2 CHANGING DYNAMICS OF ASSET MANAGEMENT IN THE UK: TOWARDS A NEW MAINSTREAM?

KEY FINDINGS

The asset management industry is entering a period of accelerating change encompassing six key themes. Some are particular to the UK market, but others reflect trends seen elsewhere in Europe and the rest of the world:

1. **An evolution in the investment ecosystem.** The number of companies listed on public markets has reduced in the last decade, notably in the US and to a lesser extent in the UK and mainland Europe. At the same time, there has been increased interest in private markets as asset managers have expanded into real assets such as infrastructure.

2. **An increasing emphasis on responsible and sustainable investment.** Investment remains dominated by the larger DB pension schemes but growing numbers of younger people saving in pensions as a result of automatic enrolment suggests that responsible investment could grow significantly in popularity. Although negative screening dominates dedicated responsible strategies, asset managers are incorporating ESG criteria into their mainstream investment strategies.

3. **An ongoing change in product demand**. Over the last decade there has been a shift in asset allocation out of traditional equity and fixed income into more solutions-focused strategies including liability-driven investment, infrastructure and direct lending. In the institutional market this shift has been fuelled by interest from DB pension schemes and insurance companies looking for investments that offer ways to more closely match their future liabilities.

4. **Rapid technological change**. Technology continues to be a fundamental element in changing how asset management firms serve their wide range of investors. Three key areas are:
   - improving the efficiency of back office systems such as transaction processing.
   - using big data to improve decision making and achieve better investment outcomes.
   - enhancing the investor experience and making investment easier than ever for the individual by facilitating access to funds through a variety of media.

5. **Diverse patterns of corporate M&A activity.** Mergers and acquisitions are still ocurring between traditional asset management firms but asset managers are increasingly diversifying their capabilities into other areas including private markets, technology or provision of advice. They are also exploring ways to improve their distribution capabilities either directly to end investors or by strengthening their relationships with platforms and financial advisers.

6. **A significant regulatory and policy focus on the industry**.The regulatory and policy environment continues to reflect a mixture of challenge and opportunity for the industry in the UK and globally. Value delivery for customers is a key theme, alongside an ongoing look at the industry's wider role from a financial stability perspective.

The asset management industry is entering a period of accelerating change. Six key themes are identified and discussed in this chapter. Some are particular to the UK market, but others reflect trends seen elsewhere in Europe and the rest of the world:

1. **An evolution in the investment ecosystem** that has seen an increasing emergence of private markets, particularly in the context of wider expectations of market-based finance in the post-2008 environment.

2. **An increasing emphasis on responsible and sustainable investment**, as a result of tangible threats from environmental damage and broader socio-political concerns to ensure a more inclusive and accountable capitalist model.

3. **An ongoing change in product demand** towards greater solution and outcome-based investment strategies.

4. **Rapid technological change**, which has the potential to transform every aspect of the asset management value chain, from capital markets through to fund products and retail distribution. The flipside of this innovation is an ever more complex set of risks in terms of cyber security.

5. **Diverse patterns of corporate M&A activity**, which are seeing both horizontal and vertical consolidation as some asset managers deepen their capabilities in the advisory and distribution space.

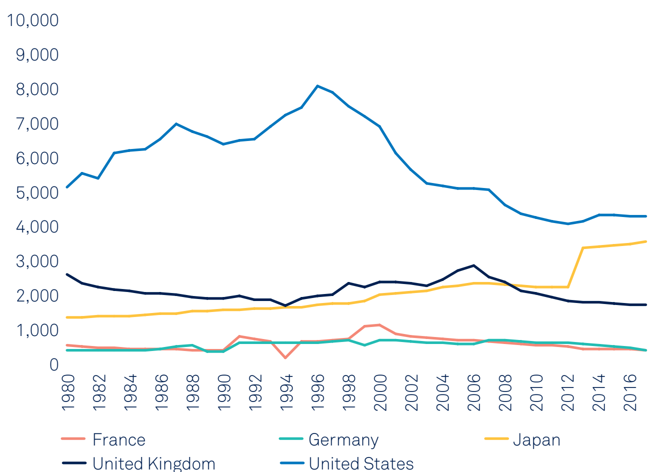
6. **A significant regulatory and policy focus on the industry**, with a key theme of value delivery for customers, alongside an ongoing look at its wider role from a financial stability perspective.

