The Gatekeepers Report, 2019

Unlocking the secrets of fund research

FUNDSCAPE

graham bentley
investment intelligence

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ABOUT US

FUNDSCAPE

Fundscape is a research house specialising in the end-to-end research and analysis of the UK fund industry. It publishes the quarterly Fundscape Platform Report, widely regarded as the industry benchmark for platform data and statistics in the UK. With many years' industry experience, its staff are well-placed to provide unique insight into asset management and distribution trends, including product development, marketing and distribution strategies.

Bella Caridade-Ferreira, CEO

Bella has 20 years' experience in the research and analysis of the UK, European and Asian asset management industries. She set up Fundscape in 2010. Before setting up Fundscape, she worked for Lipper FMI as Global Head of Research and Publications and was the author of numerous publications and reports including the popular European and Asian Data Digests, the fund market profile series and the UK Platform guide.

Early in her career she worked in investment banking and a London-based consulting firm where she specialised in market entry strategies for cross-border retail and institutional asset managers. She has a master's degree in International Business and is fluent in four languages.

Dr Tim Burrows, Research and data analytics manager

Tim is Fundscape's research and analytics expert whose work underpins all of Fundscape's reports and databases. In particular, he produced the analysis that underpins this gatekeepers report. He has a PhD in Economics from Loughborough University, which examined the managerial performance of mutual funds.

GBI²

Graham Bentley, MD

gbi² is an investment marketing consultancy working in the City based in Suffolk. Graham Bentley, MD, has over 44 years' experience in the investment business, including Henderson, M&G and Old Mutual. An expert in behavioural finance and the psychology of investing, he is a former economics and stock market guru at Virginmoney.com and a contributor in the investment press, radio and TV.

Graham sits on a number of committees, most notably as chair of Ascot Lloyds' investment committee and the Investment Association's Sector Advisory Group and is non-exec director of Marlborough International.

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Executive summary

- This is the third annual edition of the Gatekeepers report. It accompanies the quarterly Gatekeepers database and provide an overview of the current year's gatekeeper results.
- The last couple of years have been challenging for the investment fund industry with geopolitical factors like Brexit and the US-China trade wars weighing on investor sentiment. 2018 was a difficult year with platform gross and net flows falling to £127bn and £45bn respectively coming hot on the heels of stellar sales in 2017.
- The first half of 2019, however, was even worse with net sales falling to £6.6bn as a result of the slowing DB pension pipeline and rising uncertainty. The last time sales were this low was 2012 when advisers and platforms were putting blood, sweat and tears into RDR and sales fell.
- How much gatekeepers control is difficult to state with certainty since they are understandably reluctant to share information on flows. Based on Fundscape's proprietary platform data, we estimate that the various types of gatekeepers (funds of funds, preferential fund deals, shortlists, model portfolios etc) account for circa 70% of all fund flows and in adverse market conditions, the figure is higher.
- In adverse market conditions, the amount that gatekeepers control actually rises as both intermediaries and investors prefer to place their money with safe pairs of hands. We estimate that gatekeepers control roughly 70% of the market, but when volatility is rising that figure can go as high as 95% and more.
- We estimate that gatekeepers controlled £468bn of platform assets at the end of June 2019. We expect that figure to rise to £699bn to figure by 2024, a conservative compound annual growth rate of 10%. An optimistic scenario would take gatekeepered assets to £825bn+.
- In this report, we analysed gatekeepers individually as well as cohorts. The best cohorts are consumer-facing gatekeeprs that are published by trade press (three-year return of 12.71%) or D2C lists (three-year return of 10.63%). The worst cohort is DFMs with a three-year return of 8.22%. However, it is important to consider the breadth of the investment strategies which can range from aggresssive through to income-generating or capital preservation portfolios.
- Given the adviser trend to outsource to DFMs, this report has focused on DFMs and their investing behaviour. DFM-led model portfolios on retail-advised platforms represent £176bn as at June 2019 and DFM influence ranges from 2.9% on Aegon through to substantially more on platforms like Raymond James and 7im. The average across the advised platform world is 18%.

- If we take into account non-platform assets and the broader private client and wealth market, we estimate that DFMs control around £865bn in the UK. The largest is Deutsche Bank with a market share of 22.9%, followed by GAM on 12.5% and Cazenove on 7%.
- Despite the known benefits of diversification, DFM portfolios are heavily weighted towards UK equities. They also tend to use many of the same funds. The Merian Global Equity Absolute Return is top of the DFM pops with a remarkable 62 selections implying it is a virtual fixture across portfoios of all risk hues. This is partly because what DFMs need from fund groups and funds in terms of size, liquidity and performance limits the field somewhat (see chapter 5).
- The most popular fund groups with all fund selectors are BlackRock, Fidelity and Quilter with 733, 462 and 456 fund selections respectively.
- Rising stars are Baillie Gifford, Liontrust and JPMorgan. Baillie Gifford has six sector-topping funds and although it has 247 picks, it is yet to command the the number of picks that its peers attract.
- There are ten selection factors that fund managers should strive to achieve to improve their selection chances (pg 106). Performance is of course a must and funds should have consistent alpha in the three years before as well as the current year if they want to get selected.
- We believe the focus on transparency will widen to include relative performances of model portfolios. Fund research will be subject to deeper scrutiny regarding its processes and especially the ex-post performance of its selections. This will require regulatory supervision to ensure that process and performance is communicated adequately.

