The Hidden Challenges of Performance Based Fee Models

Product innovation and regulation transparency requirements are redefining the asset management business model
The Asset Management industry is in a period of seismic change. Long bull markets, low volatility and technological advancements have resulted in dramatic growth in low cost, passive funds. Indeed, in 2017, the passive fund industry grew 4.5 times faster than the active management industry. This growth has applied pressure to actively managed fund costs and has resulted in an overall fall in fee income across the industry.

To a certain degree, the growth in index funds reflects investors’ growing awareness of the negative impact of fees on long-term investment returns and their resulting desire for value and clarity around what they are paying for. In today’s Post-MiFID II and PRIIPs world, this desire is mirrored across distribution channels. Regulators, shareholders and end-investors alike are calling for change, and increasingly asset managers are taking a step away from the well-worn paths of tradition.

Change is in motion. Following the UK Financial Conduct Authority’s (FCA) landmark 2017 review of the £7tn UK asset management industry, new measures introduced by the UK regulator and due to be in place by September 2019, aim to ensure asset managers act in the best interest of investors. In April 2018, the U.S. Securities and Exchange Commission proposed Regulation Best Interest, where a broker-dealer is required to act in the best interest of a customer when making a recommendation, and may not put its financial interests ahead of the customer’s interests. Managers will need to ensure that they can provide open and transparent evidence of funds’ value-for-money.

But there is more to this picture than MiFID II, PRIIPs and some FCA pronouncements. EMIR, AIFMD and the ongoing ESMA directives are also contributing to the pressure for fund managers to review their modus operandi, to bring costs down for the investor, to make those costs more transparent and, ultimately, to improve value for investors.

The industry has responded by aggressive cost management initiatives and outsourcing. It is clear though that it isn’t enough.

**CHALLENGING THE INDUSTRY’S PRICING PRINCIPLE**

With the index-fund market, including ETFs, continuing to attract a large share of the investor pie, mainstream active managers are looking for ways to better align investor appetites for low-cost Beta with managers’ interests in providing higher value and premium fee products. According to a growing number of active fund managers, there is no better way to do this than by challenging the industry’s most fundamental pricing principle: the traditional flat-rate management fee.

The world’s largest pension fund, Japan’s Government Pension Investment Fund (JGPI), is one of the vanguards of this movement. JGPI is shifting from an AUM- to performance-based remuneration system for the external, active fund managers it employs.

Last October, Fidelity International, the £301bn AUM asset manager, unveiled a new ‘fulcrum fee’ on its retail funds that will charge less when investments underperform. Earlier this year, Fidelity then revealed it is also mulling over introducing ‘time-based’ loyalty discounts for clients who stay invested for longer.

Orbis Investments demonstrated a distinctive approach. It charges no management fees, but half of its funds’ benchmark-plus gains are paid into a reserve, from which it takes its fee. When the funds underperform the index, the reserve pays a refund to investors.

Last year, Baillie Gifford cut management fees on 20 of its active funds. And in March this year, JPMorgan Asset Management announced it was cutting the charges on its UK funds and switching from a fixed expense model to a variable one.
THE HIDDEN CHALLENGES OF PERFORMANCE BASED FEES

THE NEED FOR A FLEXIBLE INFRASTRUCTURE AND HIGHLY CONFIGURABLE, BEST-OF-SUITE SOLUTIONS

One of the main findings of the FCA’s 2017 asset management market study was that institutional investors such as pension funds and insurers found it difficult to get the necessary cost information to make effective decisions. This is unsurprising as most asset management firms struggle to understand their own costs at a portfolio or fund level.

As product line-ups, fund structures, investor bases and geographies expand, and variations in fee schedules and structures continue to evolve, active fund managers must look beyond the shop window. They must consider which solutions they will need to ensure they have the flexibility to respond to these innovative structures and fee schedules.

At a technology infrastructure level, a high degree of flexibility will be required to support these changing requirements and ensure regulatory compliance.

Some firms end up with multiple finance systems, trading platforms and data warehouses that they must reconcile at an ever-increasing cost. In this quest to become more nimble and cost-effective, Heads of Technology and Operations are looking to consolidate their technology infrastructure with highly configurable, best-of-suite solutions.

The good news is that with the right fund products, and the right systems and processes to support them, active management is proving that it is still competitive and can continue to be an essential destination for investor’s capital.
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