies," she says.

ETFs often serve as building blocks for multi-asset portfolios. Schroders' multi-asset team, for instance, deploys ETFs for tactical allocations while relying on mutual funds for longer-term core exposures, Ms Ng says.

Assets have flooded in for some actively managed products holding ETFs. Two ETF managed portfolios launched four and a half years ago by HypoVereinsbank hold a combined €3.6bn, while Schroders' ISF Global Multi-Asset Income, built on ETFs among other investments, ballooned to more than $928m in less than a year.

The solutions niche is not the only opening ETFs are leaving active managers. By herding assets into benchmark-bound allocations, they have also stoked massive equities correlations that are leaving more and more alpha uncontested, says Mikhail Zverev, head of global equities at Standard Life Investments. "The more money is managed passively, the less price discovery happens in the active equities space, the greater the inefficiencies available for active managers to exploit," he says.

Standard Life has been adding products to its family of unconstrained funds to stake out these gains. "This move towards unconstrained investing that we've embraced as a firm is very much a reflection of our view that the opportunities for active stock pickers in this market are undiminished and might actually be enhanced," Mr Zverev says.

> 'In a tough market, in a very solutions-driven market, it's the best time for fund managers to prove their worth'
> **Sze Yoon Ng**
> **Cerulli Associates**

ETFs are no less vulnerable to attentive asset management in the fixed income market, over which a cloud of interest rate rises hovers, says Jonathan Willcocks, managing director and global head of retail sales at M&G.

Among M&G's most recent rollouts are UK and European inflation-linked corporate bond funds with the capability to generate returns in a rising rate environment by shorting duration. The merits of such adaptability will dawn on investors, especially baby-boomers as they stream in ever-larger numbers into retirement, Mr Willcocks says.

Not content to wait for those behavioural changes, active managers are beginning to nudge them along, Ms Mackay says.

A potential Mifid II ban on inducements for independent advisers threatens to upset the distribution chessboard, forcing fund managers to renegotiate every bend in the distribution channel, including advertising.

A tidal wave of regulation is making it hard to do business in Europe Corbis

Regulatory tsunami in Europe floods business

Regulation

The huge scale of compliance is costly and a barrier to entry, writes **David Ricketts**

If there is one thing asset managers in Europe have had in abundance following the financial crisis, it is regulation.

Such is the pace of change that words more apt for describing natural disasters have made their way into the industry lexicon – tsunami, tidal wave and avalanche being just a few of the favourites.

But it is little surprise that the industry has been so dramatic in its use of language.

Asset managers have only just bedded down some of the expensive changes brought in with the arrival of Ucits IV, most notably onerous production and upkeep of the key investor information document.

And just when the industry was hoping for a pause to catch its breath, several upcoming regulatory initiatives now require their urgent attention, including Ucits V, Ucits VI, Mifid II and the Alternative Investment Fund Managers Directive. Other changes, such as Prips and the European Markets and Infrastructure Regulation, are also likely to require significant investment over the coming months.

But it is not just new rules from Brussels that managers have to contend with. Regulation from the US is also taking its toll, with the Foreign Account Tax and Compliance Act expected to lead to its own hefty compliance and reporting costs.

Jarkko Syyrilä, deputy director-general of the European Fund and Asset Management Association, believes "it is an unprecedented time" for asset managers regarding regulatory changes.

Fund houses are currently juggling between 30 and 40 different changes, he says.

"We now have much more detailed regulation, and all of this is taking up a huge amount of management's time," says Mr Syyrilä. "The compliance tasks are huge."

The industry largely welcomes moves to bolster investor protection and prevent another Madoff-like scandal. At the same time, it has pleaded with Brussels to consider the full impact, and cost, of all of these changes.

For example, Efama has warned that the financial transaction tax alone will result in EU investors within Ucits funds paying €13bn every year.

The knock-on effect of the FTT could be most dramatic for Europe's €1tn money market fund industry, Efama predicts. These funds would likely pay two-thirds of any transaction tax because their holdings are short term and they therefore have a high turnover.

> There are 'not as many benefits as there are potential hurdles' when setting up shop in Europe

Mr Syyrilä adds that one consequence of all the regulatory initiatives occurring in Europe is that barriers to entry for new participants will increase.

"For smaller players it will be difficult to comply with all of this. Even big firms are complaining," says Mr Syyrilä.

One of the larger companies battling regulatory changes outside its domestic market is Pimco. The US asset manager set up in Europe in 1998 when it established its Ucits platform.

