FTfm

Distributing mutual funds

FINANCIAL TIMES **FTfm Special Report** | Monday March 11 2013

The results are conclusive: trust is key to success for fund firms

Commentary

OWEN WALKER

It is often said that trust is the hardest thing to gain, but the easiest to lose. The experiences of many fund management companies over the past few years are testament to that.

The unexpected fund blow-ups, malpractice and lack of transparency exposed since the 2007-8 financial crisis have left some big industry players wondering how they can regain the high standing they once had among investors and advisers, which they had taken years to build up.

Indeed, for fund companies that are often quite far removed from the end investor – those whose money they are being paid to manage – it is often more fruitful to target their attempts at regaining their reputation at intermediaries.

For the past four years, the Financial Times has conducted research into the image of US fund managers among financial advisers, seeking to find out what the most important attributes are for a strong reputation, and how to achieve them.

The latest survey – conducted last September – sought the opinions of 397 US financial advisers, the majority of whom are subscribers to Ignites.

The results are conclusive: the key to a strong reputation among intermediaries is trustworthiness. This attribute is rated far higher than any other when advisers were asked which was most important to them when choosing an asset manager. Trustworthiness has also consistently been top over the past four years.

Of the advisers who took part, 96 per cent identified trustworthiness as an important attribute, with 79 per cent labelling it highly important. The next best-regarded attribute was financial strength and long-term stability, which 64 per cent viewed as highly important.

As an interesting side note, fund managers who spend hundreds of thousands of dollars on fancy brochures may be interested to know that sales and marketing materials were the lowest-ranked attribute, with just 17 per cent of advisers labelling them highly important.

The significance of being seen as trustworthy should not be overlooked, especially when 58 per cent of the polled advisers said trust issues had become more of a concern over the past 12 months.

"Trustworthiness is the paramount attribute that every asset manager needs to focus on," says Daniel Rothman, US director of customer and markets insights at the FT, who conducted the research. "The major financial crisis may be behind us, though there continue to be minor episodes within the asset management community that bring this to the fore."

But while trustworthiness is a fine ideal, it is also intangible and tricky to measure. So the FT researchers delved a little deeper. They asked the advisers to rank the top five actions that managers could take to improve trustworthiness. They were rewarded when three tangible attributes emerged above all else: consistent returns, clear and consistent investment process, and increased transparency.

The first is expected. What fund manager is not focused on returns? But what is noteworthy is the value placed on consistency and a level of returns that can be depended upon. Trustworthiness is not achieved by posting stellar results one quarter, only to be a bottom-quartile fund three months later.

The second two are, however, more revealing. And it goes to the heart of why some fund managers have seen their reputations reduced to tatters in recent years.

The sudden poor performance of a fund is unfortunate, but it is the risk investors and advisers take when they put up their capital. But what is not acceptable to many is when the underperformance is completely unexpected. A product that is marketed as low volatility and low risk should not suddenly fall off a cliff.

Asset managers that value client service and communication highly will be much more likely to keep advisers abreast of any developments at the fund – either good or bad.

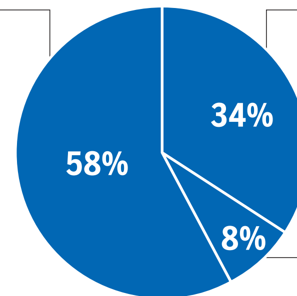
The FT research shows that while advisers view performance as a key measure of reputation, they will forgive underperformance if it is not unexpected and the asset manager has been open and transparent.

"Advisers told us they do not want to be surprised by asset managers and they want clear and frequent communications," says Mr Rothman. "They want communication during good periods and especially if there are issues that have come up."

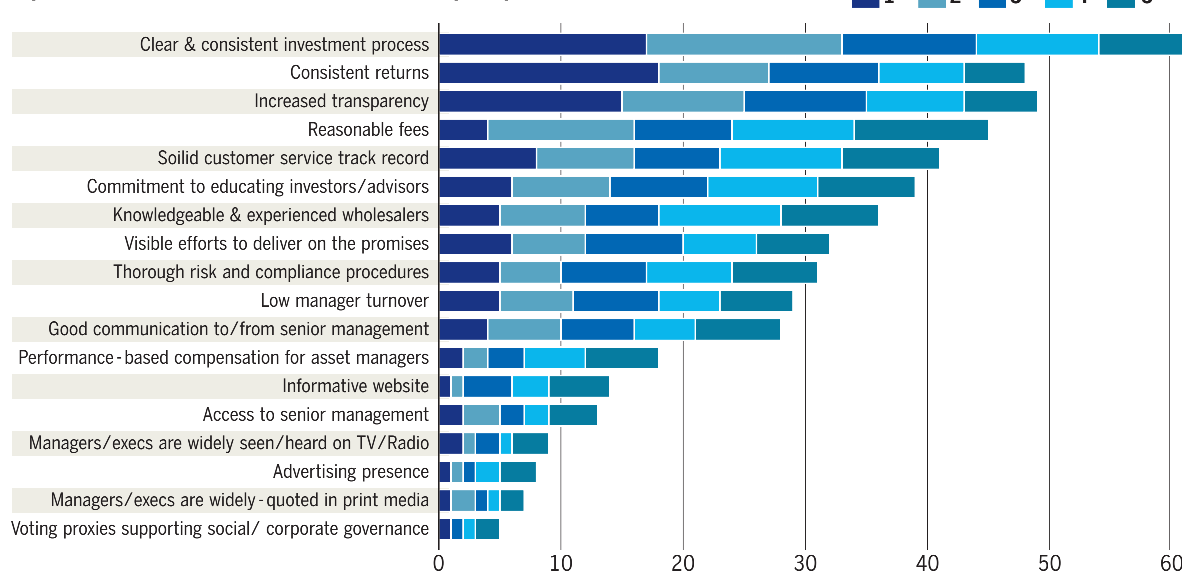
Trust is not, therefore, the intangible attribute it first appears. Among investors and advisers, it is possible to build it up, but only through consistent, expected returns and a commitment to client services and communication.

