The Pressure to Perform March 2011



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The Pressure to Perform

Executive Summary

- This report explores different aspects of the funds industry that illuminate the pressure on fund companies to perform. This also manifests itself as the pressure to justify fees as well as a further knock-on effect — the potential for an overly short-term outlook.
- Analysing trends in fund sales reveals changing investor appetites. While mixed asset funds enjoyed 42% of net sales for the industry in 2010, equity funds fell but still enjoyed inflows at historically high levels.
- Analysis of the industry's overall asset allocation highlights that while equity funds still make up 65% of assets, this figure was 82% at the end of 2001.
- A revival in equity fund performance and the importance of emerging markets are highlighted in comparisons of the average returns of different fund classifications, with bond funds typically out-performing equity funds over three years, but the reverse occurred in 2010.
- The impact of performance on fund sales is examined for global equity funds. For first quartile funds over one year, average quarterly net sales have been £282m, while third and fourth quartile funds have typically suffered net redemptions of £7m and £29m.
- Analysis of fee developments reveals why recent changes are different from those before. Yet the importance of performance cannot be ignored profitability remains the most powerful justification of a fund's fee level.

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Introduction: Occupational hazards

In a recent television programme Outside the Court (BBC, 31 January 2011), one man, when asked why he was standing outside Highbury Magistrates Court in London, replied, "It's an occupational hazard. If you're a thief you're gonna get nicked now and again, ain't you." Surprising candour, if an unsurprising reality.

While fund managers' first aim is to generate money for investors, not take from them, the reality of "occupational hazard" is worth considering. Most obviously, this manifests itself as the pressure to perform, but also, linked to the first, the pressure to justify the fees being charged. A knock-on effect of such pressures is the potential for an overly short-term outlook. These themes are explored in this report.

Where are investors putting their money?

To set the scene it is important to understand the development of the types of funds being favoured by investors. First, there has been much discussion of mixed asset funds recently and their appeal is clearly shown when looking at the asset classes into which investors have moved their money in recent years (figure 1¹). Net sales of £16.6bn for these funds made up 42% of the inflows into the industry in 2010. While one initially might assume this proportion was unprecedented, mixed asset funds look to have prospered in uncertain economic times, with 63% of industry sales in 2008, although the volume involved (£4.1bn) was roughly a quarter of that seen last year.

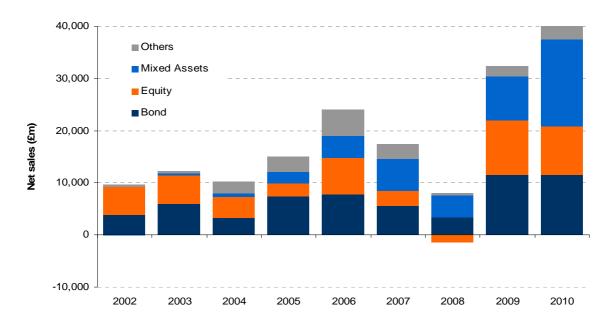


Figure 1 Net sales of mutual funds domiciled in the UK by asset class.

¹ Please note that funds of funds are excluded from sales and assets data throughout this report to avoid double-counting.

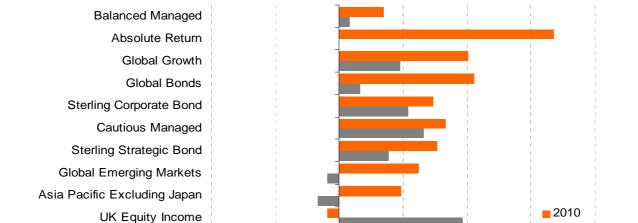




But focusing on mixed assets alone misses the bigger picture: the sheer scale of sales activity for the industry as a whole. Even as equity funds (primarily those investing in UK equities) dropped by 11% to £9.3bn in 2010, these volumes are still at historically high levels, with those fund managers able to take advantage of opportunities in emerging markets attracting the greatest proportion of inflows — Global (formerly Global Growth), Global Emerging Markets, Asia Pacific ex Japan. Such activity helps to underpin the IMA's decision to create a new China/Greater China sector from the start of 2011.

