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New product launches shed light on distribution in the fund industry

Executive Summary

- 97% of growth in the European fund industry since the end of 2001 has come from products launched in this period.
- With such a crucial role played by innovation and product development, this report looks at structural and distribution issues related to the level of sales for new product launches compared to sales of funds launched in previous years.
- The UK, where distribution is dominated by independent advisers, was not only the most successful local European market in 2010, but it has a consistently high proportion of flows into funds launched in previous years (81% in 2010).
- For the largest markets where proprietary distribution channels are predominant (France, Germany, Spain, Italy) in both 2010 and 2005 (the previous sales peak) flows into previously launched funds did not rise above 45%.
- The relationship between sales channel and preference for new funds is not endemic, with the Nordic markets (and Sweden most prominent) bucking this trend and sales being weighted to older products.
- Looking at cross-border funds, the role of third party distribution comes to the fore, with an accompanying preference for older funds (averaging over 80% most recently). This preference is also felt by banks and insurance groups, not just 'pure players'.
- Global comparisons reveal that fund sales in the US are heavily weighted to previously launched funds (averaging 90%), whereas sales growth in Asia has been reliant on new launches in six of the past eight years.
- This research provides statistical evidence of the relationship between fund distribution channels and sales patterns, as well as clear exceptions to the general preference of proprietary channels for new fund launches.

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Introduction

"A person with a new idea is a crank until the idea succeeds." (Mark Twain)

At the end of 2001 the European mutual funds industry¹ stood at €3.01 trillion in assets under management. By the end of the first quarter of 2011 this had grown to €5.45 trillion, an 81% rise.

Of this latest total, 43% (€2.36trn) of assets are now managed in funds that have been launched in the past nine years. In other words, 97% of industry growth since the end of 2001 has come from new product development.

The importance of innovation for the European mutual funds industry is clear. And Lipper has previously looked at the potential performance advantage from which investors can benefit through new product launches². The current report will look at structural and distribution issues related to fund flows, new launches and the variations between European fund markets.

It is worth setting the scene by recalling that net sales for long-term European funds (i.e. excluding money market funds³) reached a five-year high in 2010 with €290bn. The previous high level was achieved in 2005, when investors contributed €370bn.

One of the main differences in activity between 2005 and 2010 was the type of funds garnering inflows. In 2005, European domestic funds (i.e. funds being sold to investors in a single market) attracted inflows of €184bn, but in 2010 this figure was just €64bn. By contrast, cross-border funds (the International market where funds source a significant proportion of sales from more than one country) saw net sales rise in this period from €186bn to €225bn. In this way cross-border activity rose from 50% to nearly 80% of industry-wide sales.

Linked to this cross-border dimension is the relative success of different *types* of fund company. Fund distribution in continental Europe has traditionally been dominated by banking and insurance groups that sell products within their local market, while the early adopters of the UCITS passport to sell mutual funds into multiple markets were 'independent' or 'pure play' asset managers. The current report will look to see whether such differences can be identified and if they have evolved over time.

Drawing these strands together will be analysis of relative flows into new fund launches (here, those funds being launched in the year being examined) versus those funds launched in previous years (referred to in this report as the 'backlist'). For example, in 2005 those funds launched in 2005 are deemed to be new launches, while those funds launched in 2004 or earlier years are deemed to form the 'backlist'.

This analysis is not primarily concerned with the scale of flows into new launches in any given year (such funds are unlikely to suffer redemptions), but with how backlist funds' sales patterns vary in relation to new launches when the data is sliced in different ways.

The resulting analysis provides some new insights into how new products have fitted into the evolving industry over the past ten years, both in the production and distribution of funds. In doing so, this research sheds light on Mark Twain's two ideas – determining who are the cranks and who the successes.

¹ Open-ended mutual funds (collective investment schemes) excluding funds of funds to avoid double-counting.

² Dunny Moonesawmy, 'Ruling out new funds: wrong decision?' (September 2010).

³ Money market funds and funds of funds are excluded throughout the rest of this report.

Variations by fund market

Looking at the latest full-year data for the largest European fund markets (excluding those funds sourcing significant sales from more than one market) reveals both the varying levels of appetite for mutual funds in 2010 around Europe, but also a first insight into the success of funds launched before the year began.