Joe McDevitt, who heads Pimco's London office, says there will always be asset managers that are better prepared for the regulatory onslaught than others.

"The problem with regulation is that it can create oligopolies, and you get good firms that are dealing with regulation but do not innovate or create competition," he says. "Regulation takes a lot of money to deal with and it is the larger ones who have the scale to deal with it."

One concern Mr McDevitt has is that such a large amount of regulatory change could thwart industry innovation in Europe.

Given today's regulatory agenda, Mr McDevitt questions whether Pimco would be as successful at building its European presence from scratch again.

"Pimco was able to establish its Ucits platform when we first came to Europe. I expect the hurdles today mean many new managers will decide to hold off on starting Ucits funds," says Mr McDevitt.

"New managers with great investment skills, whether they come from within Europe or elsewhere, may be inhibited by the preponderance and cost of new regulation from considering the establishment of a Ucits platform in Europe."

Michael Green, chief executive of international business at American Century, says there are "not as many benefits as there are potential hurdles" when setting up shop in Europe.

"One of the unintended consequences [of increasing regulation] is that it makes it harder for new managers to set up.

"It reduces choice from the consumer's point of view and it's hard to see how that's a good thing," says Mr Green.

That said, the opportunities to win a greater slice of assets in Europe in future could be worth the pain of complying, he suggests. "When we emerge from these current headwinds, the business environment and the savings industry opportunity could be immense."

Despite the tinge of optimism, Efama's Mr Syyrilä sums up the future regulatory agenda in a succinct way.

"There is still much more to come," he says. "At some point we need a pause to implement all this and reflect."

Time to back or sack your fund firm?

Underperformance

The costs of switching fund managers can seem high, but it could be worth it, says Owen Walker

One of the key decisions that keeps institutional investors awake at night is the question of whether to sack or back an underperforming fund manager.

Not only is timing essential to the success of such a decision, but the costs of switching managers can run into millions of pounds or euros. Investors need to feel confident that any change will be worth the often considerable time and expense involved.

Keith Nunn is an employee-nominated director and investment committee chair of The Pensions Trust, a £5bn multi-employer pension scheme aimed at the UK charity sector. He has overseen seven manager terminations over the past six years – at one point averaging two a year.

"Underperformance is the main reason we fire managers – it was the case in four out of the seven times," he says. "The odd quarter or year of underperformance is not serious, neither is slight underperformance. But the problem comes when you lose faith that the manager can deliver."

'You only need the new manager to outperform the old by one percentage point to break even'

Pat Race, Mercer

The scheme's mandates are typically three to five years long, and it expects managers to beat their benchmarks over that time. Mr Nunn says it is rare that a manager is sacked for underperformance over less than three years.

Keith Skeoch, chief executive of Standard Life Investments, is a former pension fund trustee and has experienced the investor-manager relationship from both sides. "You can underperform for a number of reasons," he says, "but the heinous crime is delivering performance that is not consistent with your investment profile and process."

He says any consideration of whether to keep an underperforming manager should start with why the manager was hired in the first place. If the asset class was chosen as a diversifier, it should not always produce performance that is consistent with the rest of the portfolio.

Paul Kemmer, managing director at P-Solve, a consultancy, agrees, saying that manager underperformance often has more to do with a change in the economic environment rather than a lack of skill. But he adds: "Once you decide to sack a manager, you should do it as soon as possible. [Pension fund] trustees are often nice people who want to give managers a second chance."

However, Pat Race, UK head of investments at Mercer, says his large defined benefit scheme clients will usually wait for an underperforming manager to get back on track before firing them.

"Often the manager will come to the meeting and expect the trustees to congratulate their recent good performance, only to find they are being sacked," he says. "It can be hard for them to take."

The costs of transitioning to a new fund manager can sometimes seem prohibitive to investors. The process often includes fund entry and exit charges, adviser fees to assist identifying the new manager, carrying out due diligence and negotiating the contract, legal fees and communication costs. There may also be tax implications.

Mr Race says transition costs for a global equities fund are often in the region of 1 per cent of the assets covered by the mandate. This can be very expensive for large mandates. "But you only need the new manager to outperform the old manager by one percentage point to break even – which is easily done if you pick the right manager," he adds.

Mr Nunn agrees, saying The Pensions Trust's mandates are typically hundreds of millions of pounds and the transition costs "pale into insignificance" if the new manager outperforms the old one.