Zooming in on some of sectors that have seen most activity (figure 2), a comparison with pre-crisis sales in 2006 highlights both the increased size of inflows in 2010, as well as the shifts in IMA sectors being favoured.

Two themes emerge; the first is those investors willing to take on risk and searching for returns in emerging markets, while the second is other investors wanting to manage potentially volatile returns by investing in balanced funds and the "new breed" of absolute return funds. On the flipside, developed market funds, most obviously the UK (All Companies and Equity Income), have generally suffered.



0

2,000

Net sales (£m)

4,000

Figure 2 Net sales for selected IMA sectors in 2010 and 2006.

Source: Lipper FMI, a Thomson Reuters company

Europe Excluding UK

UK All Companies

-4,000

-2,000





2006

8,000

6,000

Changing shape of the UK industry

With the rise in popularity of mixed asset and fixed income products in 2010, it is useful to set this in an historical context to establish how big an impact this shift has had in the industry's overall asset allocation. While equity funds still make up 65% of assets, the evolution over time is striking (albeit that mixed asset funds will inevitably hold equities too).

On the face of it, the risk profile of a typical UK investor has changed quite significantly over this period, with equity assets moving down from 82%. Having said this, to assess such an assertion fully one would have to look more closely at exactly which types of funds made up these allocations each year (which is outside the scope of the current report). The trend also suggests that investors, or their advisers, may well be using mutual funds to create diversified portfolios across asset classes, where previously funds were used primarily as a means of gaining equity exposure alone. This may also have been boosted by the introduction of ISAs in 1999.

For fund management companies this change has revenue implications with lower charges levied on bond funds, typically accompanied by lower margins. Interestingly, while UK-domiciled equity fund fees often compare favourably to cross-border funds sold into the UK (normally domiciled in Luxembourg or Ireland), the reverse tends to be the case on the fixed income side. This is also something to bear in mind as more 'offshore' funds enter the IMA sectors.

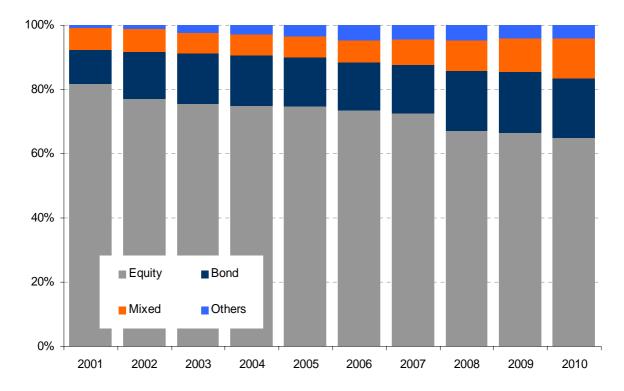


Figure 3 Proportion of assets by asset class for UK-domiciled funds.





Picking up on the issue of 'offshore' funds, another aspect to be aware of is the very way in which the UK funds industry is pictured. While UK investors still invest predominantly in local products (i.e. those domiciled in the UK), this does not mean the reverse is not happening. Instead it is clear to see that UK groups are keeping pace with the European-wide growth of cross-border products. When comparing UK-based groups' mutual fund sales for UK-domiciled ranges to their Luxembourg or Ireland domiciled ranges, figure 4 actually reveals that in 2009 sales activity for the latter recovered at a more repaid pace than for the former. UK groups with a pan-European, indeed an international outlook is not new, but it is becoming an increasingly important dimension of the funds industry.

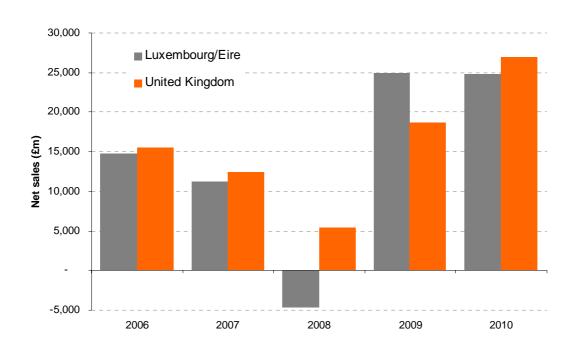


Figure 4 UK groups' net sales for UK v Luxembourg/Ireland domiciled funds (ex-money market)