Questions of trust - annual FT survey of US financial advisers

Has trust become more of a concern or less of a concern in the past 12 months?



Top five actions firms can take to increase their perception of trustworthiness



Source: *FT Fund Image 2012*

Inside

Efficiency drive Providers push for lower costs **Page 2**

Regulation Payments under greater scrutiny **Page 2**

Compensation Why pay is core part of funds' strategy **Page 4**

Costs Advisers take bigger slice of redistributed fees **Page 4**

ETFs Sponsors see growing role for packaged products **Page 6**

401(k) plans Rule changes prompt focus on value **Page 6**

Analytics Sales and marketing mine rich seam of data **Page 7**

Sales channels Asset managers evolve to new routes **Page 7**

Fund flows Caution urged over I-shares **Page 8**

Contributors

Owen Walker
Managing Editor, Ignites

Loren Fox
Director of Research, Money-Media

Emile Hallez
Retirement and Defined Contribution Reporter, Ignites

Mariana Lemann
Sales, Distribution and Marketing Reporter, Ignites

Jesse Mark
Senior Research Analyst, Money-Media

Jackie Noblett
Technology and Operations Reporter, Ignites

Peter Ortiz
Regulatory and Compliance Reporter, Ignites

Beagan Wilcox Volz
Associate Editor, Ignites

Whitney Curry Wimbish
Managing Editor, BoardIQ

Juliette Fairley
Freelance Journalist

For advertising contact **Jennifer Rasmussen,** tel 917 551 5031, fax 646 417 7455, email jennifer.rasmussen@ft.com or **Steven Canfield,** email steven.canfield@ft.com

Providers push for lower costs and greater efficiency

Research findings

Jesse Mark and **Loren Fox** scrutinise a survey of managers and senior executives

The mutual fund industry has never had it tougher, despite the rise in the US stock market and the large flows into stock and bond mutual funds since the year began. And fund providers have never asked employees to do as much with so few resources.

The problems stem from the fact that most mutual funds are sold through a financial adviser. This resource-intensive process requires the fund manager's sales-people to court the adviser's employer, shepherd the fund through a quantitative screening, build a relationship with the adviser, and then persuade them to actually use the fund.

Fund manufacturers are also being pressured to reduce their fees, as they watch low-cost index funds and exchange traded funds expand market share.

The broker-dealer companies that comprise the single biggest sales channel for mutual funds are also pressing the fund management companies to agree to more revenue-sharing in return for shelf space. At the same time, many mutual funds look similar, so leading investors treat them as easily replaced commodities.

Fund providers are therefore pushing for lower costs and greater efficiency where they can: in the fund distribution organisation. To hold down expenses, the fund managers are being especially careful in new hiring, according to a study conducted by Ignites Distribution Research.

Sales managers and distribution executives from 20 fund firms of varying sizes were surveyed and interviewed, with the average company managing $45bn in assets. In 2013, these firms plan a modest 2.8 per cent increase in headcount of external wholesalers, the fund salespeople who visit branch offices to interact personally with financial advisers.

On the other hand, the survey found fund managers plan to hire 6.6 per cent more internal wholesalers, those sales personnel who remain at their desks and support the externals and service advisers via phone and email.

Internal wholesalers, at a fraction of the cost of externals, can be a valuable resource to offer inbound support to advisers, to prospect and pass on leads to the field force, and to selectively conduct outbound sales.

While phone calls and webinars will never replace personal relationships, asset managers may be able to use internals to service small advisers cost effectively and to qualify leads. And some companies are looking at creating desks of senior internal wholesalers to service important advisers who prefer phone calls to meetings.

As fund providers seek more effective ways of serving advisers, they could look to developments outside the industry. For example, credit card companies and airlines have long used a tiered service model to provide premium service to high-value clients.

But a tiered service model in the adviser-sold fund industry is not widely adopted. One exception is Russell Investments, which separates out advisers with more than $20m-$25m invested with Russell, and hands these elite advisers to a specialised group of divisional client executives for a more personalised service.

For the external wholesalers travelling from office to office, the key is to ensure they spend their time with the financial advisers who should be their focus. A typical external wholesaler spends 76 per cent of his or her time with financial advisers, whether selling prospects, servicing or up-selling clients, the research found.

Most external wholesalers have a focus list of 200-300 high-priority advisers. Some forward-thinking companies are going further with the focus list, by cross-checking activity and expenses to see what ratio of time wholesalers spend with advisers on the list, and aim to alter incentives based on this activity.

> While some heads acknowledge the importance of edistribution, they lack management team support to explore it

Other fund managers are looking to edistribution, or the use of the web to connect with advisers.

Many distribution executives are trying to establish whether the web can be a sales tool to attract new clients and assets, as opposed to simply a support tool for current assets.

While it takes significant investment, leading companies are beginning to use digital interaction as a way of creating both deeper and broader relationships.

One company says its goal is to use the web to reduce the number of personal meetings its wholesalers have with advisers. Some heads of distribution acknowledge the importance of edistribution, but lack support within the management team to explore it.

Distribution organisations need to think differently about how they sell through financial advisers. It will take more than a few tweaks to adjust their business models – how the fund salesforce works will need to be rethought.