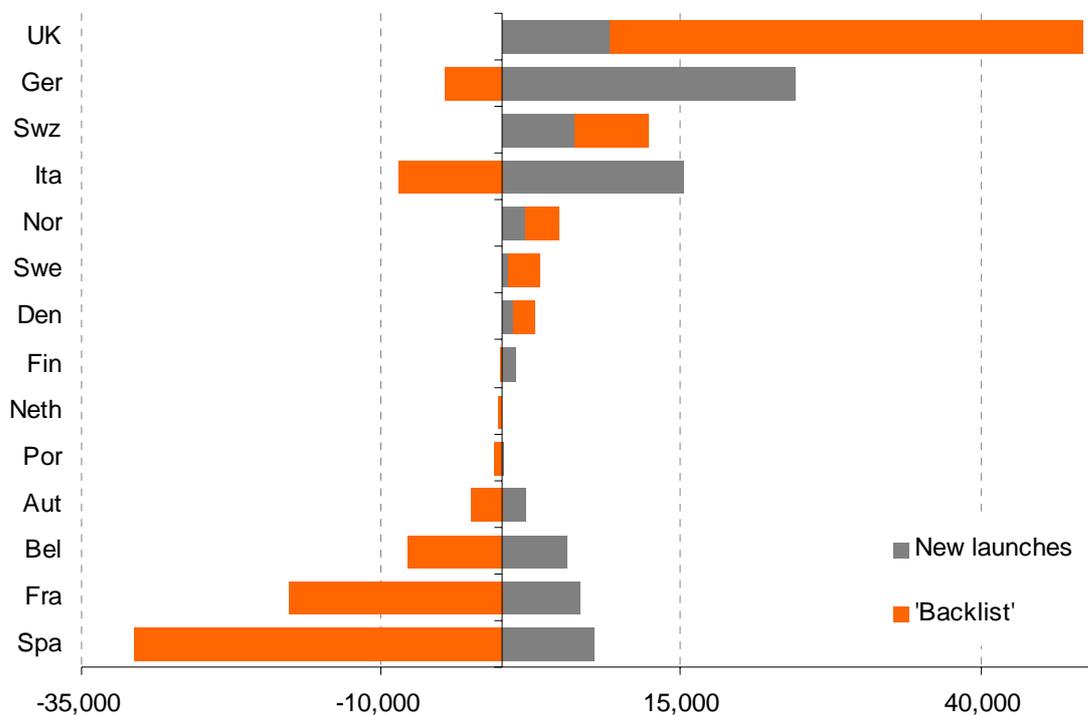
The UK was not only the most successful industry in 2010, but also the one with the greatest proportion of sales into backlist funds, accounting for 81% of net sales. Nordic markets have lower total sales, but the favouring of funds with a performance track record is also noticeable, accounting for about 60% (Norway, Denmark) or 80% of net sales (Sweden).

By contrast, the German market was the second most fertile for fund companies, but this was achieved through funds being launched in 2010, while funds launched previously actually suffered redemptions. A similar picture can be seen in Italy, ranking fourth overall, but with outflows from backlist funds more than half as large as inflows for new launches.

Those markets that suffered the greatest outflows from backlist funds are also those where banks and insurance groups have traditionally played a dominant role in mutual fund distribution: Spain, France, Italy, Germany.

In this chart Switzerland is the one market that does not provide a clear-cut picture, made even less so when Figure 2 is examined. Of course Swiss investors' openness to cross-border funds⁴ makes the size of this market notoriously difficult to assess.

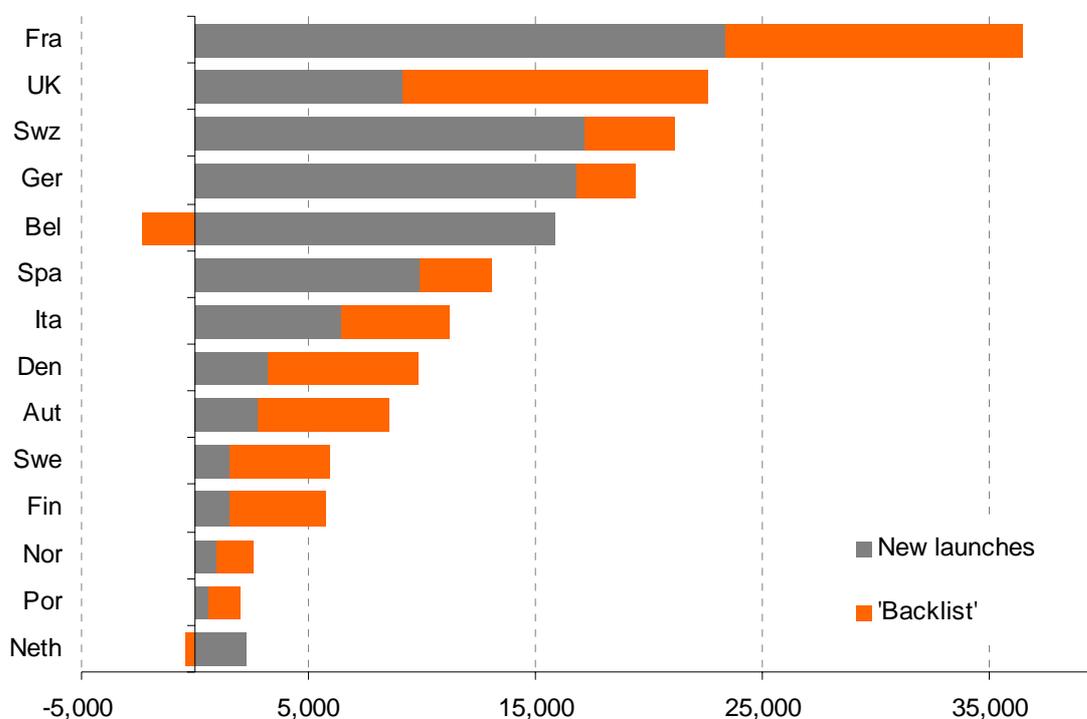
Figure 1 Net sales of mutual funds by market in 2010 (€m)