1. EVOLUTION IN THE INVESTMENT ECOSYSTEM

PUBLIC VS PRIVATE MARKETS

The number of listed companies in many of the key public markets for UK asset managers has fallen in recent years. Chart 6 shows the fall is most significant in the US, where numbers are almost half what they were in the late nineties.

CHART 6: NUMBER OF LISTED DOMESTIC COMPANIES IN TRADITIONAL MARKETS[10]



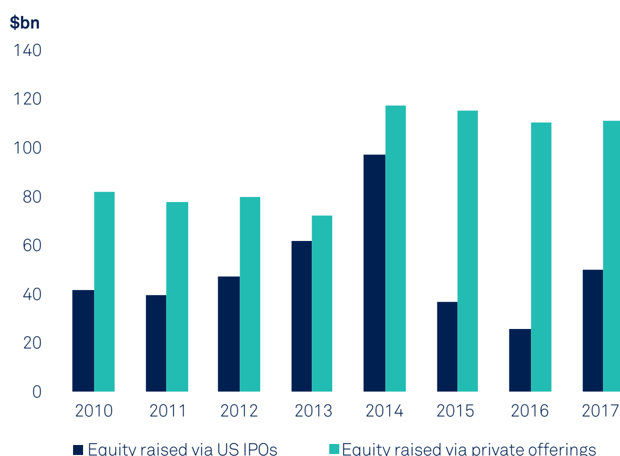
Source: World Bank, LSEG

Much of the decline in the number of public companies in the US since the mid-nineties is related to the number of business failures and delistings following the dot.com bubble. It has become more stable since the financial crisis of 2008 but in an environment where the number of companies overall is increasing, it suggests that many of today's new companies have chosen to grow outside the public equity market raising capital in many forms such as venture capital, private equity or debt financing (see Chart 7). Companies listing publicly in the US more recently have tended to be more mature in contrast to the prior boom-bust cycles.[11]

[10] Listed domestic companies, including foreign companies which are exclusively listed, are those which have shares listed on an exchange at the end of the year. Investment funds, unit trusts, and companies whose only business goal is to hold shares of other listed companies, such as holding companies and investment companies, regardless of their legal status, are excluded.

[11] Looking behind the declining number of public companies. An analysis of trends in US capital markets, EY, 2017

CHART 7: EQUITY RAISED VIA US IPO VS EQUITY RAISED VIA PRIVATE OFFERINGS[12]



Source: Professor, Hal S. Scott, Nomura Professor and Director of the Program on International Financial Systems (PIFS), Harvard Law School, U.S.A

Europe has experienced a similar trend. In the UK, numbers have fallen to less than two thirds of the figure they were just over a decade ago. Markets in continental Europe have not experienced drops of this scale, but nevertheless the trend has clearly been downward in the last ten years.[13]

Looking specifically at the UK, there are ever more companies. At the end of 2017, four million companies were on the Companies House register compared to 3.4 million in 2014. A large number of these will be extremely small, but many firms appear to be choosing not to list on public markets. Reasons for this may include:

- the increased burden of registration
- tougher corporate governance and transparency regulations
- debt becoming a more attractive way of raising capital than equity

The reduction in the size of traditional public equity markets has occurred alongside the shift into more diversified assets among IA members. Part of this has been a notable increase in the demand for real assets in recent years from institutional investors looking for alternative sources of yield and diversification. The growing involvement among IA members in infrastructure investment (£40 billion at the end of 2017) has already been explored (see page 22).