He adds that the scheme will often make use of options such as in-specie transfers and temporarily moving into more liquid assets to keep the costs of a transition lower.

But while transition costs can be mitigated to some extent, there are more calls from institutional investors that consultants should bear some of the expense. Those arguing that consultants should shoulder some of the costs say it would make them more accountable for the advice they provide. Unsurprisingly, there is little appetite from consultants for these arrangements.

Mr Race says he often has conversations with pension fund clients that want the consultancy fee to be performance related. "It's not a bad idea for consultants to have skin in the game," he says, "but I would also want to have a say on when the client leaves the manager, which is a more fiduciary management role."

The Pensions Trust has one fiduciary management mandate, worth £215m as of September 2012, which represents 4.3 per cent of the fund's total assets.

This is run by Cardano, which also acts as adviser to an £800m section of the scheme, and the remuneration is based on returns.

"Trying to get that out of our [traditional] advisers would be very difficult," says Mr Nunn. "You can get an investment manager to play that game, but getting an adviser to take that is very, very difficult to do.

"But it is an excellent idea and one that I shall be talking to our advisers about."

ALL ETFs
ARE NOT ALIKE

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High pay and short-termism divide industry

Remuneration

Europe's regulators want to tighten rules but many in the sector think clients must drive change, writes **Madison Marriage**

Fat cats must slim down: regulators want to overhaul the short-term investment mindset that has been aggravated by bonus-heavy remuneration structures Charlie Bibby

There is widespread consensus that fund manager pay needs to be overhauled to put an end to short-term investment decisions that contradict institutional investors' long-term needs.

Regulators in Europe and the US want to address the issue by tightening remuneration rules. However, their efforts have been lambasted as being too prescriptive and conducive to a "brain drain" from the fund industry.

Yet change is necessary, industry participants agree. Jeff Molitor, chief investment officer for Europe at Vanguard, the US fund house, says: "When a fund is hot, there are a number of managers that will be paid based on what their assets are.

"If the fund gets more assets, they get paid more, which is quite a silly outlook – client assets don't get a fresh start every year."

US financial services firm State Street similarly recognises that "earnings pressure can sabotage long-term strategic initiatives" in the fund industry.

Between 1945 and 1965, for example, the average fund held a typical stock for six years; by 2005 that holding period had shrunk to just 11 months, according to a recent State Street report on investor behaviour.

Sir Michael Darrington, the former chief executive of Greggs, a bakery chain, says that the tendency towards short-term investing is exacerbated by regulation requiring pension fund trustees to meet target returns in order to cover their liabilities.

Despite their long-term funding plans, pension funds are now prone to dumping underperforming managers after just two years, he says. This, in turn, encourages managers to chase short-term performance.

Craig Baker, head of investment research at Towers Watson, the consultancy, agrees that "often just the way fund managers are monitored and measured by clients puts the pressure on [to seek short-term performance]".

Mr Baker says remuneration structures could reflect the long-term interests of institutional clients better by using a three-pronged approach: longer term calculations on how bonuses are determined, co-ownership of the fund, and equity ownership of the asset management business.

Sir Michael, who is leading an initiative to combat excessive executive pay entitled Business Against Greed, also wants to see fund groups assess manager incentives over five to seven-year periods, rather than the widespread practise of yearly asset and performance reviews.

"If you build value and your fund is seen to outperform its peers over a five to seven year period, then you can start to earn a bit more," he says.

"Most funds do not outperform their indices but fund managers are grossly overpaid, which seems to be incorrect."

Italy's largest independent fund manager, Azimut, has already adopted a pay structure that closely reflects Mr Baker's ideal. Following a management buyout in 2002, Azimut's 1,400 staff own 25 per cent of the firm and the rest is floated freely on the Italian stock exchange. Senior management do not receive bonuses, and employees cannot sell their shares in the company until they retire.

Bonuses for fund managers, meanwhile, are determined according to the weighted average performance of Azimut's global fund range, and its managers invest a significant portion of their personal wealth in the funds they run.

"This is mainly to prevent short-termism [among] top managers. [Our managers] are not interested in doing really well one year and then running off," Azimut says.

Yet Azimut seems to be the exception, not the rule. The chief executives of several asset management heavyweights, including BlackRock, Investec Asset Management and Schroders, for example, received bonuses well over 1,000 per cent of their respective base salaries last year.

