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The future of fund management

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Blackrock, known to many as the world's largest investment manager, with $10 trillion of assets under management (AUM), recently published Chairman Larry Fink's widely followed annual letter to investors[1]. A couple of key takeaways that I'll expand on in this article were: firstly, Blackrock attracted a remarkable $289 billion of net inflows in 2023; and secondly, despite their dominant position as a passive strategy provider, they see a significant need and growth opportunity in actively managed strategies going forward. It's been a tough period for many active managers but while we see significant changes to the landscape ahead, we firmly agree that active strategies will remain a crucial part of the investment toolkit.

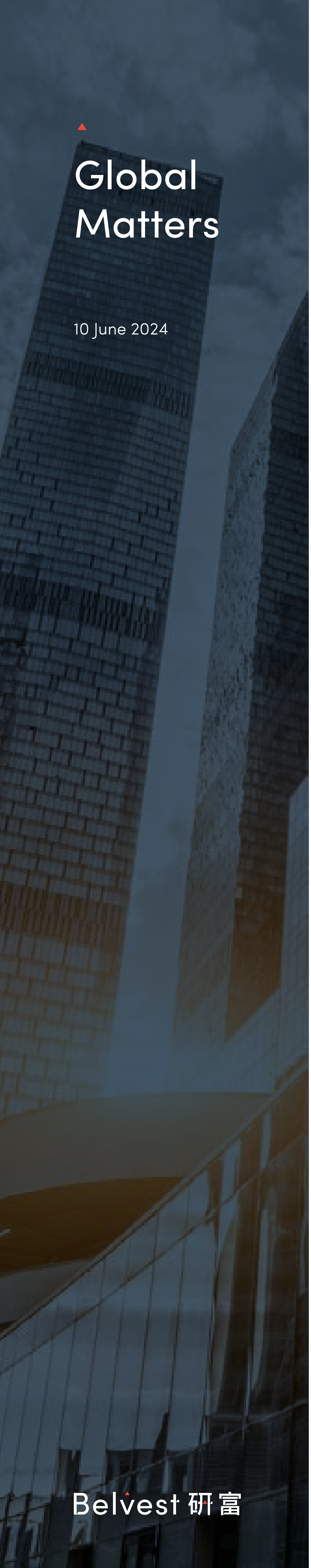
In contrast to the huge growth in passive AUM in recent years, conditions for active managers are arguably the hardest they've been at any time in recent decades, driven in particular by: the higher interest rate environment, leading to steep losses on fixed income assets and investors switching into or holding onto cash; relentless downwards pressure on fees, due to industry consolidation and regulation; and rising operating costs, due to inflation and the ever-growing regulatory burden. Investment performance has also been a challenge for many active managers, in many cases due to the so-called 'Magnificent Seven' stocks significantly outperforming (and as a result the US market as well), which most active strategies are underweight to due to the typical (and I'd add sensible) preference of managers to be more diversified and cognisant of valuations. Huge inflows into passive strategies, which are by definition valuation-ignorant, have no doubt been a significant factor in the outperformance of this cohort, which now represents over 30% of the S&P 500 index.

Against this backdrop, scale is an increasingly important requirement and source of competitive advantage, without which few investment businesses will survive in the longer term. No surprises then that we've seen more and more deal activity, to combat these headwinds, and to capitalise on the low valuations across the sector. That's particularly the case in the UK at the moment, given Brexit related challenges and the lacklustre performance of the local stock market relative to the US. London-listed asset management firms such as Abrdn, Jupiter, Liontrust, Premier Miton and Schroders all trade on forward price /earnings ratios of between 8x to 13x, representing discounts of 34-56% versus Blackrock's 19x[2].

While mergers seem an obvious solution, they do not necessarily help to address the core problem that much of the industry suffers from: that of charging unsustainably high fees relative to the value added. It's well understood that many active managers underperform the market net of fees, so why wouldn't investors continue to reallocate towards low-cost passive strategies, especially when performance differentials are as wide as they are now for many comparable strategies? There's a long way farther to go on this front, and it will be a painful journey for much of the industry, but it is the right direction of travel for the average dollar invested.