At the same time, asset managers are exploring investment opportunities in the loan market as bank involvement has decreased following the financial crisis. A number of IA members are now engaging in direct lending and members reported around £31 billion in assets under management in direct lending vehicles at the end of 2017. Around one fifth of this (£6 billion) was reported to be in private placements, which involve the sale of securities to a relatively small number of institutional investors, with the remainder being in a variety of arrangements such as commercial real estate finance, structured finance and other private loans and mortgages.

The market has seen the start of a number of new direct lending funds in recent years. Increased competition has led to some reports of the need for investors to move down the credit spectrum in order to achieve the returns they are looking for.[14] Nevertheless, members frequently mentioned private markets as one of the most likely growth areas for the next twelve months. Reasons behind the attraction of private markets included the search for returns relatively uncorrelated to the mainstream asset classes and the continuing appetite for attractive levels of yield now not possible in more traditional sectors.

"IF YOU LOOK AT THE INSTITUTIONAL SPACE THERE IS MASSIVE DEMAND FOR PRIVATE MARKET INVESTMENTS. IT'S PROBABLY THE MOST DEMANDED CATEGORY THAT WE HAVE, WHETHER IT'S INFRASTRUCTURE, REAL ESTATE OR PRIVATE DEBT. THAT TREND WILL CONTINUE."

[12] Contribution to Panel 4 discussion IOSCO Annual Conference, Professor Hal S. Scott, 2018. Full presentation available on the IOSCO website.
[13] Listed domestic companies, World Bank Open Data
[14] Revisiting Direct Lending. KPMG investment advisory, April 2018

ROLE OF ASSET MANAGERS IN FUNDING SMES

The UK asset management industry has long directed investment towards smaller firms via small cap equity markets. While starting from a lower base, since 2008 funds under management in the IAs UK Smaller Companies sector have increased by 270% to £16 billion, compared to an increase of 130% for the UK All Companies sector (to £173 billion).

Furthermore, after the financial crisis, the contraction of bank lending led to the emergence of asset managers as a significant source of capital for companies looking for private investment. One of the beneficiaries of this has been small and medium sized enterprises (SMEs). Investment in this size of enterprise lies outside the scope of many IA members, and some felt quite strongly that the industry is an allocator of capital rather than a provider of funding.

There are a range of challenges in investing in SMEs for asset management companies, affecting availability to both institutional and retail investors. These are currently being explored in the UK under the auspices of the Patient Capital Review, as well as the Investment Management Strategy II.[15] Issues for the asset management industry relate to both the demand and supply side, and include:

- Ensuring that fund structures can be adapted to less liquid investment (an issue not just for the SME part of the market, but illiquid assets more generally).
- Scalability for funds, where the challenge of finding suitable companies to invest in may become evident at relatively low levels of assets under management.
- A lack of customer demand in parts of the market, particularly in DC default arrangments, where there is sometimes a lack of familiarity with the asset class amongst trustees.[16]

Nonetheless, a number of IA member firms are actively developing expertise in this part of the economy, not least via some of the direct lending funds referred to on page 27. As with other private assets, appetite from insurance companies and pension funds is high.

"IF THE QUESTION IS CAN ASSET MANAGEMENT PLAY A NEW ROLE IN ALLOCATING CAPITAL TO SMES WHERE PREVIOUSLY IT HAD BEEN DONE BY THE BANKS?, THE ANSWER HAS TO BE YES."

It was also mentioned that asset managers could assist on an ongoing basis by using their expertise to help smaller companies to continue to grow and succeed in a sustainable way.

"IT'S OFTEN THE PROVISION OF EXTERNAL ADVICE AND GUIDANCE THAT GETS COMPANIES THROUGH THE DIFFICULT PERIOD WHERE THEY ARE GROWING INTO SOMETHING MORE SIZEABLE. THE ASSET MANAGEMENT INDUSTRY HAS A ROLE TO PLAY IN THAT TERRITORY."

[15] The UK Investment Strategy II, HM Treasury, 2017. See chapter 7
[16] Putting Investment at the Heart of DC Pensions, IA position paper, 2018.

