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Demand for retail “institutional” funds to accelerate: Strategic Insight

By Editorial Staff *Thu, Aug 18, 2016*

Distributors are likely to apply the standards of the DOL fiduciary (or "conflict of interest") rule to all client money, not just qualified assets, said Dennis Bowden (pictured), lead author of a new Strategic Insights report for asset managers.

The Department of Labor’s fiduciary (conflict of interest) rule will accelerate the movement toward the use of low-cost institutional mutual fund share classes by fee-based advisors, and the impact of the DOL rule will extend beyond merely tax-deferred accounts but also taxable accounts, according to a new report by Strategic Insights, an Asset International company.

The report, “Fund Sales Benchmarking 2016: Perspectives on Intermediary Share Class and by Distribution Channel,” is based on a survey of advisors and is intended to help asset managers that distribute their funds through broker-dealers understand how the DOL rule, which begins to take effect next April, will affect their ability to price their products and, ultimately, their profitability going forward.

RIJ has written in the past that one of the DOL rule’s aims was to extend the standards, for prices and advice, of the ERISA institutional world to the rollover IRA world, largely so that the financial benefit of tax deferral would not be consumed by the higher pricing that prevails in the retail advisor space. But that leaves asset managers wondering how to promote the sale of their funds.

The findings of the Strategic Insight report show that the broker-dealer space is in fact moving toward institutionally priced funds, which would not carry loads, revenue-sharing expenses or 12b-1 fees through which investors indirectly subsidize the costs of distribution. The report did not reveal any downward pressure on the wrap fees that fee-based advisors charge, which range from 1.0% to 1.5% per year.

“We focused on share class pricing, which is near the top of the list of concerns among asset managers,” said Dennis Bowden, the lead author of the report. “The DOL rule will accelerate the existing trend to lower-priced share classes, such as institutional share classes. We’re seeing that in fee-based accounts; so far demand is shifting away from share classes that include 12b-1 fees. We think the use of 12b-1 fees in fee-based accounts will be rare in a few years.”

“One of the important factors for distributors as they think about DOL rule is the need to equalize payment streams across the funds on their platform. The DOL rule has an overall halo of emphasizing ‘low costs,’ but the bigger impetus for changes in share class pricing will be [fee] equitization. To that end, you may see externalization of fees, resulting in lower fund expense ratios and separate distribution fees that would be paid either by the investors or the fund managers,” Bowden added.

Distributors also told SI that they will apply the standards of the DOL to all client money, not just qualified money. “Clearly, the rule directly impacts qualified assets, such as IRAs,” he told *RIJ*. “But we’re also finding that distributors are not looking at the rule as affecting IRA assets in isolation. Those assets sit side by side with taxable assets on a fee-based platform. So we think the changes that distributors will be making, which will affect fund managers, will be more holistic. And that’s where this DOL rule becomes really impactful.”

Strategic Insight conducted its survey in the first quarter of 2016. It approached fund firms that sell primarily through financial intermediaries and requested 2015 sales data (along with 2014 data from those firms who had not participated in last year’s survey), broken out by share class pricing structure and distribution channel. SI analyzed this data alongside previous years’ survey results, which encompass annual sales data from 2006 through 2014.

The 2016 Fund Sales Benchmarking analysis uses results provided by 35 mutual fund companies that sell primarily through financial intermediaries. The 35 participants include most of the large companies distributing primarily through financial advisers, as well as many small- and mid-sized firms.

Survey participants managed a total of $5.2 trillion in long-term fund assets (as of the end of 2015), representing 45% of total industry long-term assets and more than one-half of actively managed holdings. The median sized firm controlled more than $65 billion in fund assets. Participants reported in aggregate over $1 trillion in open-end stock and bond mutual fund sales during 2015.

In a separate but related report on the DOL rule’s impact on distribution, a new report from Cogent Reports, called “The Advisor of Tomorrow,” said:

- Advisors lament that the DOL fiduciary ruling casts an overall negative industry gloom and is fueling investors’ focus on fees. Perhaps even more importantly, advisors believe that the DOL action forces them toward a fee-based compensation structure and limits their product selection.
- Two camps are emerging: Fee-based advisors who see the DOL action as formalizing an inevitable market shift, and commission-based advisors who fear that their services are being commoditized, leaving them vulnerable to competition from automated advice services.
- Many advisors feel monitored rather than supported by their firms. The growing volume and scope of internal and external regulations heightens their concerns about personal liability.