Watching like a hawk: the SEC has made distribution fees an examination priority Getty

Reviews lead to greater scrutiny of payments

Regulation

SEC and FSA inquiries into fee structures are likely to lead other watchdogs to call for more transparency, reports **Peter Ortiz**

How US mutual funds pay distributors and what services they receive is seen as an emerging risk for the Securities and Exchange Commission, a reaction that also highlights the latest push by global regulators for greater transparency.

The SEC's examination-priorities list for 2013 highlights attention on "payments for distribution in guise" and a renewed interest in continuing sales charges or 12b-1 fees the funds pay to distributors. The added regulatory pressure comes as funds and their advisers find it more expensive to get their products on broker-dealer platforms.

While the SEC has made distribution fees an examination priority, the UK's Financial Services Authority's Retail Distribution Review (RDR) banned its version of 12b-1 fees, or continuing commission, on independent advised sales in January. The Netherlands will follow later this year and Germany and Spain are looking to eliminate continuing sales charges by their funds.

"There is definitely a global movement to transparency," says John Rekenthaler, vice-president of research at Morningstar.

The goal of the RDR is to provide investors with greater transparency on what services they were receiving by unbundling the distribution fee out of the funds' expenses. The investor who hires the adviser pays them directly rather than the fund paying the adviser commission.

SEC examiners' visits to fund companies are part of a national effort by the US regulator's various divisions and regional offices to learn more about the large amount of money paid to distributors, says Andrew Bowden, deputy director of the agency's Office of Compliance Inspections and Examinations. SEC examiners will conduct so-called sweeps, or site visits of asset managers, advisers and distributors.

The SEC's review of mutual fund distribution and service payments is being termed a fact-finding mission as examiners gather information on changes over the past decade, Mr Bowden says. These examiners will review whether advisers are receiving more in revenue share than they did five years ago, what funds are forking out for shareholder servicing fees, what services funds are receiving in return, the level of board oversight and what is being disclosed to investors.

"Given the amount of mutual funds sold through distributors, the amount of investor money invested in those funds, and the amount of money paid by advisers and funds to distributors in the past 10 years, it's an important area to go out and make sure we have a good understanding," Mr Bowden says.

> 'The one thing I don't see happening is all this [SEC] attention resulting in a rollback of price increases'

Rulemaking efforts around distribution fees, commonly called 12b-1 reform, have been a perennial issue with the industry. Elisse Walter, now acting SEC chairman, announced in April 2011 as a commissioner that such reform would take place the summer of that year, but the effort lost momentum as money-market reform and other Dodd-Frank demands took precedence.

There are clear distinctions between the SEC's new examination of distribution fees and the FSA's "commission-centric" rule, says David Hearth, partner at Paul Hasting. Perhaps the most notable difference is that the SEC is focusing its attention on how fees are paid, reported and disclosed, as opposed to the FSA moving right ahead and banning continuing sales charges.

But funds, nonetheless, will have to contend with increased SEC scrutiny in how they are paying for distribution. If they do not have enough to cover distribution from their 12b-1 fees, limited to 25 basis points, or record-keeping fees, then they will have to rely on their advisers to cut a payment to the distributor, Mr Hearth says.

"The front-end bill [to get on the platform] is higher," he adds, saying that in some cases there are continuing basis point charges that stay on the distributor's platform.

The fund adviser often is left with a "stark choice" between paying out of its own pocket or suspending sales of that fund through that intermediary, Mr Hearth says. "The one thing I don't see happening is all this [SEC] attention resulting in a rollback of price increases."

John Bosley, chief operating officer of Bonaire Software Solutions, expects the focus on transparency with the FSA's RDR and the SEC's own review of distribution fees to influence other regulators considering ways to improve transparency within their market structures.

The financial crisis and its global implications have additionally spurred even greater communication among regulators, so it should not be surprising to see them looking to each other for potential lessons on future reforms, Mr Bosley says. "If one country sees another taking a leadership role to protect consumers, they will be pressured to do the same."

Morningstar's Mr Rekenthaler adds that he expects the SEC's examination of distribution fees to be "possibly a first step along a longer path" towards further reforms.

©2013 OppenheimerFunds Distributor, Inc.

IT'S 1950
somewhere in the world.

An emerging consumer class. Exploding income. Expanding productivity.
They sparked five decades of growth in the U.S. after World War II.
And today, it's happening again in the developing world.
With 40 years of success in global investing, we're ready for this moment.
GLOBALIZE yourthinking.com

Scan this code to test your global IQ.

Download free Global Tracker℠ app:

Visit blog.oppenheimerfunds.com

Look for OppFunds:

Emerging market currency investments are subject to risk and may be especially volatile.

Compensation needs to be core part of strategy

Remuneration

Mariana Lemann looks at moves to link wholesaler rewards to company profits

Tighter margins, market volatility and economic uncertainty are leading to new distribution strategies, which in turn have led to new compensation models.

There has been an increasing move for fund executives to align wholesaler compensation with the firm's long-term profitability, while also trying to find ways to recognise talent and keep high performers motivated.

John Hancock adopted a much simpler wholesaler compensation package for external representatives this year.

The company cut the number of metrics used to determine the compensation of its 72 external wholesalers to four in order to increase the competitiveness of its compensation plan, says Andrew Arnott, president and chief executive at John Hancock Funds.

"Every morning they know exactly where they stand and exactly what they are making. We give them immediate visibility into the diversity of their own book," he says.

The new plan was a product of John Hancock's annual revision of its wholesaler compensation package.

"Past plans were fairly complicated and unnecessarily so," Mr Arnott says. "It would be frustrating for a person not to know exactly where they stand," he says.