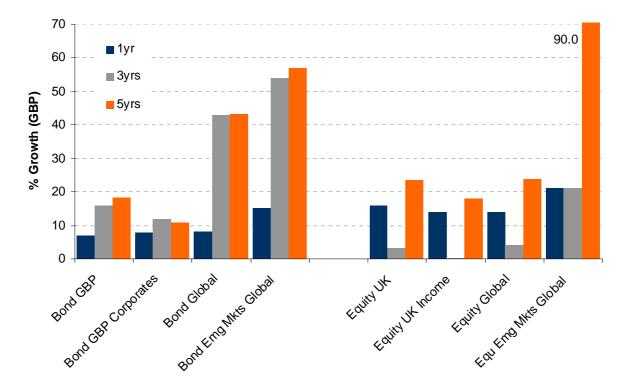


Performance, performance

While past performance is not a guarantee of future returns, one cannot escape the fact that fund managers who are able to build a strong track record are clearly in a powerful position when making their case to prospective investors or their financial advisers.

At the same time fund managers cannot escape from historical performance hit by historic events, the effects of which are still being felt. Figure 5 illustrates the result of recent market activity where the average performance of equity funds registered for sale in the UK in 2010 outpaced the cumulative performance over the past three years. In itself this is unsurprising, but it underlines investors' need to understand the longer term nature of fund investments.

Figure 5 Average performance of selected bond and equity classifications to 31/12/2010.



Source: Lipper, a Thomson Reuters company

When turning to bond funds, 3-year performance data immediately shows why investors have shifted to this asset class in the wake of the financial crisis, with a particular emphasis on emerging market debt. In the same way, the most successful global bond managers have achieved this success with significant emerging market exposure.

Average 5-year performance for these classifications (here the emerging market equities column is shortened to better visualise other classifications) also shows the effects of the 2007-2008 period on equity funds in particular, as well as the benefits that those investors reaped from having a portfolio diversified to include emerging markets.





Staying with equity funds, the average returns of the best and worst performing classifications in 2010 for funds registered for sale in the UK (here filtered to look only at classifications where there are at least five funds), brings further themes to the surface.

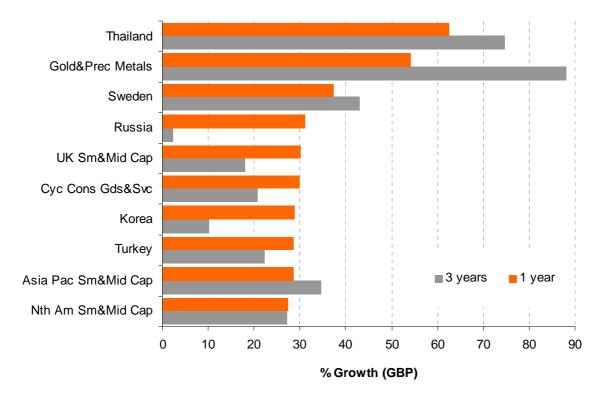


Figure 6 Average returns of best performing equity classifications to 31/12/2010.

Source: Lipper, a Thomson Reuters company

Emerging Asian economies (Thailand, Korea), the lure of gold and the bounce in smaller company funds' performance all catch the eye. The last of these three, with its geographic reach across the UK, Asia and North America suggests such funds have some 'legs' to attract investors in 2011. Although not featuring in this top ten, European small cap funds (returning an average of 25.16%) and Global small caps (23.62%) bolster such expectations. On the other side of the equation, 3-year performance for four of these five small cap classifications lags the one year record. Exactly how the financial crisis has played through into smaller companies is worth further research.

The BRIC (Brazil, Russia, India, China) economies as a defined investment universe really came to the fore for the funds industry in 2009, so it has been interesting to see how funds investing in these markets have performed in 2010. Russia is clearly the most impressive, with average returns breaking the 30% mark. Indian funds performed well too (up by an average of 25.16%). Yet the 1-year average performance of Chinese and Brazilian funds takes them down into the bottom ten classifications with average performance of 13.5%. Brazilian funds offer the complete reverse of the pattern seen for Russian funds, with 3-year performance for the former (35.64%) far outpacing 1-year returns, while the latter have only managed to achieve a miserly 2.34% over this longer time period. While the volatility of returns is to be expected with these emerging markets, this offers a neat demonstration of the fact.