Source: Lipper, a Thomson Reuters company

⁴ See Lipper, 'Symbiosis in the evolution of UCITS' (March 2010).

Figure 2 Net sales of mutual funds by market in 2005 (€m)



Source: Lipper, a Thomson Reuters company

The above chart provides analysis of the most successful year for European groups in the post-dot.com era, a useful comparison with the 2010 data. All of the largest fund markets enjoyed inflows and both new launches and older funds generally prospered. Belgium is the most obvious exception here, where strong appetite for guaranteed funds is the likely cause of this apparent anomaly.

Although the overall pattern is very different, those markets that favoured backlist funds in 2010 also did so five years previously, with the proportion of flows into these funds varying from 60% (UK, Norway) to around 70% (Sweden, Denmark). These were not the only markets with this characteristic in 2005, but they are the only ones to repeat the feat in 2010.

In the same way, Spain, France, Italy, Germany still heavily favoured new products in 2005. Of these markets, Italians were the most receptive to funds with a track record, but still these sales failed to rise above 50% of market activity (accounting for 43%).

This initial analysis does indicate that there is a relationship between fund sales and the broad distribution structures in place in different markets.

This being said, the Nordic markets — which also tend to be more bank/insurance dominated — have not followed this pattern, demonstrating that the distribution channel mix does not inevitably result in predetermined attitudes to new launches versus older funds. It is also worth considering other factors, for example, the Swedish pensions system (PPM), giving investors greater choice in selecting their own funds for retirement provision, may be playing its part. Also it's worth noting that the Nordic markets account for less than 10% of European fund assets.

Historical trends

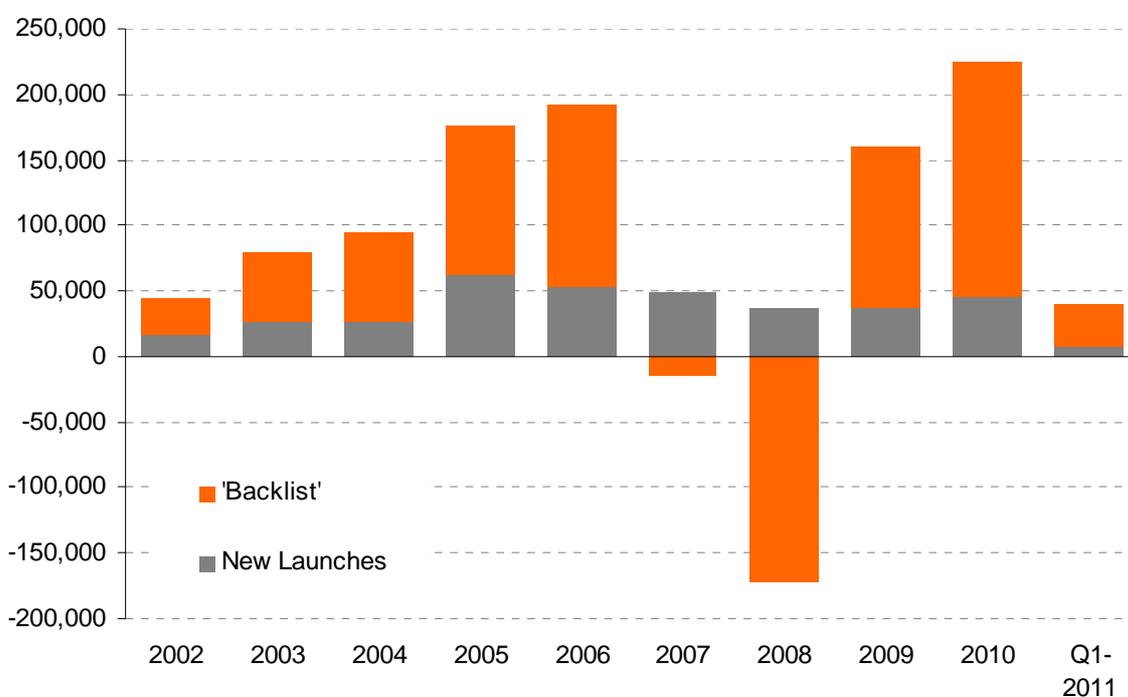
Having looked at domestic markets and how sales patterns vary around Europe, those funds being sold cross-border into multiple markets (primarily funds domiciled in Luxembourg or Ireland) can be assessed. Taking this universe of funds as a whole, historical data enables a check on the robustness of any patterns that can be discerned.