Wholesaler compensation is one of the main levers fund firms use to recruit and retain talent. At the same time, it is a critical piece of an efficient distribution strategy, especially for an industry that relies so heavily on intermediaries to sell products.

After investment professionals, sales people are the most highly compensated at fund companies.

There can be a lot of moving parts determining their final compensation. Therefore, designing adequate and competitive packages is one of the significant challenges for heads of sales and mutual fund chiefs, says Rubesh Jacobs, a director at Kasina.

"We advise firms to use compensation as a tool to drive their strategy, not just as a way to compensate sales people to sell a lot of products," he says.

John Hancock's compensation plan is aligned with current trends in wholesaling compensation, consultants say.

"What we encourage firms to do is not to have a lot of metrics, but reduce the list to three, four or five metrics at the most," Mr Jacobs says. In addition, metrics must be measurable. Numbers of meetings, new advisers or types of advisers wholesalers reach, for example, can be tracked.

"We see fund managers creating metrics on things that [wholesalers] don't really control, for instance,

> 'We advise firms to use compensation as a tool to drive their strategy'
>
> **Rubesh Jacobs**
> **Director at Kasina**

something ambiguous such as the firm's perception on a territory," Mr Jacobs says.

One component that is highly valued by asset managers – net sales – is tricky to incorporate into companies' compensation plans because wholesalers have no control over redemptions.

"A lot of companies, including ourselves, are careful to make sure that we pay on what they can control and net sales in itself is not necessarily something that a wholesaler can control," John Hancock's Mr Arnott says. "Conceptually, you do want to drive towards best net results, but you need to be smart about the plan you construct . . . We focused on the activities that will result in better net sales."

Net sales represent, on average, 17 per cent of field wholesalers' compensation package, according to a study by Cerulli Associates, Sequoia System International and the Investment Management Consultants Association. It is the third-largest component in the average package after gross sales and base salary, which represent 41 per cent and 30 per cent, respectively.

"Net sales as a pure measure have the potential to unfairly punish wholesalers," says Bing Waldert, a director at Cerulli Associates.

Firms need to be careful about the weight placed on net sales, consultants say. "If you have a poor-performing fund and the wholesaler advises the adviser to redeem from that fund, it is a short-term negative, but it deepens the relationship between the fund company and the adviser," Mr Waldert says.

Incentive: wholesaler compensation is one of the main levers fund firms use to recruit and retain talent Dreamstime

Franklin Templeton is another firm that reviews its compensation practices annually. Wholesaler compensation plans include a discretionary component based on cash and the opportunity to earn company stock.

These components are based on gross sales, redemptions, delivery against business plans, and the diversity of products used by the adviser, among other drivers identified by sales management.

But even well-designed plans can have unintended consequences.

Since the financial crisis, the gap between the compensation received by the top and lowest performers has shrunk. In 2009, the difference between the top and the lowest performers was $546,500. In 2011, the difference dropped to $419,600, according to a Kasina study that examined 31 asset management and insurance firms in 2011.

The challenge for the industry is to widen the gap, Mr Jacobs says. The wider the gap, the higher the incentive for low performers to increase production or to leave the firm, he adds.

Advisers take bigger slice of redistributed fees

Costs

Low growth and keen rivals mean higher charges, says **Juliette Fairley**

The costs involved in distributing retail investment funds have risen significantly because of a change in the transaction fee structure, and also as a peculiar consequence of increased competition and choice.

When Andrew Rogers, chief executive at Gemini Fund Services, had word from broker-dealers selling his company mutual funds that the cost of servicing accounts would change from the usual per-transaction fee to 10 to 15 basis points per account, the switch resulted in doubled costs.

"The lack of trading volume and the growth of exchange traded funds has squeezed the revenue of custodial platforms, such as NFS, TD Ameritrade and Schwab," says Mr Rogers. "We're faced with a different business model."

It used to be that when financial advisers sold a 2 per cent load mutual fund to a client, the fund manager secured a full 1 per cent on the transaction, while the financial adviser and distributor split the other 1 per cent.

"Under the new model, more of the 2 per cent is going to the adviser and distributor because of the growth of passive funds. It's a redistribution of wealth," says John Rekenthaler, vice-president of research at Morningstar. "The growth of passive funds with their lower expense ratios is challenging actively managed funds."

Increased competition is also causing distribution costs to creep up at large wirehouses, such as Merrill Lynch, Morgan Stanley and UBS. Before the collapse of 2008, many of these companies exclusively sold only in-house mutual funds.

"These in-house products still exist but financial advisers today want choice, and the implication of offering choice from the wirehouse's point of view is increased competition," says Mike Papedis, executive vice-president of business development at Hightower, a national partnership of financial advisers in New York.

"That increased competition cuts into making a fat margin from only selling proprietary products."

At Fidelity Financial Advisor Source, the fund management fee for a large-cap passively managed ETF or index fund currently is 5 to 15 basis points compared with 50 to 75 basis points for a large-cap mutual fund management fee.

Scott Couto, president of Fidelity Financial Advisor Solutions in Boston, says: "We work with intermediaries, such as Morgan Stanley, Merrill Lynch, Wells Fargo, Raymond James and LPL.

"Over time, we've noticed that the expenses associated with getting access to their systems have increased because they are providing an environment in which their advisers are well trained and have access to great resources and tools."

Annual expenses per year for Schwab, Vanguard and Fidelity passive stock funds tend to be 10bp to 20bp,

> 'The growth of passive funds with their lower expense ratios is challenging actively managed funds'

compared with 70bp to 110bp for actively managed stock mutual funds, according to Morningstar.