The recent Ucits V proposals, which could cap asset manager bonuses at 100 per cent of fixed salary in Europe, aim to combat the short-term investment mindset that has been aggravated by such bonus-heavy remuneration structures.

But many believe that regulatory interference could simply complicate matters. Vanguard's Mr Molitor says "the last people who should get involved in [improving pay structures] are regulators".

> '[Our managers] are not interested in doing really well one year and then running off,'
>
> **Azimut**

"I don't think there is any magic number [governing variable to fixed salary], but putting a regulatory barrier in there seems odd."

Carl Sjostrom, director of executive reward in Europe at Hay Group, the management consultancy, agrees that regulatory efforts such as Ucits V will do little to address the underlying problem of short-termism. "I cannot think of a single case in the world where artificial adjustments to how people are paid have been beneficial," he says.

While doubt lingers over the effectiveness of regulatory pressure on pay, shareholders have done little to address concerns over high bonuses and opaque remuneration structures.

UK fund company Jupiter narrowly avoided a full-scale shareholder revolt over executive pay last month. Shareholders at both Schroders and Henderson, meanwhile, voted overwhelmingly in favour of both firms' pay proposals at their AGMs last month, despite calls from a corporate governance consultancy to reject their "excessive" remuneration packages.

Vanguard's Mr Molitor believes that pay is likely to continue to go unchecked in the private side of the fund industry as well. For most fund managers, he says, "you don't get the public airing of compensation the way you do of executives at publicly traded companies".

"I am not sure that the situation is changing. It is fairly widespread that managers get paid on a one year basis and partly based on what assets they have," he says.

Mr Molitor believes pay structures will only evolve to encourage long-term investing if clients drive that change.

Deborah Hargreaves, director at the High Pay Centre, a think-tank, agrees that institutional clients need to take a more proactive approach to overturning short-termist pay structures.

"Trustees should be paying a lot more attention to pay in this area, given that their fees will be funding that pay. Sometimes they don't see that as being particularly their role," she says.

Sir Michael, however, is more optimistic. He believes an investor spring is on the verge of taking off, following the so-called shareholder spring witnessed at many publicly listed companies over the past 18 months.

"A lot of people are really furious about the fund management industry and CEO pay, because their pension pots have been going down in value over the past 10 years, but fund managers have been getting wealthier," he says. "People will see they pay for what they get and start to put the pressure on."

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Asset manager intentions: Europe

Wanted: products that deliver results

Innovation survey

Pension funds have a strong appetite for new ideas, despite a number of product failures, says **David Ricketts**

Being ahead of the curve is crucial in any industry, and asset management is no exception.

Often criticised for pumping out products that fail to deliver, fund managers nevertheless strive to remain creative and develop fresh investment strategies that can better help institutional clients meet liabilities.

However, it seems that when it comes to innovation, the first stumbling block for asset managers is defining the term.

According to a survey last year by Ernst & Young, the professional services firm, fund groups are divided on how best to approach innovation.

A number felt that it should only apply to "something totally new, differentiable from peer offerings". Others regarded the term more broadly, counting repackages, style shifts, derivatives or structured products as innovative.

Creative solutions tailored to meet the needs of each client were cited by just under a third of respondents to the survey when it came to defining innovation, with pooled liability driven investment funds, tailored exchange traded funds or custom liquidity swaps cited as specific examples.

Almost all asset managers considered the creation of new products as innovation, although pension funds are unlikely to accept new ideas for the sake of it.

Nick Lyster, chief executive for Europe of Principal Global Investors, says pension funds "are increasingly open to innovation" from asset managers, provided the strategies are well researched and supported by a company they know and trust.

"Pension fund managers are naturally sceptical people – it is part of their job to be questioning," says Mr Lyster.

"Many have learnt the lesson that the financial services industry, both banks and asset managers, have not always delivered on their promises."

Asset managers have also had their fair share of setbacks and have learnt that launching products that claim to be innovative does not always guarantee success.

Structured and leveraged products, portable alpha, private equity and currency funds were among the industry innovations cited by pension funds as those that have failed to deliver.

Despite a number of product setbacks, appetite for new ideas among pension funds remains healthy.

Chris Ford, head of investment for Europe, the Middle East and Africa at Towers Watson, says new investment ideas from managers are always welcome. However, they should expect a fair amount of scepticism from clients about whether products are being marketed as part of an elaborate sales pitch.

