Over the Horizon: Trends Reshaping the Business

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In a broadly encompassing look at the asset management business, one of the industry's leading analysts sees several paradigm shifts taking hold and more dislocation ahead.

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"The search for stability will continue, but will be defeated, because 'safe' is not as safe as expected."

Less appetite for risk taking:

› Aging of the population has contributed to reduced risk tolerance; more than 80% of assets are held by Baby Boomers and their predecessors.

› In a cataclysmic change, investors have redeemed $1.5 trillion of actively-managed U.S. equity assets since 2008. The top four priorities named by institutional investors all revolve around risk management and advisors are seeking a new approach to replace buy-and-hold. Low-volatility return streams will remain strongly desired by institutions and HNW investors alike.

› Huge flows have gone into bond funds despite low yields –more than $1 trillion a year over the past five years. Two-thirds of investors surveyed say they don't understand bond math.

› The demand for equities is poised for an elongated cyclical rebound, with indexing the approach of choice. The period since 2008 should have been the best for active managers, but it's been the worst due to out-of-benchmark bets, cash holdings, fees, and overseas exposure.

Growing commoditization threats:

- Size has led portfolios to look more like the market, and active share – the metric that measures how much portfolios overlap their benchmark indexes— is declining. Managers have to be better and better just to equal the market.

- The retail shift to indexing is still accelerating. Investors are valuing liquidity they're unlikely to use. ETF investors are richer than others, so the trend has further to go. Meanwhile, active managers are being pushed into riskier and less diversified lines of business. Globalization and complexity are the allies of active managers, but are being relegated to niches

The institutional search for serenity:

- In a major structural shift, DB pension plan asset allocations have shifted away from equity allocations. Corporate plans have made a big reallocation to bonds by reducing equity exposure, and will commit even more to bonds when fully funded.

- The 401(k) market has a real growth rate of 1-2%, and investment-only products now claim nearly half of it, offering a significant opportunity. However, six firms control three-fourths of the target-date market, which dominates many plans. They, too, have been reactive, rebalancing away from equities.

- The freezing and termination of pension plans has made "solutions" a business. The big withdrawal phase is about a decade away, giving plans a window before the dynamic shifts.

Retail market squeeze:

- Retail distribution consists of one-third big national firms, one-third discounters, and one-third everyone else. National full-service firms have lost share since 2008; Vanguard is the big winner.

- RIAs and many brokers now see themselves as asset allocators, not stock or fund pickers. They like ETFs, which are cheap enough to wrap; 85% say Morningstar is their #1 source of information.

- The existing distribution paradigm is vulnerable because millennials don't believe in long-term investing, don't seek advice, and don't try to outperform the market. Returns to retail investors have been worse than random performance, and they have been reactive rather than sticking with buy-and-hold.

- Flows into alternative mutual funds are up, as investors search for "better bonds" and ways to protect principal.

Hedge funds and bundling:

- The hedge fund boom has tracked that of mutual funds. Hedge funds grew 10% a year until 2008; since then they've grown at a 3% rate, which can be expected to continue. Their client base is now dominated by institutions, which want steady 7% returns, unlike HNW investors who expect10% or 12% with higher volatility.

- Institutionalization has changed the industry's return profile, which has been consistently worse than mainstream markets over the last five years. Investors are concerned that alternatives may disappoint.

- The information game looks crowded, with 4,000 equity long managers and 5,000 hedge funds. Those trying to take advantage of the system are bigger than the system itself. This makes trading strategies harder to execute; it also creates synthetic correlations in the behavior of stocks, as large investors flood into ETFs and index vehicles on down market days.

- We're not in Kansas anymore. Retail investors are now a third of the equity market (down from two-thirds a few years ago), and hedge funds are now bigger than the traditional actively-managed institutional business. The equity yield curve has become steeper as capital has flowed to the short end.

- For the largest managers, the three most important imperatives are controlling the bundling of investment solution components, developing credibility in global money management, and building global distribution.

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