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A rethink on managed funds

The world of managed funds is changing, driven as much by technology as by regulation. Lisa Pennell reports.

The age of technology has brought massive change to many facets of everyday living, in ways that previous generations could only have dreamed of. Even though the benefits have been many, the evolution should perhaps come with a caveat: in the wrong hands or used in the wrong way, technology has the potential to cause more problems than it fixes.

Take the health industry for instance. An international survey by health insurance provider Bupa found that four in five Australians use the Internet for health information, while half of those are using the information to make a self-diagnosis. It's leading to a two-fold problem. At one extreme, people are presenting at their GP's surgery panicking, convinced their tension headache is a brain tumour. At the other extreme, people with life-threatening conditions are putting off a visit because, based on their Internet research, they believe their issue is not serious. The ramifications are mind-boggling.

The potential misuse of the power of technology is an important point to consider in the financial planning industry, too, where giant leaps have been made in financial planners' capabilities over recent years through the use of technology. Team this fact with increased demand by investors for lower costs and more transparency post-GFC, then overlay it all with the forthcoming *Future of Financial Advice* (FoFA) reforms, and the result is a heady mix indeed. And while the devastating effects of the GFC were a potent reminder of the important balance between risk and return, a new trend away from managed funds and towards direct investing, made simple by new technology, may be creating unwarranted and unacceptable risk in some portfolios.

Contributions towards retail managed funds (RMF) have continued to decline in recent months, with data from Morningstar showing $2 billion in net outflows in the March quarter, bringing the cumulative total of net outflows to $15 billion in the 12 months to March 31, 2011. The wholesale managed funds (WMF) industry is not faring any better, with $1.6 billion negative net flows during the March quarter and the total industry size falling by 1.1 per cent over the year.

Meanwhile, low-cost alternatives, such as exchange-traded funds (ETFs), continue on their meteoric rise in popularity. According to Morningstar, total funds under management in the ETF market in Australia has increased by almost 38 per cent in the 12 months to March 31, 2011 alone. As of March 2011, there were seven managers offering 47 different ETFs, accounting for $5325 million of locally sourced assets.

Perhaps most important to note is the increased use of direct equities. The July 2011 *Planner Direct Equities Report* from Investment Trends (IT) shows financial advisers allocated 28 per cent of new client money towards direct investments, with 19 per cent going to direct equities. These percentages are far higher than for the year to October 2010 when advisers had allocated just 23 per cent of new money towards direct investments, including 15 per cent to direct equities.

'Huge amounts of power have been put in the planners' hands over the past few years - planners now have vast capabilities through technology'

It's clear the forthcoming FoFA reforms have an important part to play in how these trends will play out - the move away from up-front and trail commissions is putting financial planners' value proposition well and truly under the spotlight. Although significant numbers of planners have been organically gravitating towards a fee-for-service model over recent years, FoFA appears to be escalating what was a gradual shift into an aggressive and radical swing.

According to a 2006 IT report, 70 per cent of financial planners' income was commission-based revenue at that time. By 2010, that percentage had dropped to 55 per cent. In October 2010, another IT survey showed that financial planners were still predicting that 40 per cent of their income would come from commission-based revenue by 2013.

Now that planners are approaching the 2012 deadline for a mandatory fee-for-service environment, along with an opt-in clause that proactively raises the question of value with the client every two years, many planners are being forced to completely review their business model far sooner than they had expected.

The July 2011 IT report also reveals there's been a recent surge in direct equity investments, with financial planners increasing their allocation to direct share investment as well as recommending direct equities to a wider range of clients. Analyst Recep Peker says the change is being driven both by client demand and an urgent desire by planners to differentiate their client value proposition.

"Planners are getting more confident. They're more comfortable pushing direct shares onto their customers and fewer are worried about compliance risk. Planners are increasingly citing cost-effectiveness, transparency and tax-effectiveness as key benefits of direct equity investing," Peker says.

"Two-fifths [of surveyed planners who recommend direct shares to their clients] are concerned about opt ins particularly, and cite recommending direct shares as a way to differentiate their value proposition. This general trend towards more listed investments is coming largely at the expense of managed funds," he says.

Colonial First State's FirstChoice has been the industry's largest platform since its inception in 2002 and now has almost $50 billion in funds under administration. It also operates the FirstWrap platform, which offers managed funds and direct equities.

Peter Chun, general manager of product and channel development at Colonial First State, says that while there is an increasing planner appetite for direct equities, the rise is off a low base.

