Inside the Flight from Active Management

By Kerry Pechter *Wed, Aug 3, 2016*

Nine-tenths of new fund flows are going to passive strategies, helped by a desire for low costs, the DOL fiduciary rule, and robo-advice. There's still a ton of money in active management, but "we see massive change happening," said Jeff Levi of Casey Quirk by Deloitte.

What started as a trickle has turned into a flash-flood.

Indexing (aka passive management), which took decades to become established as a legitimate investment practice (and not just a timid way to "settle" for average market returns), has emerged as the dominant form of diversified investing in the 21st century.

Although active strategies still account for most existing invested assets, index-linked and multi-asset class (MACS) investment strategies attracted more than 90% of net new money worldwide last year, according to the 2016 Performance Intelligence Asset Management Benchmarking Survey, conducted by **Casey Quirk by Deloitte**, a strategy specialist for asset managers, and **McLagan**, a compensation consultant. The survey found:

The global professionally managed active investment management industry, which historically has relied on traditional active funds for most of its revenue and profits, got less than 10% of new money in 2015. Of the asset managers firms surveyed with more than $10 billion in AUM, only 56% reported positive net flows in 2015, compared with 60% one year earlier and 63% in 2013. By contrast, 44% reported net outflows last year, against 40% in 2014 and 37% in 2013. Vanguard, founded by, Jack Bogle, the champion of indexing, has been perhaps the biggest instigator and biggest beneficiary of this trend (see chart below).

One exception to the rule has been American Funds, a $1.22 trillion unit of the Capital Group. Until June, when the active fund family suffered outflows of $707 million, American Funds had experienced positive flows, with a net $6.84 billion for the first six months of 2016. according to **Morningstar**. Its American Balanced Fund was the most popular active fund in June, with an estimated net inflow of $1.17 billion.

Steve Deschenes, director of product management and analytics at American Funds, said that his firm has become the second largest fund family primarily by pricing its funds 20 to 30 basis points lower than comparable active funds and by hiring managers with good track records who put their own money in their funds. "We are the low cost active manager," he told *RIJ* this week. "And all of our funds have a high degree of manager ownership. It's amazing the differential that you can achieve with that."

Net Flows of Top 15 Fund / ETF Families (U.S., first six months of 2016)		
	Net flow ($m)	AUM ($bn)
Vanguard*	$134,766	$3,132
American Funds	6,843	1,216
Fidelity Investments	(7,054)	1,193
iShares*	26,473	862
T. Rowe Price	(121)	482
SPDR State Street Global Advisors*	2,813	434
Franklin Templeton Investments	(20,636)	385
Pimco	(7,489)	304
Dimensional Fund Advisors*	12,881	285
JPMorgan	(4,466)	270
BlackRock	(1,976)	229
MFS	1,278	183
Oppenheimer	(5,118)	175
Dodge & Cox	(3,592)	171
Invesco	(602)	143

*Specializes in index funds and/or exchange-traded funds. Source: Morningstar Fund Flows Report, July 2016.

Is low cost the driver?

But American Funds and perhaps MFS are the exceptions. "We see massive change happening," Jeffrey Levi, Casey Quirk by Deloitte, principal, Deloitte Consulting LLP, told *RIJ* this week. "Today the average investor pays many layers of fees to get advice. I would expect some of those layers to disappear over time, as players integrate more.

"Some asset managers will be using technology for efficiency, for automating routine functions, to reduce headcount, and to raise accuracy and lower costs. Others will use technology as a differentiator, with automated platforms and mobile asset allocation capability. Some firms will be slow to adopt direct-to-consumer technology because of channel conflict and the high cost of acquiring online customers.

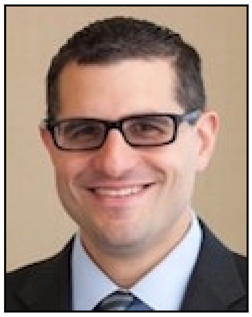
"But you'll see more to direct-to-consumer efforts among asset managers as they try to build a more scalable business. Most of the robos have aimed for the underserved mass affluent, but direct doesn't have to be robo. Money managers own the direct-to-consumer high-net-worth private wealth management business. So more asset managers will go direct, but not necessarily pure robo."

Individual investors, who are projected to generate 90% of all new money invested through 2020, are "increasingly skeptical of active management, fee-sensitive and outcome-oriented," he added.

A prominent member of the Money Management Institute (MMI), an association of wealth management firms, told *RIJ* privately, "Low cost is the driver. I don't think it's a lot more complicated than that."

"The asset management industry is now in an era of disruption and consolidation, similar to what Wall Street firms underwent in the late 1970s and 80s," said Fred R. Bleakley, director of the U.S. Institute, in a release. "Surviving firms will be leaders in specialty active management, Smart Beta passive, and multi-asset class solutions."

"Many traditional active managers must adapt," said Levi (right). "Their business models are outdated in a world in which individual investors and their need for advice are the revenue generators. Fees are under increasing scrutiny, and regulatory pressures are on the rise. This shifting marketplace will in turn drive greater convergence in the industry across wealth management, asset management, insurance and financial technology."



Buyer archetypes

Four buyer archetypes are emerging—outcome-oriented, cost-conscious, those influenced by gatekeepers, or those interested in investment quality. Each has a distinct set of preferences and behaviors, according to the Casey Quirk by Deloitte report. The largest group, which includes those who favor traditional investment quality, account for roughly half of industry assets under management, but are projected to shrink in the future. The other three groups will see the majority of growth.

Despite the shift in flows, active asset managers still have a lot of money. Global assets under management rose slightly, to an estimated $69 trillion in 2015, from $68 trillion in 2014. Industry revenue fell less than one percent to an estimated $344 billion from $346 billion in 2014.

Aggregate average fees declined to 50.1 basis points, or 0.501%, from 51.4 basis points, or 0.514%, in 2014. Operating margins also fell to an estimated 32% from 34% in 2014. Negative returns from capital markets contributed to low growth overall, according to the survey, now in its 15th edition.

Inequality effect

Financial inequality could help put a floor under the active asset managers' losses of market share, however. About half of American households owns stocks, but the richest one percent of U.S. households owned more than 40% of all non-home financial wealth in the U.S. in **2010**. The richest 20% owned over 95% of financial wealth.

If the richest 20% decide that they prefer to have premium financial services, including active management, there might be a natural limit to the level of growth of the low-cost, automated, indexing sector of the financial services industry.

The Casey Quirk by Deloitte study included more than 100 investment management firms headquartered in North America, Europe, and Asia Pacific, investing more than $20 trillion for institutions and individuals.

The firms surveyed included privately held, publicly traded, and wholly or partly owned enterprises with assets under management ranging from below $5 billion to more than $1 trillion. Survey participants included the executive teams of leading asset management firms as well as senior leaders at investment management firms who belong to the U.S. Institute and European Institute.