With the shift towards fee-only advising well under way, financial advisers have too many options to be concerned with rising distribution costs.

Charlie Epstein, a Holyoke, Massachusetts-based financial adviser, says: "We're not feeling the pinch that wirehouses and mutual fund manufacturers are experiencing.

"But if it did trickle down we'd shift to another fund family unless there was enough of a return to cover that extra distribution cost, especially when ETFs are trading so inexpensively."

Noah Hamman, chief executive of AdvisorShares, adds: "Because of declining growth from mutual funds and increasing growth in ETFs, we believe broker dealers, such as Schwab and Fidelity, will eventually look for opportunities to generate income from ETF listings, which can ultimately increase costs for ETF sponsors."

According to Lipper Annual Money Flows, $10.8bn moved into ETFs compared with $7.5bn into stock mutual funds for the week ending January 9, 2013.

Another reason for the higher distribution costs is the increased amount of compliance asset managers need to put in place.

Chuck Miller, managing partner at Carlton House Capital in Chicago, says: "It can take up to six to eight weeks to get a response from compliance to review and approve marketing materials created for financial advisers. Reviewing and approving requires time and staff, and you have to compensate the staff. These costs are being absorbed by the mutual fund company."

STATE STREET. WORLD GOLD COUNCIL

*GLD's liquidity as measured by 12-month average daily trading volume ($1.9B) is 19 times greater than IAU's ($98M). Data is as of 9/30/12 (Sources: Bloomberg, SSGA).

Important Information Relating to SPDR Gold Trust:
The SPDR Gold Trust ("GLD") has filed a registration statement (including a prospectus) with the Securities and Exchange Commission ("SEC") for the offering to which this communication relates. Before you invest, you should read the prospectus in that registration statement and other documents GLD has filed with the SEC for more complete information about GLD and this offering. You may get these documents for free by visiting EDGAR on the SEC website at www.sec.gov or by visiting www.spdrgoldshares.com. Alternatively, the Trust or any authorized participant will arrange to send you the prospectus if you request it by calling 1-866-320-4053.

LISTED NYSE ARCA

ETF's trade like stocks, are subject to investment risk, fluctuate in market value and may trade at prices above or below the ETF's net asset value. Brokerage commissions and GLD expenses will reduce returns. These investments may have difficulty in liquidating investment position without taking a significant discount from current market value, which can be a significant problem with certain lightly traded securities. Diversification does not assure a profit and may not protect against investment loss.
Investing in commodities entails significant risk and is not appropriate for all investors.

"SPDR" is a registered trademark of Standard & Poor's Financial Services LLC ("S&P") and has been licensed for use by State Street Corporation. No financial product offered by State Street Corporation or its affiliates is sponsored, endorsed, sold or promoted by S&P or its affiliates, and S&P and its affiliates make no representation, warranty or condition regarding the advisability of buying, selling or holding units/shares in such products. Further limitations that could affect investors' rights may be found in GLD's prospectus.

For more information: State Street Global Markets, LLC, One Lincoln Street, Boston, MA, 02111 • 866.320.4053 • www.spdrgoldshares.com.

Not FDIC Insured – No Bank Guarantee – May Lose Value

IBG-6409

Packaged products flourish as a way to distribute ETFs

Strategies

Sponsors see third-party managers playing a big role in the expansion of their industry, writes **Jackie Noblett**

As exchange traded-fund sponsors look to expand their reach in the retail market, tactical portfolios are one of the fastest-growing channels to deliver the products.

Registered investment advisers and other third-party asset managers have gravitated towards ETFs as a way to execute tactical asset allocation strategies. When packaged into separate accounts, mutual funds or other products, they are finding a receptive audience among advisers, retirement plans and institutional investors.

In 2012, about 107 third-party ETF managers oversaw or managed $53bn in assets, a 40.5 per cent growth rate on 2011, according to BlackRock research.

Morningstar's early research suggests even faster growth, of the order of 60 per cent, to about $63bn in 2012.

While still a small fraction of the $14tn in US ETF assets, ETF sponsors see third-party managers as an important part of the growth of the ETF industry. Companies have set up dedicated teams to woo these model makers, developing new products to meet their needs as well as providing distribution and marketing support to ETF model makers looking to reach advisers.

Registered investment advisers and third-party managers have been using ETFs in portfolios for almost as long as ETFs have been available. Managers say ETFs allow them to make an allocation to an asset class with a single product rather than multiple securities.

But it was not always easy for strategists to build all-ETF portfolios.

Windhaven Investment Management, the largest ETF strategist with $14bn in assets under management, started building ETF portfolios in 1994. It would build a matrix of asset classes that it wanted to allocate to in its risk-managed asset allocation strategy and then see if there were ETFs that matched those specific slices of the market.

"In the beginning it was very sparse," says Stephen Cucchiaro, chief investment officer at Windhaven.

But Mr Cucchiaro encouraged ETF manufacturers to fill in the boxes, to the point where the company will sometimes act as a seed investor for new funds that meet a specific need in Windhaven's portfolios.

Indeed, the proliferation of ETF products had a large impact on the evolution of all-ETF packaged products and the managers that developed them.

The ETF's expansion into fixed income in the past decade was a large driver of bond specialist Sage Advisory Services' ability to build all-ETF portfolios, says Michael Walton, vice-president of marketing and product development at the company. "Replicating institutional fixed income into an ETF format, that's what made it easy for us to develop global asset allocation strategies."

But it took some time for these ETF portfolios to catch on with investors.

"It took a while for investors, advisers, consultants to really get used to ETFs," says Sean Clark, chief investment officer of Clark Capital Management.