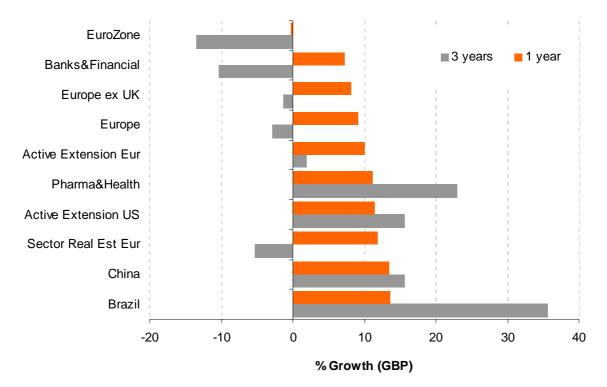


Figure 7 Average returns of worst performing equity classifications to 31/12/2010.

Source: Lipper, a Thomson Reuters company

To complete this picture, the bottom of the table (figure 7) contains those equity classifications that would be expected. Many developed markets continued to suffer in 2010 — with Europe the most acute. And while a sector classification (Cyclical Consumer Goods) achieved good performance last year, another (Pharma & Healthcare) dropped into the lower echelons, although here too the 1-year versus 3-year performance numbers are reversed, reinforcing the unavoidable fluctuations in returns even at this aggregate level. If nothing else, the need for investors to look beyond the latest 1-year performance figures is well illustrated.

Worryingly for those funds taking advantage of Ucits III powers to combine long and short stock selection with a target net exposure of 100% long (the most common being 130/30), average performance for such Active Extension funds has been relatively poor.

Having touched on equities and bonds, it is worth picking up on activity in the mixed asset classifications (figure 8). Using the three main categories in the UK, GBP Aggressive (over 65% equity), GBP Balanced (over 35% and less than 65% equity), and GBP Conservative (less than 35% equity), discrete 1-year aggregate performance data reveals uniformity of relative returns.

Each of these three classifications duly takes its place depending on its equity-bond weightings, with the average aggressive fund performing better than the others in good market conditions (2003 to 2007, 2009 and 2010), while cautious funds performed best (or least badly) in downturns (2001, 2002 and 2008). 2004 was the only year when balanced funds, on average, outperformed their aggressive cousins.





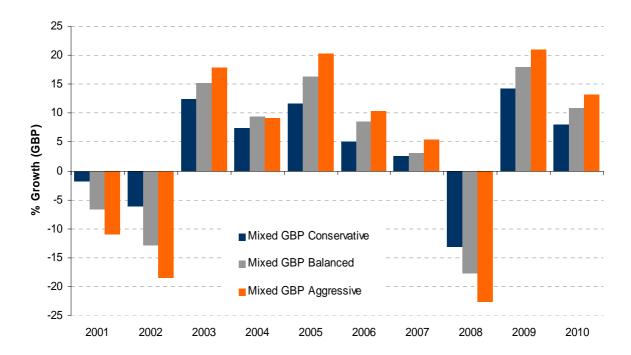


Figure 8 Average performance of largest mixed asset classifications to 31/12/2010.

Source: Lipper, a Thomson Reuters company

Impact of performance on sales

The concentration of inflows into a small number of funds is not a new characteristic of the funds industry, but it has been particularly pronounced in 2010. 1% of mutual funds domiciled in the UK (i.e. 22 funds out of a universe analysed of 2,178 funds) attracted net sales of £22.6bn, which is 56% of the industry total. The most successful fund (in terms of net sales) was Standard Life's Global Absolute Return Strategy with inflows of £4.4bn. When considering that all funds in the IMA Absolute Return sector generated sales of £6.7bn, this one fund's success is not only all the more extraordinary, but also gives pause for thought for those companies developing new products in the same arena.

With such a concentration of sales in mind, the importance of managing funds that can stand out from the crowd is clear. While a company's brand and its relationship with intermediaries are crucial, one cannot escape the need for an impressive performance record.