The results are far more similar to the UK and Nordic markets than the largest Continental European industries, with backlist funds forming between 60% and 80% of sales activity each year except during the initial sell-off in 2007-08 of the financial crisis. It is worth highlighting that new product launches actually kept the cross-border industry in positive territory in 2007, underlining the importance of product development for these groups too.

As mentioned earlier, the early pioneers of cross-border distribution were ‘pure play’ asset managers, and it has been these same types of fund companies that have tended to dominate sales activity more recently, such as Franklin Templeton, BlackRock (originally via Mercury), Schroders, Fidelity, JPMorgan (originally via Flemings). These groups have gained traction through banks’ open (or guided) architecture platforms, private banks, funds of funds as well as institutional investors. A closer look at the types of businesses finding success with cross-border distribution will be taken later in this report.

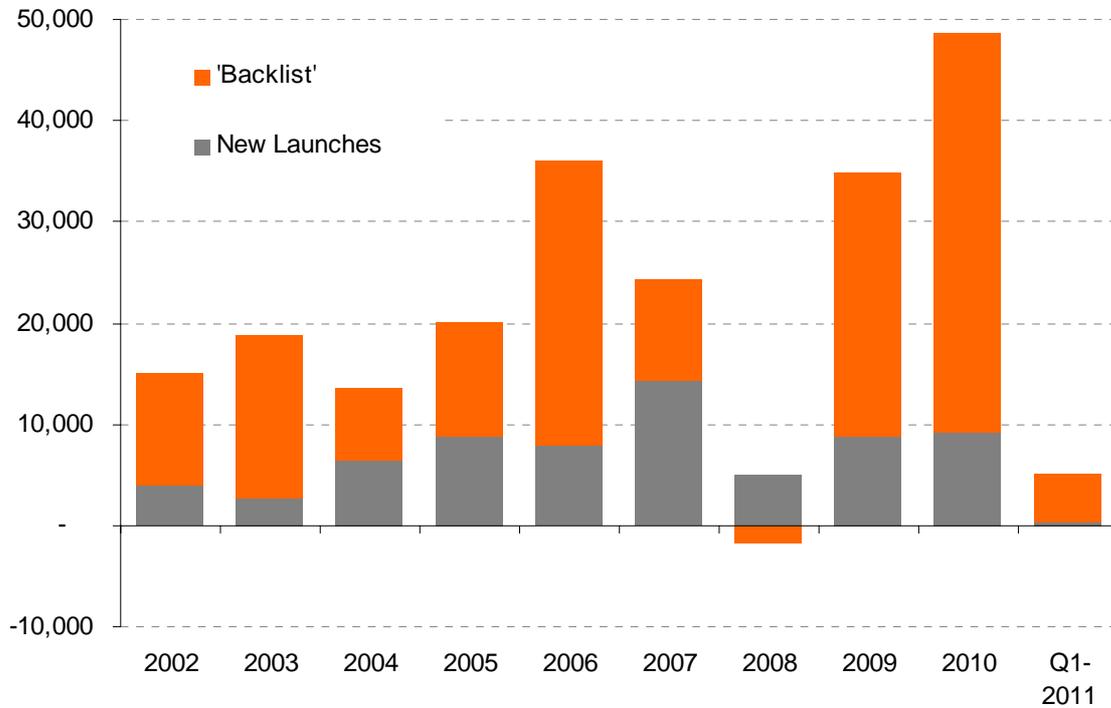
On this point it is worth noting that ETFs are included within the universe of funds assessed in this report, the vast majority of which are classified as cross-border funds. In terms of assets under management, the bulk of activity in Europe for ETFs related to bank-owned entities until BlackRock acquired iShares. As for annual sales, the majority each year have related to backlist funds, with the exception of 2007 when one year sales for new ETF launches peaked at €10.3bn while previously launched funds only garnered €3.6bn. The latter have since generated sales of between €25bn and €40bn in each subsequent year.