"The ETF manufacturers have done a wonderful job in educating [people] about the benefits of ETFs, and the cumulative effect of that education is driving growth."

The changing advisory model is also fuelling the growth of all-ETF portfolios. Many advisers are focusing more on a holistic management of clients' finances and leaving some or all of the portfolio management duties to others.

'What's driving it is financial advisers knowing that they want to do something in the ETF space'

"What's driving it is financial advisers knowing that they want to do something in the ETF space; they also want something that's more tactical but they feel like they don't have the capabilities in building those portfolios. They look to the ETF investment strategists, then, as a solution," says Sue Thompson, head of the institutional asset management and registered investment adviser group at BlackRock's iShares.

Many of the elements of an ETF that appeal to a fee-based adviser also translate into ETF managed portfolios, managers say.

The ETF's transparency and identity with an index helps investors have a better sense of what is happening with their portfolios as tactical managers adjust their allocations.

There is also a cost component. With the asset-weighted average expense ratio of an ETF being 32 basis points, managers say they can build portfolios that cost less than the average actively managed mutual fund, even with their management fee included.

The question is how long the ETF managed portfolio growth rate will continue to accelerate. BlackRock's Ms Thompson says she believes there are several years of strong growth ahead before the law of large numbers starts to weigh on the industry.

Seniors exercising in Miami, Florida: few retirement plan participants inquire about fees Getty

Changes in fee rules prompt a focus on value

401(k) plans

Sponsors are keeping a watchful eye on charges incurred by participants, writes **Emile Hallez**

Pushed by new regulations and heightened fiduciary responsibilities, retirement plan sponsors are keeping a watchful eye on the fees their 401(k) participants incur.

Sponsors have spent the past year benchmarking the services for which their plans pay, including record-keeping costs and investment fees. Though few plans have so far swapped record-keeping platforms for those of less expensive competitors, some expect significant changes this year.

But fees alone are rarely the reason sponsors select providers. Of greater concern is the quality of service for the money, industry consultants say. Record keepers have therefore been swift to emphasise value over low costs.

The Department of Labor's two recent fee-disclosure rules, known as 408(b)(2) and 404(a)(5), took effect last year and generally require providers to be more transparent about their fees.

"The pressure is certainly on these providers to drive their fees down," says Linda York, director of syndicated research at Cogent Research, noting that revenue-sharing is an increasingly sore subject with plan sponsors.

"Some of the very largest plans are going more toward [collective investment trusts] or other multimanager options for their plans. They're getting away from the institutional share classes and having a more customised investment menu."

Because a due diligence process does not necessarily lead to the cheapest possible investment and service options, fund management companies might continue to offer products at a premium.

In addition, sponsors do not take decisions to switch record keepers lightly, given the onerous process of a large-scale change, experts say.

"It's a lot of work for a plan to change providers. They have to have a really compelling reason to change," says Ms York.

A survey of 200 plan sponsors conducted last year by OppenheimerFunds indicates fees are the biggest concern sponsors have when shopping for plan providers. After fees come timely and accurate service, record-keeping capabilities, an existing relationship with the provider and investment philosophy.

There is evidence that participants pay virtually no attention to the fee-disclosure notices they receive

Record-keeping is generally known as an intensely competitive business. Large-scale companies that offer bundled services – record-keeping and proprietary funds – can often undercut the competition on the record-keeping end, making up the cost in bulk through the funds they provide.

"You've seen some companies get out of the record-keeping business and focus on the [defined contribution investment-only] side," Ms York says. "That pressure is just going to continue."

It is uncertain whether many plans will hire new record keepers this year, but requests for proposals are likely to increase, Ms York says.

For fund managers, the same level of fee scrutiny may not be catching on as quickly.

"When we look at things that drive consideration of investment managers, from the plan adviser perspective and the plan sponsor perspective, we don't see fees as a critical attribute," Ms York says. "Strong, consistent investment performance is something that drives consideration of investment providers."

There is also evidence that participants pay virtually no attention to the fee-disclosure notices they receive in the mail.

A study conducted late last year by the Plan Sponsor Council of America indicates that only 1.4 per cent of participants inquired about their plan fees. Only 0.6 per cent of participants added or dropped funds in light of the new information.

"They might make it a few pages into [fee disclosures], and then their eyes glaze over," says Jeff Keil, principal of Keil Fiduciary Strategies, adding that consequences of the new rules have yet to be seen.

"This whole fee-disclosure issue has been a non-event from a sponsor and fund-industry perspective. As most people feared, investors aren't paying much attention to the new disclosure."

A number of record keepers touted their level of fee transparency ahead of the Department of Labor's new rules, including Fidelity. The company indicates the response from individual investors has been minimal, though sponsors have raised questions about value.

"The hint of fee disclosure changes goes back several years," says Steve Patterson, executive vice-president of sales for Fidelity's workplace investing group. "We have not used fee disclosures as a means to win new business."

But potential clients are inquiring about the revenue generated by their plans, he says. Sponsors are also increasingly interested to learn more about investment options not covered by the Investment Company Act of 1940.

Sales and marketing mine rich seam of data

Analytics

IT is being used to steal a march on rivals, writes **Mariana Lemann**

As fund companies tighten their belts, distribution and marketing executives are exploring ways that data mining can help refine their strategies.

"Asset managers are sitting on a treasure trove of data, but marketers and sales managers haven't until fairly recently been able to get their hands on it," says Julia Binder, director of ebusiness research at Kasina.