Taking one Lipper classification as an example — Global equity funds domiciled in the UK — the relationship between performance and sales can be analysed. Rolling 1-year periods of fund returns were compared to these funds' net sales in each succeeding quarter. So, for example, the periods of performance assessed start with one year before the first quarter of 2005, i.e. 1/1/2004 to 31/12/2004. The next period is one year before the second quarter of 2005, and so on. This same exercise was carried out for 3-year performance as well. Performance was assessed by looking at each fund's quartile ranking.





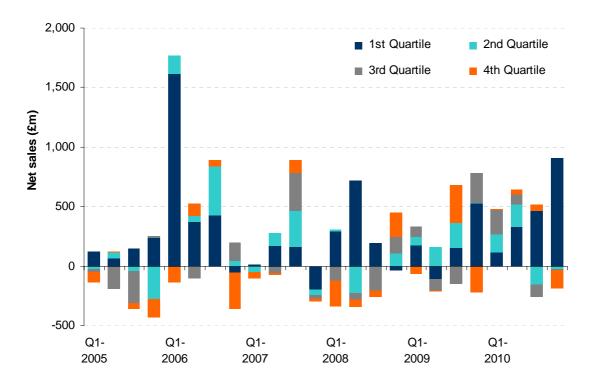


Figure 9 Quarterly net sales for Global equity funds compared to rolling 1-year performance

Source: Lipper, a Thomson Reuters company

Having previously carried out a similar exercise for European equity funds sold cross-border in Europe², the new findings were quite revealing. The first aspect that stands out is that first quartile funds generally receive the greatest proportion of sales. The only caveat on this point is the concentration of sales highlighted at the start of this section — sales for first quartile funds will not be evenly distributed across the universe.

On the face of it this relationship between performance and inflows is carried throughout the funds analysed. For 1-year performance analysis (figure 9), average quarterly sales for first quartile funds is £282m, £49m for second quartile funds, average redemptions of £7m for third quartile funds and redemptions of £29m for fourth quartile funds. For 3-year performance (figure 10), the equivalent figures paint a similar picture, with average flows of £312m, £6m, -£24m and -£67m respectively. While still valid, it is worth noting that these figures can also be distorted by disproportionately high flows in any given quarter (e.g. Q1 in 2006).

By analysing the data a little further and calculating the correlation coefficient for each quarterly period, the strength of the relationship between sales and performance across all quartiles can be better understood. In only around half of the quarterly periods assessed is there a strong correlation (taken as being a coefficient of 0.8 or more) for both 1-year and 3-year rolling performance, with an average coefficient of just 0.5 for 1-year performance data and 0.6 for the 3-year data. So there is a weighting of sales to the best-performing (first quartile) funds, but sales into different quartiles is not at all consistent.

² See Lipper, Zen and the art of mutual fund maintenance (July 2010).





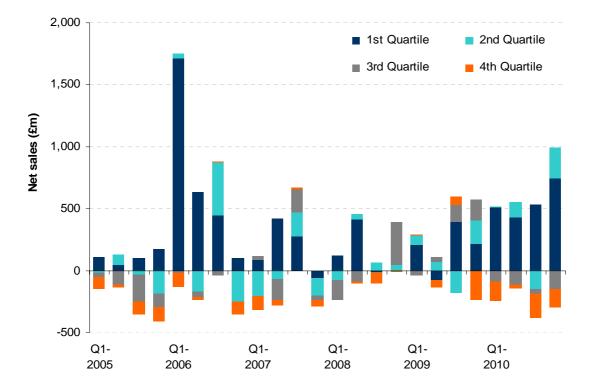


Figure 10 Quarterly net sales for Global equity funds compared to rolling 3-year performance

Source: Lipper, a Thomson Reuters company

This leads on to the fact that, unlike Lipper's previous analysis for European cross-border funds, there does not look to be evidence of a bias to 1-year over 3-year performance. This suggests a more considered, longer term view from UK investors and their advisers which is a welcome sight.