Averages hide a wide range of outcomes though, something which active manager performance studies often fail to highlight sufficiently. The worst offenders in terms of long-term performance outcomes are normally large and diversified asset-gathering firms, that to varying degrees lack focus, talent, alignment and conviction, all of which are key ingredients in delivering successful long-term investor returns but are quickly lost through the process of product proliferation, mergers, people turnover and excessive AUM. While many firms present and operate as active managers, their portfolios often look very similar to the relevant benchmark (a low 'active share'[3]) which leaves little room for outperformance. Such firms have historically gotten by off the back of a strong brand and distribution, but now represent the squeezed-middle where investors would likely be better off with passive strategies at a fraction of the price.

That so much capital is still invested with such managers is a poor reflection on the army of fund selectors at pension funds, financial institutions and other long term investment funds around the world. Too often they struggle with the same absence of key performance ingredients and end up taking the easy road that appeases investors and management; of investing with familiar brands, into the most popular funds, and the recent winners, all of which are likely to lead to mediocre performance. As Sir John Templeton said, to achieve superior returns one must be doing something different from the rest.



Global Matters

10 June 2024

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The new Consumer Duty regulation in the UK is making it harder for this squeezed middle to survive; funds are rapidly being closed and assets are migrating towards lower cost or passive strategies, which probably represents a good outcome for their investors in the long run.

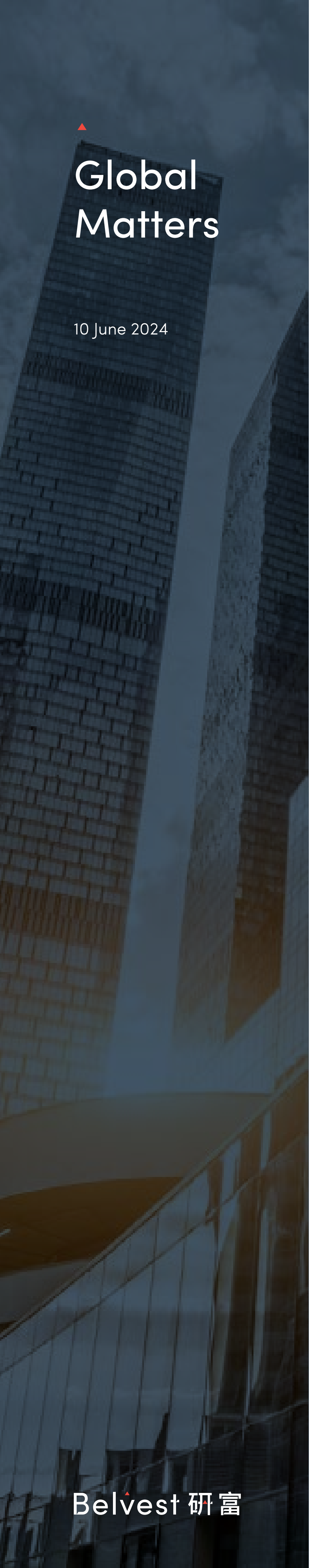
Nonetheless, there remains an important role for active managers to fulfil in the future, as highlighted by Blackrock's thinking and supported by decades of evidence of the best active managers adding huge value to client portfolios (net of fees). However, the industry is likely to shift towards having a higher bar in terms of when it's worth taking active exposure, such as through demanding higher active share for equity funds together with evidence of long-term performance delivery, or focusing on more differentiated asset classes that are harder to replicate passively (such as infrastructure assets). This should lead portfolios to look more bifurcated in the future, with low cost and broadly diversified beta exposure at one end, complemented with specialist, focused strategies at the other end. Executed well, investors should then benefit from lower costs along with better long-term outcomes (theoretically in terms of both reward and risk).

However, to achieve this investment teams, and the industry on average, need to become less short term oriented; for active managers to deliver superior results in the long run they must have a high active share, inevitably leading to periods of underperformance, which may last for a few years depending on market conditions. It sounds an obvious point, but most industry participants simply don't appreciate this enough; I'd challenge anyone to name a strategy that's outperformed significantly over 10+ years without suffering one or more extended periods of underperformance. In fact, the best strategies over the long run, looking back over many decades, are usually those that have the highest active share, and thereby endure the bumpiest of rides along the way. However, this doesn't mean that investors must bear the full brunt of that volatility; instead once such long-term winners are identified, those risks can be largely diversified away by carefully blending strategies with different and complementary characteristics.