"Asset managers are not maliciously designing products that are in their best interests, but pension funds have deficits and they need innovative products to help close that deficit," says Mr Ford.

> 'There is a lot of idea generation, but getting it into practice is the challenge'
>
> **Chris Ford, Towers Watson**

In many cases, pension funds can be spoiled for choice when it comes to the number of cutting-edge strategies on offer.

Mr Ford says: "The challenge is that pension funds often know what their needs are, but they struggle with the huge amount of information and products.

"There is a desire to get innovation, but the struggle is to sift through the products that are innovative."

Much of the current innovation has yet to make its way into pension fund portfolios.

"There is a lot of idea generation going on, but getting it into practice is the challenge," says Mr Ford.

The E&Y survey found that fixed income, and equities in particular, remain areas of heavy focus for asset managers. A majority of innovation budgets are devoted to the asset classes.

Mr Ford says overcoming inertia can be a barrier to generating innovation.

"If an area is working, it tends to attract talent into that area, and once talent is in there, it draws more capital into that area and creates its own centre of gravity," he says.

Some consultants believe asset managers' innovative streak is still very much alive, but others say rising regulatory involvement is at risk of stifling creativity.

Tom Steenkamp, director of investment solutions at Robeco, says: "In the current situation, at least in the Netherlands, there is an atmosphere which has been created by the regulator of control and no risk.

"People do not have the guts to look at innovative products or other areas of investing at the moment. There is more focus on keeping things simple. That is also the mindset of our clients."

That said, where pension fund clients are open to innovation, Mr Steenkamp says it is important to have the research to back up ideas. Robeco has a large research team and an innovation committee – something of a rarity, it would seem.

According to the survey, only 8 per cent of asset managers had a specific innovation budget, although 19 per cent had an innovation committee that met monthly, quarterly or as the situation demanded.

Innovation committees were typically tasked with generating, testing and challenging new product ideas, establishing the bases for product manufacture.

"An idea has more impact when there is evidence behind it," says Mr Steenkamp.

"If we have ideas, our sales group will bring ideas to discuss with clients. Sometimes it will lead to investment in these funds."

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Asset manager intentions: Europe

One good return deserves another ethical investment

Events such as the recent collapse of a textile factory in Bangladesh demonstrate the importance of environmental, social and governance issues to investors AP

SRI

Responsible investment has come a long way, but to progress asset owners must add their weight, says **Mike Scott**

Recent events such as the horsemeat scandal, the collapse of a textile factory in Bangladesh, the US court case against BP and the revelations about banks rigging the Libor rate illustrate all too clearly the importance of environmental, social and governance issues to investors.

And it would appear that investors got the message. Since its launch in 2006, more than 1,100 institutions representing roughly $32tn of assets under management have signed up to the UN's Principles for Responsible Investment, which encourage investors to incorporate sustainability issues into their operations.

Great progress has been made, says Neil Brown, a socially responsible investment analyst at Alliance Trust and chairman of the PRI's ESG integration working group. "There is some very good work being done in a volume, quality and depth that is staggering compared with where we were four to five years ago."

There has been a transformation in how asset managers, particularly in Europe, pay attention to these issues, agrees Vicki Bakhshi, head of investor engagement at F&C. "There is a greater realisation that poor corporate governance or a lack of environmental controls can lead to poor performance. These are issues that are material to the performance of companies in the long term."

However, in itself, PRI membership is not enough. "It's great that so many people have signed up to the PRI, but in our research, just 9 per cent of investment strategies are performing really well on integrating ESG issues into portfolios. It shows that signing up to the PRI does not mean you are integrating ESG measures. It is just the first step," says Aled Jones, head of responsible investment at Mercer, the consultancy.

Many in the industry agree that while things are better than they were, there is still a long way to go. The main barrier is the attitude and understanding of asset owners such as pension funds, says Will Oulton, head of responsible investment at First State Investments. At a recent investment forum held by First State, 65 per cent of those present said that what would accelerate ESG integration by asset managers the most was a stronger mandate from asset owners.

"If you are a large, successful asset manager, why would you change your business model if there was no pressure to do so?" asks Stuart Kinnersley, European chief investment officer at Nikko Asset Management and portfolio manager of the World Bank Green Fund.

"Asset owners have a huge role to play in this, but many pension fund trustees still believe that ESG means ethical investing, which they believe will depress returns," Mr Oulton adds. "But the truth is that mainstreaming ESG is just sensible investing."