The importance of performance is clear — albeit solely for global equity funds in the current report — as is the risk of redemptions for under-performing funds. Having said this, the levels of redemptions in any given quarter are generally far smaller than the inflows, suggesting "stickiness" of investment from which fund companies can take comfort.

Product development trends

As market conditions change, inevitably impacting on fund performance, and different classifications or sectors gain favour with investors over time, the attraction for a fund company to launch new funds remains strong. And even though the UK stands apart from most other European countries in that sales of funds are generally weighted to those products with a performance history, still around 30% of net sales in any given year relate to new fund launches.

But while a fund manager may be able to point to a strong personal track record, without performance numbers for the fund itself a key string to the marketing bow will be missing — so getting the launch of a new fund right becomes all the more important.





As leading IFA Hargreaves Lansdown recently put it (*Investment Times*, January 2011), fund launches give managers "a clean slate" and "new funds are nimble." While some seasoned campaigners might still groan at the prospect of the latest investing fashion hitting the fund high street, innovation has clearly been a characteristic of the funds industry both in the UK and across Europe.

Activity in 2009 suggested that the brakes might have been applied to product development as fund companies took the opportunity to prune their fund ranges and tried to reduce costs. At the same time, the main reason for the net reduction of funds in 2009 was the increase in fund closures and mergers (184) rather than the reduction in new launches, which were at the same level as 2006. What has followed in 2010 has been a rise in new launches and a reduction of closures, leading to a net increase in the number of funds once more. One can expect this trend to continue this year.

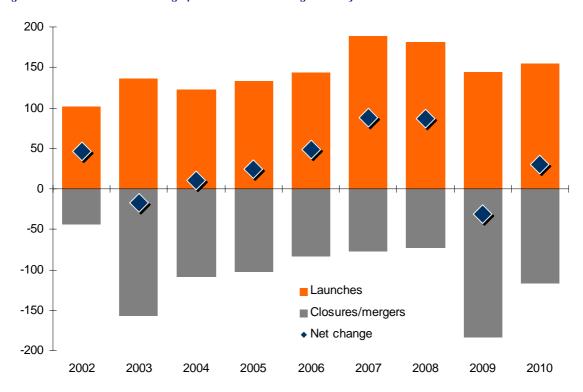


Figure 11 Numbers of funds being opened and closed/merged each year.





The fees they are a changin'

From one bookend...

Two regulatory initiatives that relate to fund fees stand like book-ends at either end of the past decade: the introduction of ISAs (Individual Savings Accounts) and the RDR (Retail Distribution Review). For the former, introduced in April 1999, the salient detail was the Government's attempt to encourage price competition through the introduction of the CAT standard for funds that chose to meet certain criteria on charges, access and terms. The charges in question were capped at 1% a year and with no initial fees.

In light of these changes, expectations for a price war rose, but apart from Norwich Union (now Aviva), no fund company made a significant move to offer actively managed equity funds that were CAT standard. Instead the vast majority of CAT standard funds available were either bond funds or index tracking equity funds. NU closed its range of actively managed CAT standard funds to new investors in 2003, saying that it was "uneconomic" to maintain the price cap and that higher fee levels better reflected "the true cost of selling and managing" the funds. In November 2004, the Financial Secretary to the Treasury somewhat surprisingly welcomed the announcement that companies would no longer be able to market products as CAT standard. Instead a range of "stakeholder" products were introduced, which have sunk without a trace (except for Child Trust Funds, which prospered until the Government's austerity measures came in).

In the middle of the decade Fidelity International took the decision to cut the management fee on its UK index tracker from 0.5% to 0.1% (with the total expense ratio, TER, falling from 0.7% to 0.3% today). Again there was discussion that this move would spark a price war. But, even though inflows rapidly accelerated for Fidelity's fund, it seemed to wander lonely as a cloud, with no competitors moving to match its move, even for similar passive funds.

... to another

Today the RDR looms large over the industry and the change expected to impact on the way intermediaries are remunerated being one of the key elements on which the initiative is based. The proposed changes to the way funds are distributed are such that the previously glacial pace at which apparent price wars had been fought over the previous twelve years has begun to quicken, with US low-cost giant Vanguard — ten years after it entered the European industry — setting up UK-domiciled funds in 2009. HSBC slashed the fees on its range of index trackers soon after with, for example, its FTSE 100 fund falling from being one of the most expensive trackers in the UK to one of the least expensive. At the same time, funds of passive funds have been on the rise, with the likes of 7IM, Architas, T.Bailey and TCF Investment offering these products. Sales of such funds in the UK are outpacing those from all other providers across the rest of Europe, with low costs being a key selling point.