Figure 3 Net sales of Cross-border funds, split by launch date (€m)



Source: Lipper, a Thomson Reuters company

Figure 4 Net sales of UK funds, split by launch date (€m)



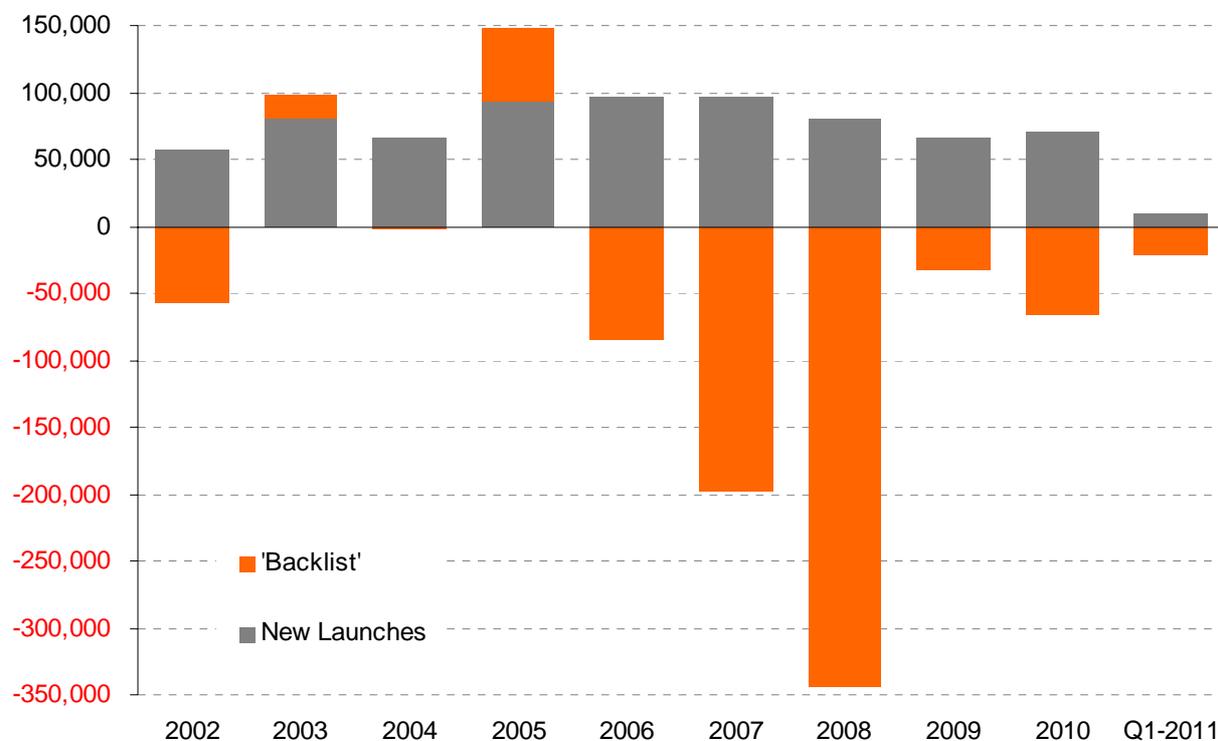
Source: Lipper, a Thomson Reuters company

The market that stands out in Europe for the importance of Independent Financial Advisers (IFAs) as a distribution channel is the United Kingdom. The success of backlist funds in this market has already been illustrated in this report, but historical data provides a better view of just how important this has been.

The weighting of flows into funds with a track record is not as consistent as the cross-border universe, ranging from 40% (2007) or 50% (2004) to around 90% (2003 and Q1-2011), but the UK industry has achieved positive net sales in every year analysed.

While the FSA's Retail Distribution Review (RDR) looks set to shake-up the way that intermediaries are remunerated, the way that platforms generate revenues (or the way they disclose this), and the formal qualifications intermediaries must have, the benefits that the current model has achieved in not simply pushing the latest product to hit the market should not be underestimated.

Figure 5 Net sales of Continental European Domestic funds (i.e. excluding Cross-border and UK, €m)



Source: Lipper, a Thomson Reuters company

Having established the differences that exist in distribution and the weighting of sales to new fund launches around Europe, it is worth providing historical data for European funds but excluding both the UK and International (cross-border) markets where third party distribution plays such an important role.

The resulting trend established above puts the relative importance of new fund launches in shaping the European funds industry in sharp relief. In only the boom years of 2003 and 2005 did backlist funds manage a full year of positive net sales.

While banking groups' retreat from promoting their mutual fund ranges in the wake of the financial crisis has been rightly highlighted elsewhere, it is possible to establish that the slow-down actually began in the second quarter of 2006. This happened as bond funds (previously the staple diet of Continental European retail investors) entered a cycle of redemptions that they only really came out of in 2009 — and have fallen back into since the winter of 2010.

One has to ask whether the possible decline in sales totals for the European industry as a whole might not actually have been good for European investors who may well not have been using mutual funds as long-term investment products. This does not inevitably put all of the blame at the doorstep of large financial services groups (at the very least because this is aggregate data), but it is an issue that needs to be addressed. And such a process may already be underway as the European Commission looks more closely at distribution as part of broader initiatives (e.g. the original intention of the PRIIPs initiative) and not just at products (e.g. UCITS, first implemented in 1988).