Fund purchases and redemptions, wholesaler visits, call logs, web-browsing trails, social network messages and sales and market-share data are just a handful of examples of data that can be used by asset managers. Armed with this kind of information, fund management companies can mitigate the risks of creating inadequate products or overlooking good prospects, Ms Binder says.

"Business intelligence and data analytics teams are being built in sales and marketing and customer service departments. Rather than centralising them at the firm, people are residing in each of the customer-facing businesses and developing data initiatives that are specific to their needs," Ms Binder says.

In fact, according to a recent survey of 15 asset management companies by Kasina, 47 per cent of the business data initiatives are being managed by sales and 27 per cent by marketing departments.

"That tells you something about where the sense of urgency is in an organisation," Ms Binder says. "It is very high on sales, but there is also pressure in marketing to justify the rising costs that marketing is experiencing and to justify how budgets are being spent."

Advisers are turned off by fund managers that do not understand their businesses, says David Swanson, founder and managing partner at SwanDog Marketing.

Companies are looking for data internally and externally from various sources. Calvert Investments, for example, is using data to segment and target financial advisers and prospects more sharply.

"Distribution is a numbers game and to create impact and drive sales, we can't be everything to everyone," says Matthew Alsted, vice-president of channel marketing and brand strategy at Calvert Investments.

Calvert identifies advisers who are buying significant shares of funds in a given strategy and the companies with the largest market share in these strategies.

'Distribution is a numbers game and to create impact and drive sales, we can't be everything to everyone'

Then Calvert compares its own market share with competitors in the strategy in order to devise plans to grow its own share.

External and internal data sources are used to determine which broker-dealer firms and product types represent the best opportunities. At that point wholesalers judge whether it is worth spending the time on a call or a visit to a given adviser, Mr Alsted says.

"Just recently these external data sources have come to fruition," he adds. "But figuring out the right way to integrate them into an internal targeting process and selling system is the real challenge and opportunity."

It may still be early days in crunching big data for asset managers, but Calvert has seen a positive impact of the strategy.

"We are discussing success stories weekly where this targeting approach has revealed a sales opportunity that has resulted in meaningful business for us," Mr Alsted says.

In this embryonic phase of incorporating data logic into sales and marketing strategies, asset managers are imitating strategies already used in other industries, especially from pharmaceutical and retail companies.

Asset managers are also seeking talent coming from these industries, Kasina's Ms Binder says."They want to hire them from Target and Walmart and Apple."

Until recently, marketing or sales leaders would be entirely dependent on information technology departments to access data. And the process of gathering information in a user-friendly format was usually time consuming.

"The barrier between information technology and the business units is crumbling, especially in the face of what is being called big data," Ms Binder says. "Data [are] being generated on a speed and volume and variety that is unprecedented."

But navigating the information is no easy task. Therefore it is essential to have clarity about what problems or issues are being tackled, executives say.

The process of aggregating different data sets is also bringing different departments closer.

"We are working even more closely with our IT partners. The value is that our IT partners get some of the business perspective and business context and understand how other companies are doing this," Mr Alsted says.

Only connect: Data can be used to segment and target financial advisers and prospects more sharply Dreamstime

Asset managers switch channels to lift sales

Organisation

Beagan Wilcox Volz finds some fund firms evolving beyond traditional sales structures

Most US asset managers structure their retail sales arms to focus on specific channels in the market.

Wholesalers at fund companies generally target those channels – including wirehouses, regional and independent broker-dealers, registered investment advisers and banks – within a given geographic territory.

Estimates vary on the prevalence of this structure, but Larry Petrone, director of research at consultant Kasina, says roughly 80 per cent of large and midsize asset managers organise their sales arms around channels to some degree.

But there are also fund companies that structure their sales units so that individual wholesalers sell across channels. Fund managers have developed very individual approaches to distribution, but industry experts cite advisers' more frequent movement among different channels, and travel cost efficiencies as two drivers of what is often called "dechannelising" in industry jargon.

Allianz Life moved away from its focus on channels with its wholesaler distribution division in early 2011. Wholesalers at Allianz Life Financial Services also now sell all the company's products, including variable annuities, fixed-index annuities and fee-based products. Before the change, the wholesalers primarily sold commission-based variable annuities.

At the time of the restructuring, the company said advisers were demanding both fixed and variable products and that the changes made sense in part for this reason.

"It's a much more focused approach," says Tom Burns, Allianz Life's chief distribution officer. "Why not have your best wholesalers calling on your best clients? There's not a lot of difference between a bank, wirehouse, independent adviser – they're looking for the same type of [products] for their clients."

Total sales through Allianz Life Financial Services increased from $3bn in 2010 to more than $3.7bn in 2012, with fixed-index annuities sales growing from 10 per cent to 15 per cent of total sales during that period.

Franklin Templeton took its cross-channel sales coverage to a national level in 2010. The fund manager had previously piloted the programme with a number of cross-channel territories, according to a spokesman for the company.

'We think it's more efficient . . . when you have less geography for somebody to cover'

"We think it's more efficient and increases productivity when you have less geography for somebody to cover," says Dan O'Lear, executive vice-president of Franklin Templeton Distributors and head of retail distribution for North America. "We do business with 140,000 advisers every year. Really, to do that, you want to get in front of as many people as you can," he says.

One drawback to being channelised, says Mr O'Lear, is that a wholesaler may cover a wirehouse adviser for years and develop a great relationship, but if that person moves to an independent broker-dealer, the current wholesaler would no longer cover them.

"Continuity of relationships is key," he says.

Russell Investments' wholesalers have always sold its products across channels. But in July 2010, the fund manager refined its approach by segmenting its adviser clients based upon the assets they hold with the company.