"We don't believe this recent trend towards direct equities will come at the expense of managed funds," Chun says. "Managed funds will still have a role to play in helping planners to drive productivity. Within a managed fund the client still gets access to all the shares, but professionally managed and with all the cost benefits of scale."

Interestingly, Peker says 50 per cent of these planners play some role in recommending which shares to buy and may also be basing their recommendation on research provided by a broker, dealer group research or other research.

And that's a dangerous game indeed, according to Andrew Baker, director of consultant group Tria Investment Partners, who says that technology has a lot to answer for.

"Huge amounts of power have been put in the planners' hands over the past few years - planners now have vast capabilities through technology. The impact of technology has been more important than FoFA. We describe the current environment as one where the nuclear weapons have been passed around," Baker says.

Greg Everett is head of financial planning at Bendigo Bank. Bendigo Financial Planning is a division of Bendigo Wealth, which operates a number of managed funds, leveraged equities and cash and term deposit solutions. The group was the first of the bank-owned dealer groups to adopt a fee-for-service model more than five years ago and, more recently, Bendigo Wealth has also entered the platform space. Everett says planners need to focus on strategy to provide the best value proposition for their clients and be cautious of the significant risk in


Frank Henze

providing specific advice on direct investing.

"The value proposition has moved away from the element of being an investment 'guru' and promising the maximum return. Anyone who positioned themselves in that light got smashed in the GFC - their reputation was severely tarnished. Planners need to be more strategic, focusing on minimising tax, getting the allocations right, and selecting quality funds. Healthy returns will be a by-product of the right asset allocation," Everett says.

Chun agrees that, going forward, planners will need to move away from "stock picking" and more towards setting strategies that can be achieved through the use of products.

"There are pockets of financial planners who are using direct equities, but these planners will need to radically change their business model," Chun says.

"Financial planners are not stock brokers. Some direct equities allocation makes sense, but we're less bullish on a complete shift because it's firstly just not appropriate and secondly because of this increasing burden of compliance and operational risk. It's going to be really tough and cost a lot of money going forward for planners to be recommending equities," Chun says.

"There is no doubt in my mind that it will be harder and harder to run a business model based on direct equities."

Michael Walsh is the head of strategy and development at Hunter Hall, whose flagship Value Growth Trust, with $1.2 billion under management, is the top performer of all funds over 15 years, with an average return of 14 per cent per annum, according to Morningstar data. Walsh takes a more moderate view, saying it is possible for planners to effectively build a core direct equity portfolio, but it's not a comprehensive strategy.

"If advisers are operating within the top 100 Australian stocks and pick a couple of handfuls from there, it's an area where they're fairly safe. It's quite easy to know which stocks are being held by the fund managers, and there's lots of information available. The benefits, including control of capital gains and tax issues as well as dividend flows, may well outweigh the leakage," Walsh says.

"This isn't the main game in a diversified portfolio though; you need genuine active management in the Australian small caps and international equities and it's difficult for planners to add value in these spheres."

When it comes to how allocations are likely to change, it depends which segment of the market you're talking about. According to Baker, current ATO data shows an 88 per cent allocation to managed funds via platforms - a number which Tria Partners projects will drop to 75 per cent for the advised mass market (portfolios of up to $200,000) by 2015.

Meanwhile, direct equities are tipped to rise from 2 per cent to 8 per cent and deposits are expected to remain constant at 10 per cent. In the Tria projections, ETFs make an entry into the advised mass market for the first time, and are projected to comprise 5 per cent of the total allocation.

"These portfolios are not big enough to take advantage of direct assets but could be suitable for ETFs. They are still well suited to managed funds," Baker says.

Frank Henze is the managing director of ETFs Asia Pacific for State Street - the first to introduce ETFs in Australia in 2001 and still the dominant provider. Henze says his company experienced a 34 per cent increase in ETF funds under management during 2010 but believes this is still just the beginning.

"We are projecting an eight to tenfold increase over the next five to ten years, partly driven by the regulatory changes," Henze says.

Robin Bowerman, a principal and head of corporate affairs and communications for Vanguard Australia, says the forthcoming FoFA reforms will transform financial planners' business models and that many have already moved in anticipation of the changes.

"The growth in indexed funds has two drivers - firstly, advisers have been left disillusioned by the performance of active funds after the GFC, despite the fact that their expectation that the fund managers should have seen it coming might have been somewhat removed from reality. Secondly, the move towards fee for service has left financial planners looking for ways to lower costs - and index funds can be half the cost of actively managed funds," Bowerman says.