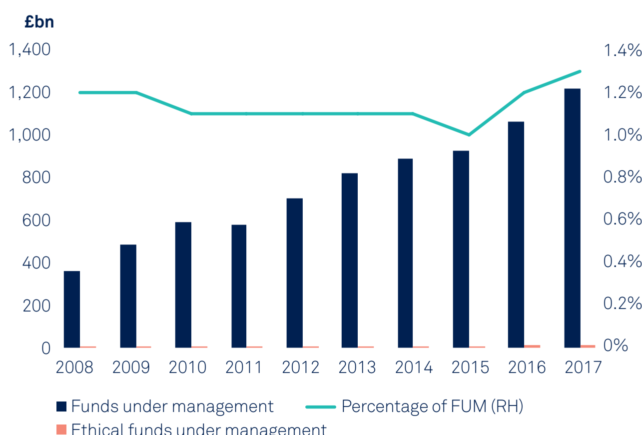
2. INCREASING EMPHASIS ON RESPONSIBLE AND SUSTAINABLE INVESTMENT

Recent years have seen an increased emphasis on responsible and sustainable investment. This has resulted, in part, from the global threats from environmental damage, but also from broader socio-political concerns, which have led to demands of greater accountability and scrutiny on how companies are run and their impact on wider stakeholders beyond measures of pure price valuation.

There are different ways to measure the value of assets managed according to these criteria, with varied terms including: ethical, sustainable, socially responsible, Environmental, Social and Governance (ESG).

IA monthly fund statistics suggests that investment into UK funds traditionally categorised as 'ethical' has remained proportionately unchanged in the last decade (1.3%), although there are some signs of an uptick in the last two years – see Chart 8. This difference likely reflects the narrow definition of the 'ethical' flag.

CHART 8: NET RETAIL SALES OF ETHICAL FUNDS AS A PERCENTAGE OF FUNDS UNDER MANAGEMENT (2008-2017)



This is consistent with our discussions with member firms, which suggested that dedicated ESG investment remains primarily the domain of the larger pension schemes, most frequently those in northern Europe.

However, a range of shifts in Government and societal attitudes in the UK are starting to change the approach to responsible and sustainable investment:

- Following a report from the Law Commission, the Government is consulting on stronger requirements for pension scheme trustees in considering and reporting on ESG issues, something which the FCA intends to mirror for Independent Governance Committees (IGCs) in insurance-run DC schemes. The proposals also include broader stewardship.
- There is an increasing body of evidence that younger people may prioritise ESG investments. With the advent of pensions automatic enrolment (see page 56), this could over time drive much greater pension scheme focus on these issues, as well as having a wider impact in the UK retail fund markets.

As well as implementing dedicated bespoke strategies asset managers may implement ESG principles within mainstream investment in a number of ways, including:

- Actively engaging with companies to promote good practice to reduce investment risk. In 2017 the IA found that nine in ten asset managers carried out active engagement with the companies they invest and almost two thirds reported that engagement with UK companies resulted in better investment decisions.[17]
- Taking them into consideration to ascertain their impact on company valuations so as to deliver improved investment outcomes for clients, rather than taking a moral view on the suitability of an investment, although whether the two are separate is not clear cut.

"THE VALUATION AND MORAL QUESTIONS ARE LINKED BECAUSE RETAIL CUSTOMERS WILL NOT END UP DOING BUSINESS WITH THOSE COMPANIES IF THEY THINK THEY ARE A NEGATIVE INFLUENCE."