Financial Services Groups v 'Pure Players'

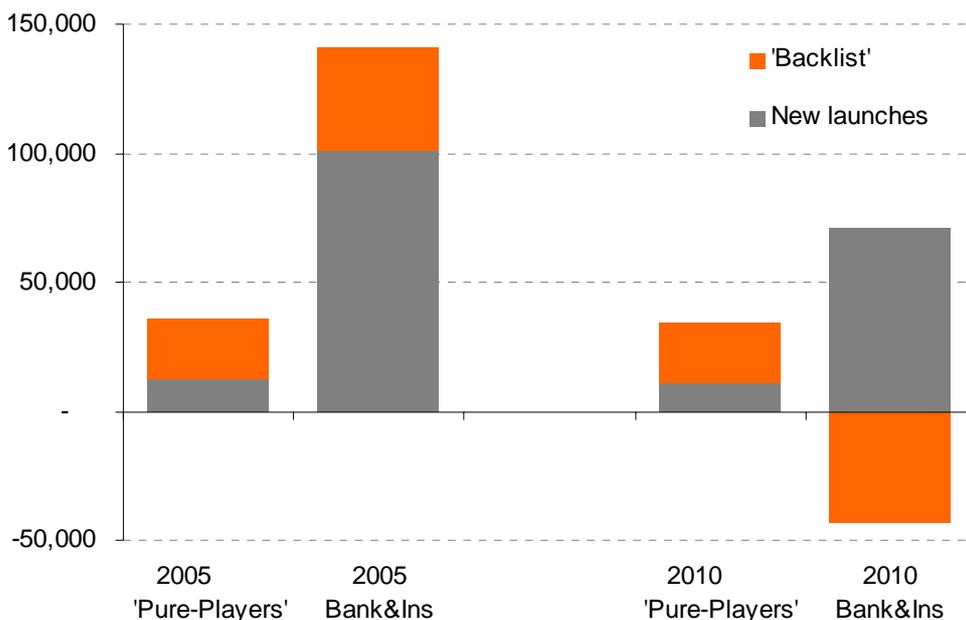
Returning to comparisons between 2005 and 2010, universes of funds can be split between those groups categorised as banks, insurers or bancassurance companies on the one hand and, on the other hand, 'pure play' asset managers, sometimes referred to as independent asset managers⁵. This also serves as a legitimate proxy for the most commonly used types of distribution channels — proprietary or third party.

First the domestic European funds universe (i.e. excluding cross-border funds) will be examined and then, perhaps more intriguingly, the cross-border universe.

For the domestic European universe the importance of a performance track record for 'pure players' is clearly important, with the level of sales such groups have been able to achieve staying fairly consistent in the two years analysed percentages. By contrast, funds promoted by broader financial services groups are weighted towards new fund launches — not surprisingly, having established this general pattern earlier on in this report.

Furthermore, financial services groups maintained positive sales activity in 2010 (to the tune of around €30bn) as a result of new launches even as the backlist suffered redemptions.

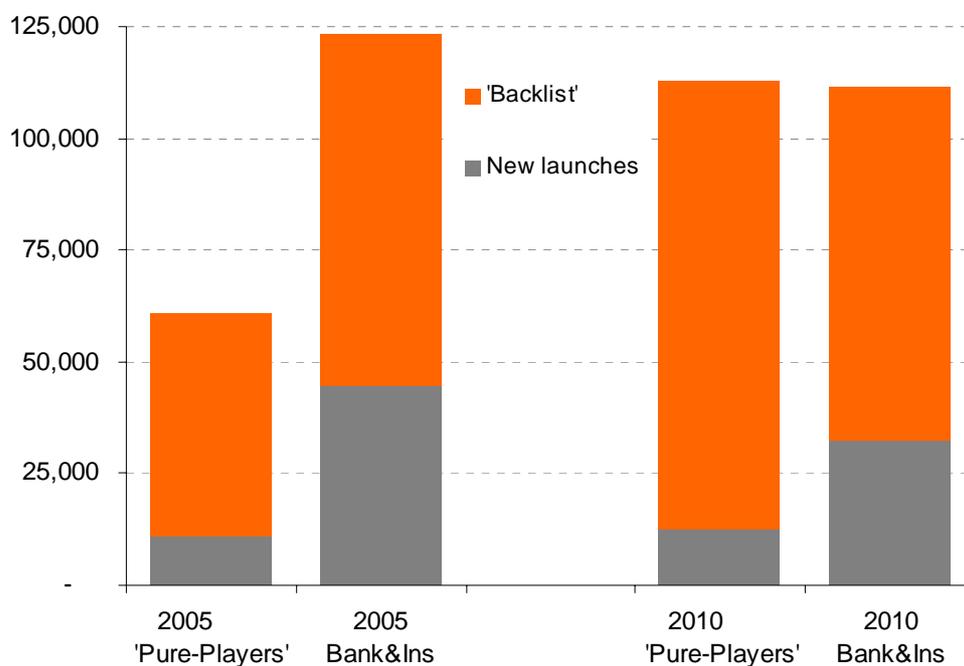
Figure 6 Net sales of Domestic European funds, split by company type (€m)



Source: Lipper, a Thomson Reuters company

⁵ Please note that these classifications are based on the identity of the ultimate global parent entity.