Philippe Zaouati, deputy chief executive of Natixis Asset Management and chief executive of the firm's Mirova socially responsible investing funds, the second-largest in Europe, says that there is room for both SRI and ESG in mainstream investing.

"ESG integration is a good thing and it is needed, but to completely erase SRI would not be positive."

> 'Asset owners need to start asking probing questions of asset managers'
>
> **Vicki Bakhshi, investor engagement at F&C**

Natixis, which has €280bn of assets, integrates ESG into all its portfolios and reports on its ESG engagement to all clients. However, it maintains Mirova as a separate SRI unit that focuses on eight sustainability investment themes. "There is a difference between integrating ESG and seeking to create an impact," Mr Zaouati says.

To get to the next stage – where integration becomes substantive – "asset owners that care about this need to start asking some probing questions of asset managers, such as what resources and expertise they commit to ESG and at what issues they look", Ms Bakhshi says.

Answering such questions is becoming easier as the amount and quality of ESG data improves. It is also due to to initiatives such as the International Integrated Reporting Committee, which is encouraging companies to incorporate ESG issues into their annual reports, and the UK's Stewardship Code, which calls on investors to consider ESG issues when applying equity mandates.

The trend for increased integration will continue, believes Alliance Trust's Mr Brown, because "there is increased demand from the buyside – and they demand it because they believe it will drive returns. You will see more and more companies just getting on with it."

One example of this is the work being done by Axa IM, which uses ESG factors to help formulate its approach to sovereign debt. It has carried out a more detailed 18-month pilot project researching the most meaningful ESG issues in its UK equities portfolio. "The UK equities team now ask specific questions about ESG," says Matt Christensen, head of responsible investment at Axa Investment Managers.

"The answers are collated and used to create a scoring system that ranks companies. That rank tilts the portfolio towards companies with higher scores and also identifies the companies the team needs to engage with to get them to change their behaviour to improve their performance – and therefore our returns."

The programme is now being rolled out across the company's operations in Europe, Asia and the US over the next two years. "We are seeing more and more pension funds asking for this information. In five years' time, things will look very different. But this is not something that you can change overnight," says Mr Christensen.

Behemoths and boutiques isolate the middlemen

Continued from Page 13

McKinsey predicts that a quarter of the revenues from retail investors over the next five years will also flow into alternatives, which it sees as one of the "biggest opportunities" for innovative managers nimble enough to create products that provide exposure to infrastructure, hedge funds and commodities while also appealing to retail investors.

So are medium-sized managers just a few short breaths away from extinction?

Absolutely not, according to Stephen Barber, group managing director at Pictet, the Swiss group, which can be best described (although reluctantly by Pictet) as a midsized manager.

"The whole argument is complete nonsense.

"It is a lazy concept and one that has been knocking around for ages. If it had been true, then we wouldn't have survived and prospered in the way we have," he says.

It does not matter how big a company is, he stresses, "it matters how distinctive it is. You have to be distinctive to survive – not big or small."

> 'You have to be distinctive to survive – not big or small'
>
> **Stephen Barber, Pictet**

Amin Rajan, chief executive at Create Research, a consultancy, agrees: "Some of the best asset houses sit in the middle and continue to thrive, such as Principal Global Investors, Schroders, Standard Life Investments, and T Rowe Price."

In fact, within big asset houses, he continues, "diseconomies of scale arise from complex bureaucracy, missed opportunities, blurred focus, unrealistic expectations, internal politics, cultural clashes, strategic vacuum and inflated egos".

Together they ramp up hidden costs – often referred to as "deadweight costs", which deliver zero benefits, he adds.

There is too much of a preoccupation with size, according to Dominique Carrel-Billiard, chief executive of Axa Investment Managers, which finished 20th in a Towers Watson list of the world's 20 biggest investment managers by assets last year.

"Size is an elusive concept in absolute. What matters is to have critical size in a given market segment. Smaller or midsized players will have no problem surviving if their market presence in a given segment is dominant and based on some differentiating feature."

Midsize managers can flourish, adds Mr Rajan, by putting their clients' interests above their own.

He advises such companies to stop selling products that are not fit for purpose, to adopt a value-for-money fee structure that shares gains and pains fairly, and to develop common investment beliefs and time horizons that minimise panic buying and selling.

"The aftershocks of the 2008 meltdown have left clients on shaky ground. Success will go to managers who know their clients' dreams and nightmares and deliver the solutions that address them.

"Size is of secondary importance," he says.

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