"The reason we did that is it became clear that the adviser who has a significant amount of assets with us has a different set of needs than does an adviser who's either being introduced to Russell for the first time or someone who's just getting going with Russell," says Michael Winnick, managing director of US sales and partnerships for Russell's adviser-sold business.

Yet asset managers and distribution experts also make strong arguments for structuring sales teams around channels. For example, using channels means there are fewer distribution systems on which wholesalers need to develop expertise.

In addition, this approach may allow fund firms to focus on a channel that yields significant sales: wirehouses. Although market share of the four wirehouses has declined since the financial crisis, they still remain the heavyweights in the industry.

"Channelisation is about maximising relationships with big broker-dealers," says Bing Waldert, a director at research company Cerulli Associates.

JPMorgan Asset Management is among the companies that employ a channel-based approach.

"Channel-based coverage, I believe, has given us a heightened level of alignment with clients," says Andrea Lisher, head of US funds at JPMorgan Asset Management.

The extent of the firm's sales force – 240 external and internal wholesalers, national accounts and sales management as of the end of February – leads to smaller territories, Ms Lisher notes. But just as important as size are the firm's rigorous use of business intelligence to prioritise where time is spent and the "relentless" focus on the quality of the client experience, she adds.

FTfm IGNITES

Caution urged over I-shares

Niels Holch (left): omnibus is being used to generate fees; Hubbard Garber: omnibus is among costliest channels

Fund flows

Whitney Curry Wimbish finds the class attracts high levels of interest

Flows into institutional shares of mutual funds have outpaced those into any other share class, driven by the growing use of fee-based accounts that open the class to previously excluded investors.

Some asset managers have expanded their line-up of institutional shares, known as I-shares, which offer stripped-down cost structures, to meet demand.

But sceptics say the situation warrants caution. I-shares are available to more customers through omnibus accounts, so not only are fund companies blind to some of their new I-share investors, those investors also face paying significant hidden costs.

I-shares were originally designed for institutional investors that could post high minimums, usually about $1m. They also do not typically charge 12b-1 fees, which pay for distribution, marketing and advertising. This is an appealing option for larger institutions that pay a third party to conduct record-keeping or do it themselves.

But the growing adoption of omnibus accounting gives more investors access to the class. Under an omnibus arrangement, an intermediary keeps all individual shareholder information and uses one account with the fund transfer agent on an aggregated basis, giving a broker the ability to execute large trades that combine investor assets.

"The I-share is designed for the institutional class, with fees set at a much lower rate, but if you're a smaller investor buying in omnibus form, you can aggregate $1m pretty easily, and qualify for I-shares," says Niels Holch, founding partner of Holch & Erickson and executive director of the Coalition of Mutual Fund Investors.

He adds: "Omnibus costs more for both the [fund sponsor] and the fund, and when it comes to I-shares, those costs are going up too, because of the omnibus structure. Omnibus is being used really to generate fees for brokers more than helping investors."

While I-shares do not hold the majority of assets under management for many companies, they draw the largest proportion of new sales across all distribution channels, Barrington Partners found in a recent study.

In its assessment of 2011 data from 18 fund companies managing about $400bn in combined assets, the Boston-based research firm found 76 per cent of flows were to I-shares.

In fact, I-shares have attracted more flows than other classes since at least 2009, according to Morningstar. Estimated net flows into the class were $278bn in 2011, five times greater than the next-highest flows.

> 'The way the fund company and the adviser will split those payments is really highly varied'

Some mutual fund firms have increased their I-share offerings. Near the end of last year, for example, Oppenheimer expanded its I-shares product line-up to 20 funds. This was because of the need for "a low-cost option for large institutional buyers that did not need a shareholder servicing payment or shareholder distribution fee", says Kim Mustin, senior vice-president and head of the firm's global strategic accounts.

"This fills an important gap for us to have a mutual fund that was really stripped down of any distribution or platform-level costs," she says.

The shares, which require a minimum of $5m, carry the lowest expense ratios of all Oppenheimer fund share classes and do not charge 12b-1 or subtransfer agency fees. Other fund companies, however, do charge subtransfer agent payments, and that is one way the asset class can cost a fund company more than expected. Barrington found intermediary fees charged by brokerage and other distributors vary widely, from five to 30 basis points.

If the intermediary fee increases a fund's expenses above what the prospectus allows, the fund company either has to gain approval from the fund's independent directors or pay the distributor itself.

Barrington says there is no benchmark for fees. Hubbard Garber, managing partner at Barrington, says: "The way that the fund company and the adviser will split those payments is really highly varied."

Barrington found omnibus to be one of the most expensive distribution channels; the study revealed that in a 12b-1 fee structure, the omnibus channel charged 35.4bp, while the direct channel charged 30.8bp and the supermarket channel 29.6bp.

Supermarkets charged the most in a non 12b-1 structure, at 35 basis points. The omnibus channel charged the next-highest, at 22.7 basis points and the direct channel charged 21 basis points.

Mr Garber predicts funds offering I-share classes are likely to limit intermediary fees by offering a "true I" class with strict eligibility requirements and no intermediary fees. In such an environment, distributors would charge investors a direct "wrap fee".

elevate
YOUR BUSINESS

OUR SOLUTIONS
- Administration
- Compliance
- Distribution
- Fund Accounting
- Legal
- Marketing & Creative Services
- Medallion Distribution
- Shareholder Servicing
- Tax Administration
- Transfer Agency
- Series Trust Solution

Open-End, Closed-End, Alternative Investment & Exchange-Traded Funds

email lisa.mougin@alpsinc.com
visit www.alpsinc.com call 303.623.2577

ALPS
A DST Company