Figure 7 Net sales of Cross-border funds, split by company type (€m)



Source: Lipper, a Thomson Reuters company

Turning to cross-border funds, those groups selling across Europe, and potentially or, for many, primarily through third party distribution channels, can be compared. The picture that results is very different from that found in Figure 6, with backlist funds more prominent for both types of asset manager.

While broader financial services groups can still sell their cross-border products through captive distribution channels (a banking network clearly does not have to be restricted to one market), the fact that backlist funds are this prominent strongly suggests that different channels are being used successfully.

Additionally, this comparison does highlight that cross-border fund flows have shifted from banking and insurance groups to 'pure play' asset managers. Backlist funds from the latter companies attracted just under 40% of sales in 2005, but this figure rose to more than 55% in 2010.

Part of this will reflect the types of funds that were favoured by investors in 2010 (notably emerging markets) and the types of companies that have a reputation for managing such products (tending to be 'pure play' asset managers). And despite both this sector preference and the wider apparent pull-back by financial services groups, banks and insurers were still on a par with 'pure players' when new launches are included in the sales totals (around €112bn for both business types).

International comparisons

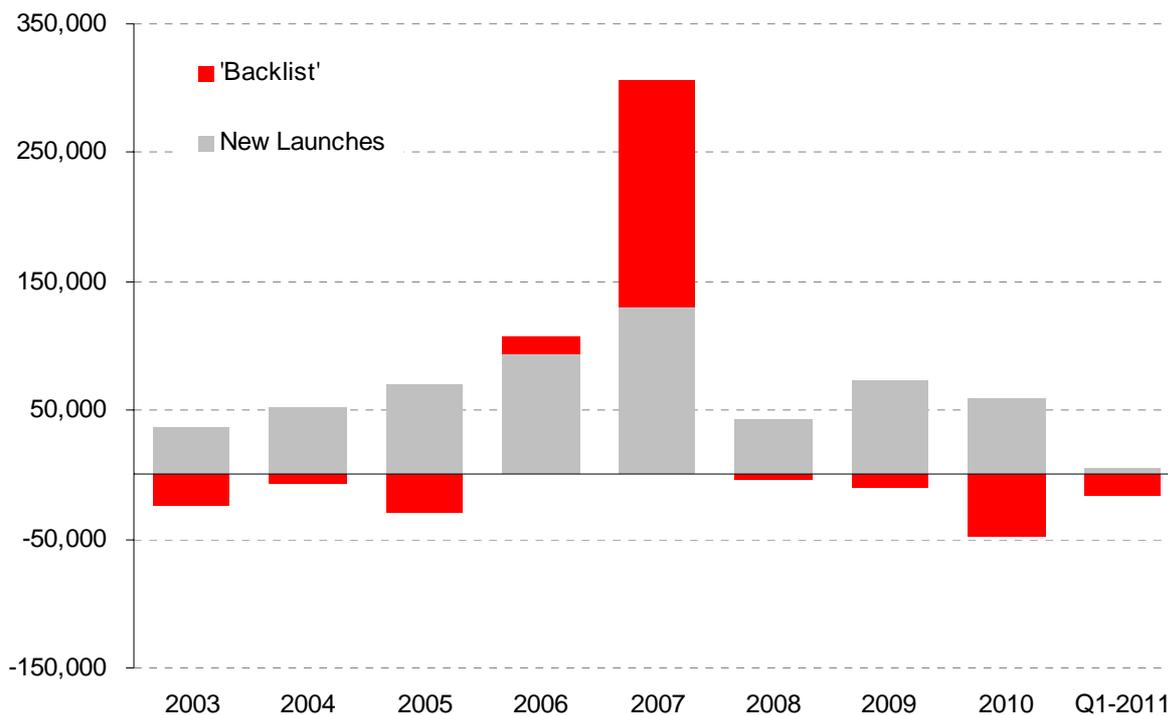
Looking outside Europe is useful to provide context for the European analysis and, looking at Asian activity, is of specific relevance for UCITS providers with global ambitions.

The common perception of Asian fund investors is that they have short investment time horizons. On the face of it, this data reinforces this view with the dominance of new launches in annual net sales totals. But the contrast with domestic European activity is also relevant: there are not redemptions from backlist funds on anywhere near the same scale as in the EU. This either suggests that there is a significant and ongoing seeding of new funds by companies while investors switch from old to new funds on a regular basis or, much more likely, investors are favouring new launches but also tend to leave a significant proportion of their money there once it has been invested.