Introduction

Welcome to the 2019 edition of the Gatekeeper Report. Regular subscribers will be keen to get to the meat of this year's report, but please rein in your enthusiasm — we already know many more readers are coming to the report for the first time. Consequently, let's have a little reminder of how this series of reports was born, and how it's changing the way the market — and the regulator no less – looks at the key influencers of fund flows in the UK retail and institutional markets.

Art or science

Despite increasing interest in passive investing, selecting funds by identifying in advance the likely best performers is a process that has no certainty of outcome. Luck may play a significant role in determining degrees of success, so fund selection has to be considered more art than science. In this scenario, process can be the major differentiator of outcomes.

The processes we employ to make investment decisions have a profound effect on the potential outcome for investors. Human beings tend to be overconfident in their belief that the future is forecastable, and the past is repeatable. This can (and does) lead to sub-optimal outcomes for investors, and business risk for those who use these forecasts on investors' behalf.

Despite this, the retail investment industry remains results rather than process-driven, focusing on data analysis. Statistics tables showing historical fund performance abound, while there are few, if any, that empirically analyse how fund managers' processes might have a causal relationship with results.

There are, however, individuals and organisations that promote an ability to better analyse investment management with the aim of increasing the likelihood that investment skill can be identified, and therefore higher-than-market returns obtained. This is a skill worth paying for. The outputs they produce guide the investment decisions of thousands of advisers and investors, giving these experts significant influence over the direction of fund flows. For this reason, we chose to call them gatekeepers.

Gatekeepers

However, while some researchers have no direct commercial interest in fund analysis other than the provision of an information service for captive investors, there are others who perform the task on a commercial basis, some of whom have business models that may present conflicts of interest and potentially moral hazard.

In the typical commercial model, the research business earns a fee in return for granting a licence to use the rating in its marketing material. No one wants to pay a fee for a poor rating, and consequently negative ratings are significant by their absence. The more ratings awarded, the higher the research business's revenue. There is a risk therefore that the award of ratings is motivated by licence-fee earnings.

The investor who is persuaded by the rating is exposed to all the investment risk, but the researcher benefits whatever the investment outcome – there is asymmetric risk involved, and hence moral hazard. The provision of research to the beneficiary, for example the investor or intermediary, in exchange for a fee is arguably far less contentious, but rare as hen's teeth.

So who rates the researchers? Who's good, and who ain't? Which funds are most popular, and which deserve more visibility but for some reason are ignored, and why?

In previous editions of this report, we were keen to help fund managers present their funds to researchers in the best light. We've looked at the most common characteristics of selected managers and funds and what those managers need to do to get listed. We discussed gatekeeper influence with fund managers, distributors and the researchers themselves – both independent and distributor dependent – and the data on their usage by advisers and investors.

This year we continue in that vein with updated analysis to answer the following questions:

- What do the players – and the regulator - think about the ratings industry?
- Do recommendations really lead to better investor outcomes?
- Do rated funds perform better than unrated after selection?
- Which groups are the winners and losers in distribution terms?
- What are the commercial realities of fund research?
- Which lists have the most influence?
- What characteristics explain fund selection?

However, new in 2019 is the inclusion of *The New Gatekeepers* — discretionary fund managers, commonly described as DFMs. Their research leads to inclusion of funds in long-term investment portfolios and multi-manager funds, and the success or otherwise of their research directly affects the success of the business.

We'll look at the rise of DFM and model portfolios, their impact on the advice market and the justification for using a DFM. We'll also look at the DFM selection process, with a particular focus on the art of completing an RFP, getting short-listed, and subsequently to significantly increase the chances of getting chosen after a beauty parade.

Finally...

The art of fund selection is under attack. As markets become more efficient, active managers find the search for alpha less rewarding and some find themselves exploring less familiar territory as a consequence. This can have disastrous consequences – we look closely at the GAM and Woodford sagas in detail, and consider the regulator's likely response.

Most importantly we make some innovative suggestions as to how the active fund management industry can use product design in order to regain some lost ground relative to the advance of passive investing.

There's lots to talk about – so let's get on with it!