"Still, we remain agnostic and think it all has its place, whether a fund is indexed or active, but the critical thing to consider is, what's the cost?"

Everett agrees there is a strong focus on reducing costs in the fee-for-service environment.

"There is certainly a demand for lower-cost index funds, but there will always be a place for managed funds. Margins are already under pressure and there will be more demand going forward for low-cost actively managed funds," Everett says.

Chun says because ETFs need the same framework as direct equities, passively managed funds are a cheaper and easier option than ETFs for many planners.

"The fees are comparable, with passively managed funds available at between 25 to 30 basis points and ETFs at around 28 [basis points]. The difference is that planners generally have a stronger framework [for the fund]," Chun says.

Henze disagrees, saying ETFs are a better choice than passively managed funds.

"Planners who appreciate flexibility would select ETFs over passively managed funds in any space where there was a choice," Henze says.

"But I believe there is a shift in usage. Rather than ETFs undermining the position of actively managed funds, the two will fall into equilibrium - there will always be a space for actively managed funds. Active funds offer a different risk/return [profile].

"ETFs are an extension of product choice and allow for more effective diversification and asset allocation. They open up new opportunities."

Baker expects quite different behaviours in the advised higher value segment, saying there is a "break point" in portfolios of around $500,000 and higher where behaviours diverge.

"We're forecasting much lower use of managed funds in this segment by 2015 (40 per cent) and a higher allocation of direct equities (20 per cent). Portfolios of this size have the scale to be able to take advantage [of] and to justify direct equity investment," Baker says.

Bowerman says in contrast to the advised mass market, the complex, high-net-worth clients will need complex holistic advice.

"And that will be expensive. Under the reforms, the way advice is delivered will change. Clients will be looking carefully at what they paid and what the value was. Fee for service removes distortion around product selection and allows planners to develop credibility and move into a new era of professionalism," Bowerman adds.

When it comes to the SMSF market, Baker believes the use of managed funds is abysmal.

"The managed funds [MF] industry needs to get its act together in this market - it's a wasteland, with just 14 per cent allocation currently. The industry has not accommodated the market well and investors have been disappointed in active returns. We project the MF allocation will grow to 20 per cent in SMSFs [self-managed super funds] by 2015."

Chun points out that SMSFs do not run on the normal trustee model and have been traditionally driven by suburban accountants.

"They've on the whole been created as a good tax vehicle, with the shortfall that they've not typically been run under the APRA structure in terms of allocation. They don't reflect the need to save for retirement and often have a high concentration of [one particular] asset class. We see an enormous opportunity to educate the trustees of SMSFs that their portfolios need more diversification," he says.

"We think there will be greater scrutiny on SMSFs going forward."

Everett agrees it's been difficult for fund managers to penetrate the SMSF market due to the sector being very fragmented.

"People typically open SMSFs for greater transparency and control over investments and investment decisions and therefore prefer direct investments to managed funds. Often too, people setting up an SMSF will not necessarily seek advice from a financial planner. We are developing solutions to help both financial planners and accountants deal with SMSF issues," Everett says.

He says despite the lingering conservatism of many investors post-GFC, the managed funds industry is changing to accommodate the new environment.

"Pre-GFC, increasingly complex investment structures were being put to market and the relationship between risk and return had been lost. A lot of that has now been stripped away with improved transparency. We don't offer complex structures; we offer simple products that meet the needs of investors who get regular updates on major holdings," Everett says.

"We've also seen an increase in the take-up of separately managed accounts [SMAs] that are still run by professional investors but which offer another solution for investors looking for transparency and tax effectiveness."

Walsh points out that managed funds are still the best vehicle to deliver returns.

"It will be sad if the industry remains risk-averse, as now is the time to get set into growth assets and enjoy the recovery instead of reacting to the recovery," he says.

Walsh says there are very good reasons to be in active funds, including managing currency and leveraging emerging markets and Asia.

"You won't find that style in index funds. Yes, you can get ETFs cheaply, but they're not necessarily the best choice - and if you want active management, you have to pay," he says.

Baker is more candid in his view, saying the growth in equity models and the trend away from using professionally managed equity funds has led to the creation of some equity models with a large risk component. He believes it may be a few years before the risk become obvious.

"This is absolutely happening - there are certainly some risky portfolios out there," he says.

"At some point, there will be a failure of one of the big companies that form a significant part of one of these models. It's likely there'll be some big accidents, some big losses. At that point, they'll say, 'Oh, maybe those fund managers did have something to offer after all.'" ■

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