[17] Stewardship in Practice Asset Managers and Asset Owners, The IA/PLSA, September 2016

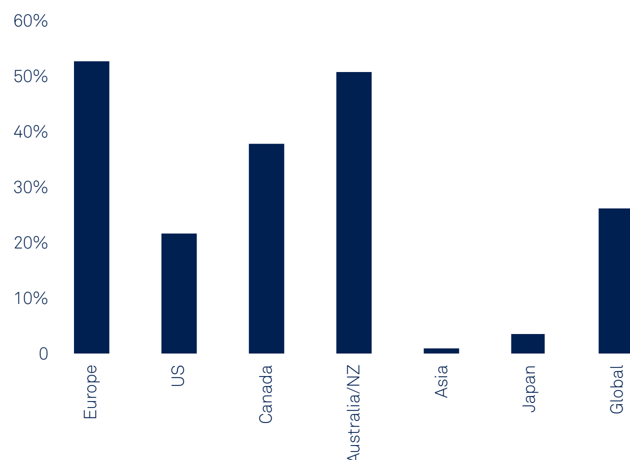
In a world where the stewardship responsibilities of asset managers are increasingly in the spotlight, some firms might consider all their assets under management as being managed according to ESG criteria. Other firms would only consider ESG strategies to apply to a dedicated set of funds or mandates with customised investment approaches.

The Global Sustainable Investment Alliance (GSIA) reported that $23 trillion of assets are being managed according to responsible investment strategies around the globe.[18] This incorporates assets being managed according to a wide range of strategies including:

- Negative/exclusionary screening
- Positive/best-in-class screening
- Norms-based screening
- Integration of ESG factors
- Sustainability themed investing
- Impact/community investing, and
- Corporate engagement and shareholder action.

Within Europe, the GSIA suggests that more than half of the assets managed in Europe are managed according to SRI criteria (see Chart 9).[18]

CHART 9: PROPORTION OF SRI RELATIVE TO TOTAL MANAGED ASSETS IN 2016



Source: Global Sustainable Investment Alliance

This mixed approach to interpretation makes it difficult to determine what is motivating investors, and how they are choosing to apply their own beliefs and values to their choice of investment strategy and work is ongoing nationally and internationally to provide greater clarity (see Box 2).

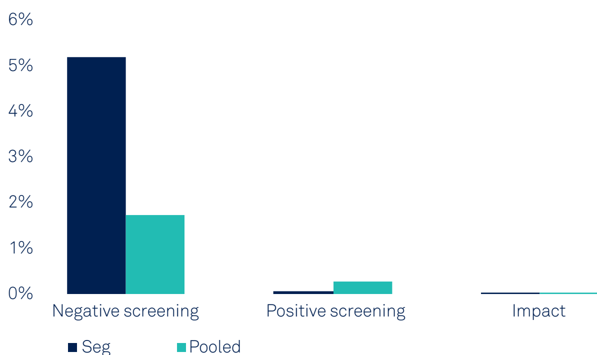
The Survey therefore approached this subject slightly differently in 2017 and asked members to provide a total figure for investment according to any ESG criteria, but, more specifically to report mandates and funds that were managed according to the following criteria:

- **Negative screening.** An approach where the investor avoids investing in businesses that are harming people or the planet, such as oil, tobacco, or weapons production. This can be motivated by seeking to protect financial value by limiting exposure to risky practices, and / or ethical concerns.
- **Positive screening.** This approach seeks to enhance value by proactively screening for businesses that are seeking to work for the benefit of all their stakeholders, not just shareholders or owners.
- **Impact-driven investment.** Impact investments are those that help to solve pressing social or environmental challenges, as well as generate a financial return. This includes 'social investment', (investment in regulated social sector organisations, such as charities and social enterprises) as well as investment in regular profit-seeking business that are also helping tackle a societal challenge.

Approximately 7% of assets in total across pooled and segregated investments were managed by screening out companies according to responsible investment criteria. A further 0.4% of assets were managed by positively screening investments according to sustainable investment criteria. Levels of investment according to impact-driven criteria were at extremely low levels, albeit there is growing interest from government for asset owners to become more actively involved this area (see Chart 10).[19]

[18] Global Sustainable Investment Review, 2016, GSIA
[19] Growing a Culture of Social Impact Investing in the UK, Independent Advisory Group, 2017

CHART 10: DEDICATED INVESTMENT ACCORDING TO SPECIFIC ESG CRITERIA



The adoption of screening strategies is becoming increasingly mainstream and there have recently been a number of high-profile announcements from asset management firms. For example, in November 2017 BNP Paribas Asset Management announced it would divest from tobacco stocks altogether.[20]

"IN FIVE YEARS' TIME IT'S NO LONGER GOING TO BE ACCEPTABLE TO INVEST IN A NUMBER OF LISTED COMPANIES. ESG WILL BECOME COMPLETELY EMBEDDED INTO EVERY ASSET MANAGEMENT BUSINESS."