Tearing up the rulebook

The latest combatants to enter this fray are active fund managers who do not make use of passive funds at all, namely, Terry Smith's Fundsmith equity fund and JPMorgan's UK Active Index Plus fund. Both have made headlines in the media for their attacks on industry "over-charging" (Fundsmith, with 1.25% operating costs) and for lowering fees to levels previously the exclusive preserve of passive funds (JPMorgan, with 0.4% operating costs).

Interestingly, Fundsmith's projected TER is slightly above the level that the retail share class of JPMorgan's UK Active 350 fund (i.e. before it altered its fees and objectives). This leads one on to the fact that Fundsmith aims to undercut industry costs through low trading costs and not just through lower operating costs (the TER). This helps to explain why the fund's TER isn't actually lower than many other funds in the industry — even more so if one looks to investment trusts where economies of scale result in Lipper's analysis revealing at least 30 companies with TERs below 1%, a number which doubles if one includes companies with performance fees.





JPMorgan's innovation is perhaps more radical in that not only are retail investors given a fee level previously reserved for the company's institutional clients, but also the performance fee does not appear to be following hedge fund precedent and instead the potential fee is capped at just 15 basis points. Of course this move does turn the spotlight on JPMorgan's other funds, where its Luxembourg cross-border products typically bear annual costs of 1.90%.

Having said this, investors' eyes should also be opened wider to the high relative fees that some index trackers charge. To put this in context, some UK equity index tracking funds are shown in figures 12a and 12b, the first highlighting the low annual operating costs retail investors can pay to follow UK indices (even before looking at ETFs), the second showing the largest UK trackers with TERs of at least 1%.

A recent FSA paper³ suggests that the regulator may be scrutinising fees more closely too, as high charges for index tracking funds and the way performance fees are structured were both highlighted. If the regulator did push through with price interventions it would be an extraordinary change of tack.

Why isn't everyone joining the revolution? Isn't the client king?

Based on performance numbers that the best performing managers can boast, and the way money is invested in funds, so far it has simply not made business sense to take the hatchet to fees, as NU learnt to their cost ten years ago (despite some decent returns for investors). The argument that a fund manager can add value and overcome the drag on performance of costs remains very powerful. The client does remain king, although a fund company's client is normally an intermediary rather than the end-investor. Market conditions or regulations or some of the recent innovations may change investors' attitudes in time, but profitability will remain the most powerful justification of a fund's fee level — performance is still the biggest influence on the bottom line.

Figure 12a UK equity index trackers with TERs below 0.5%

Fund	TER
Vanguard FTSE UK Equity Index 'A'	0.15%
Vanguard FTSE UK Equity Income Index 'A'	0.25%
HSBC FTSE 100 Index 'Retail'	0.27%
HSBC FTSE 250 Index 'Retail'	0.27%
HSBC FTSE All-Share Index 'Retail'	0.27%
Fidelity MoneyBuilder UK Index	0.30%
Edinburgh UK Tracker Trust plc	0.34%
Santander Stockmarket 100 Tracker Growth	0.35%
F&C FTSE All-Share Tracker '1'	0.37%
Liontrust Top 100 Fund	0.42%
M&G Index Tracker 'A'	0.46%

Figure 12b UK equity index trackers with TERs of 1% or more and assets over £100m $\,$

Fund	TER
Virgin UK Index Tracking Trust	1.00%
L&G (N) Tracker Fund 'Ret.'	1.00%
HBOS UK FTSE 100 Index Tracking 'B'	1.00%
HBOS UK FTSE All-Share Index Tracking 'C'	1.50%
Marks & Spencer UK 100 Companies Fund	1.00%

Sources: Lipper; Company figures for Vanguard and HSBC

³ Financial Services Authority, Discussion Paper on Product Intervention (DP11/01), January 2011.





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