As an example, one of the largest active manager allocations across Momentum Investments portfolios is to a global equity strategy managed by Jennison Associates that has outperformed its benchmark by over 3.9% per annum[4] net of fees since we invested in 2012, and ranks 3rd out of over 800 managers in their global equity peer group[5]. However, there have been some difficult years in that period: the strategy underperformed by 25% in 2020 and by 11% in both 2021 and 2016. Naturally managers that can generate and sustain such superior long-term performance can justify charging higher fees, especially if it's a limited capacity strategy. Most such managers are not listed though, which is a factor that usually supports their superior performance (through greater business focus and the ability to remain patient through periods of underperformance) but if they were publicly quoted they would typically attract much higher valuations.

The other end of the barbell needn't always be passive, and sometimes absolutely shouldn't be. For instance, fixed income indices are usually weighted by amount of debt outstanding, meaning a passive strategy tracking them allocates more to the most indebted issuers, which could also be the most risky. Small cap or emerging market strategies are other obvious areas where active managers may have a bigger long-term advantage, due to less information being available and lower investor and broker coverage. Then there are harder to access asset classes, such as infrastructure or private equity, which are not well suited for the high capacity and high liquidity design requirements of most passive vehicles. Traditional, highly liquid asset classes are the more natural places for passive to be the preferred option for most investors, such as large cap equities, high grade bonds and commodities - they often represent a large portion of a typical portfolio so the fee benefits can be significant.

There is however a strong competitor versus passive strategies, in the form of quantitative strategies. While these are generally not new, they have often been overlooked by investors, who have arguably been biased towards familiar faces and the story-telling that comes from a traditional fund manager. Their advantages are undoubtedly increasing as a result of advances in technology, artificial intelligence (AI) and availability of big data, together with the lower fees they usually charge. While quantitative strategies come in many forms across most asset classes globally, within the context of this article it's most relevant to highlight the role that low tracking error strategies can play as a core building block for investor portfolios: using a systematic, rules-based approach it's possible to construct a portfolio that is equally well diversified as a given index, but with a modest risk budget used carefully to harvest various rewarded risk premia which should lead to outperformance over time.



Global Matters

10 June 2024

The best quantitative investment firms require highly skilled teams to implement and evolve the models over time, but it's computers that do the heavy lifting, and their models can often work across many different asset classes, geographies or risk budgets, making it an incredibly scalable approach, which translates into fees that are usually only slightly higher than passive strategies. With long track records of net of fees outperformance versus market indices for some of the best managers, and often better diversification, such strategies warrant much more consideration as alternatives to a fully passive approach.

Our portfolios have already evolved towards this barbell approach in recent years, becoming a mix of truly active, discretionary strategies, in combination with core quantitative strategies, as well as selective use of passive funds and direct securities. Whilst we use a wide range of different active managers, given most have a narrow specialist focus, we only have a couple of quantitative partners, the largest of which is Robeco. They recently published a research paper on the benefits of combining quantitative and active strategies like this, which included an improved information ratio and a more balanced risk profile[6].

The asset management industry ultimately exists to look after and to grow investors savings. Passive strategies have a huge and growing role to play in a better, lower cost future for investors, but there will always be a critical role for active managers – quantitative and discretionary – in helping deliver better outcomes for investors over the long run and contributing to more balanced, healthy capital markets globally.

1 Larry Fink's 2024 Annual Chairman's Letter to Investors, Blackrock. https://www.blackrock.com/corporate/investor-relations/larry-fink-annual-chairmans-letter. 2 Source: Bloomberg, June 2024. 3 'Active share' measures the proportion of a portfolio that does not overlap with the appropriate benchmark index. Passive strategies aim for an active share of close to zero. A higher active share usually leads to greater performance divergence versus the benchmark index. 4 Source: Momentum Global Investment Management, J.P. Morgan. Returns to 30 April 2024. 5 Source: eVestment Alliance, May 2024. 6 Source: Embracing fundamental and quant investing in emerging markets, Robeco. https://www.robeco.com/en-uk/insights/2024/01/embracing-fundamental-and-quant-investing-in-emerging-markets

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