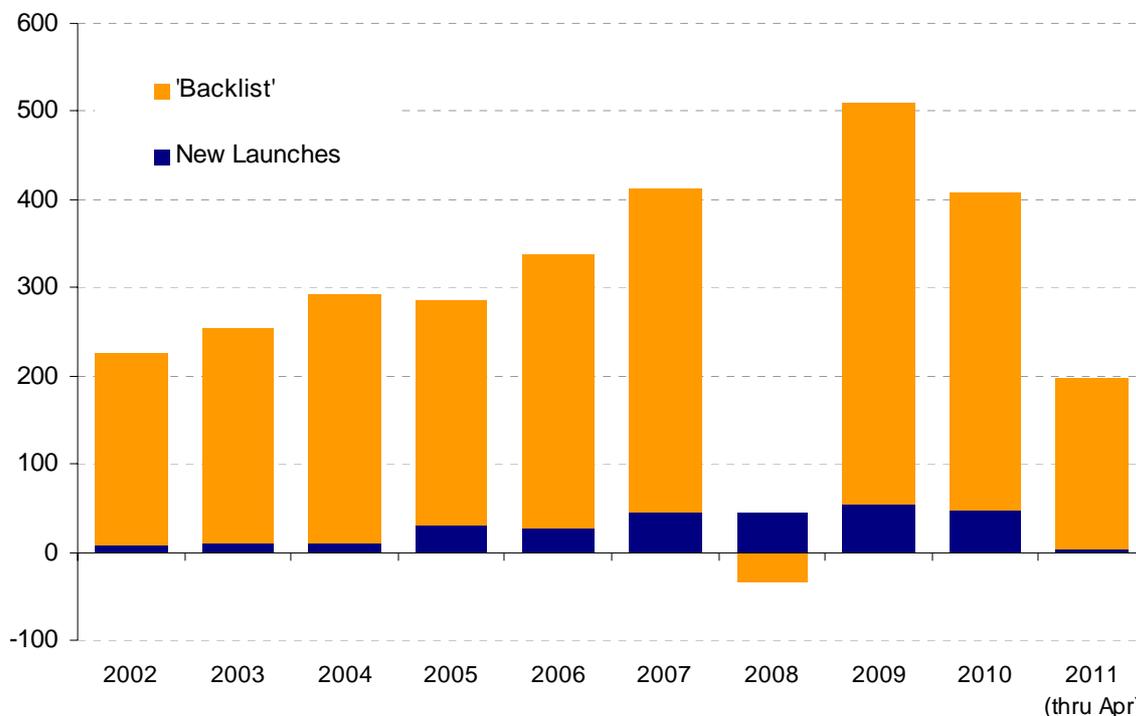
The one year that stand out like a sore thumb is 2007. The impact of the Chinese government's encouragement of fund investment in this year can be clearly seen. Removing Chinese funds from this year leaves a regional total of €120.7bn, 70% of which relates to new fund launches — more restrained than in other years but still a significant weighting.

Throughout this nine-year period, one-year net sales for new fund launches have averaged €63.8bn (excluding China in 2007), while net redemptions from backlist funds have averaged €8.8bn.

Figure 8 Net sales of Asian-domiciled funds, split by launch date (€m)



Source: Lipper, a Thomson Reuters company

Figure 9 Net sales of US-domiciled funds, split by launch date (US\$bn) ⁶

Source: Lipper, a Thomson Reuters company

Analysis of US mutual funds could not provide a starker contrast with activity in Asia or much of Europe.

Longer-term investment has been boosted over many years in the US as employers have shifted from defined benefit plans to defined contribution schemes, the most prevalent of which is the employer-sponsored 401(k) plan. In addition, the growth of the individual retirement account (IRA) has further helped the growth of the fund industry. The ICI previously estimated that of the US\$7.1 trillion invested in DC plans and IRAs, 44% was invested in mutual funds. This means that approximately one third of mutual fund assets were held in DC plans and IRAs at the end of 2008.⁷ Such an influential mutual fund-DC link simply does not exist for the European industry.

One cannot conclude from these dynamics that retail investors understand mutual funds better than in Europe, but there is clear evidence that individual funds on the other side of the Atlantic need a proven track record to succeed. Investors taking a longer-term view also manifest themselves in switching allocations between asset classes over time rather than shifting assets out of mutual funds altogether.

While the sales trends are clear, this is not to say that new product development is not important. For example, the proportion of flows into new launches peaked in 2010 (excluding 2008) at 12%. Throughout this nine-year period, one-year net sales for new fund launches have averaged US\$31bn, while net sales for backlist funds have averaged nearly nine times more (US\$273.6bn).

⁶ With thanks to Jeff Tjornehoj, Head of Americas Research, for preparing this data and for his insights into the US industry.

⁷ ICI, 'The US Retirement Market, 2008' (June 2009).

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