This contrasts with the view of some of those interviewed this year, who considered that it was the decision of the asset owner whether or not to exclude investment in specific stocks or sectors, rather than something that should be imposed upon them by an asset manager.

"AT THE END OF THE DAY CLIENTS GIVE US CONSTRAINTS AND OBJECTIVES AND THEN IT'S OUR JOB TO MANAGE TO THOSE OBJECTIVES AND CONSTRAINTS TO GENERATE THE BEST PERFORMANCE WE CAN."

Others felt that having a strong approach to ESG investment, as part of a mainstream strategy, made their service more saleable and attractive to investors even when those investors were not be looking to impose specific value-driven constraints.

[20] BNP Paribas announces new measures regarding the financing of tobacco companies, November 2017

BOX 2: SUSTAINABILITY AND RESPONSIBLE INVESTMENT

Never before has there been a greater focus on the impact that the asset management industry has on society and planet. From governments, to the media to investors, there is growing demand for the asset management industry to turn a lens on itself and consider its role in the transition to a more sustainable economy.

At national and international level, major policy developments are taking place, including the European Commission's Sustainable Finance Package. This package, through which the Commission seeks to connect finance with the needs of the European economy and the EU's agenda for sustainable development, was published on the 24 May 2018 and includes proposals on:

- A taxonomy for sustainable finance
- Harmonised disclosures on the integration of sustainability risks and relating to sustainable investments
- Amendments to the MiFID II Suitability Assessment to take account of ESG preferences
- Amendments to the Insurance Distribution Directive also to take account of ESG preferences
- Introduction of low carbon and positive carbon impact benchmarks

In particular, the proposal for a sustainable finance taxonomy cuts to the heart of a key stumbling block with respect to the growth of sustainable and responsible investment – the lack of common language. Supporting the development of common language is a key priority for the asset management industry.

Domestically, a Taskforce for growing a culture of social impact investing in the UK – a collaborative approach between Government and industry – is focusing on ways of boosting social impact investment and identifying how to attract capital to contribute to solutions to social problems. A further UK-based initiative, bringing together public and private sector, is the Green Finance Taskforce that is looking for ways to mobilise capital on the scale necessary to meet the two degrees or less scenario agreed in Paris 2015.

3. ONGOING CHANGE IN PRODUCT DEMAND

Product demand among UK clients over the last ten years has shifted in two key ways related to client objectives, which we cover in more detail through Chapters 3-5:

- Greater demand for yield, both in the retail and institutional market, in the context of a low interest rate environment.
- Greater demand for outcome-oriented strategies. Examples include LDI in the institutional market to absolute return and volatility controlled funds in the retail market.

This has been reflected in asset class diversification, partly to provide access to yield (eg. infrastructure, direct lending) and partly to deliver outcome-oriented strategies. A particular driver here is the demand from pension schemes and insurance companies looking to manage their liabilities and match their cash flow requirements.

The combined effect has been to produce an evolution in asset allocation away from traditional equity and fixed income into a range of assets such as:

- Infrastructure
- Derivative overlay strategies
- Private equity
- Direct lending
- Hedge funds

"THE GREATEST CHALLENGE AND OPPORTUNITY ARE BOTH IN THE SAME SECTOR. A NUMBER OF FIRMS HAVE GOT INVOLVED IN REAL ASSETS. THERE IS HUGE DEMAND FROM PENSION FUNDS THAT ARE TRYING TO HEDGE LIABILITIES. THE GREATEST CHALLENGE IS THE ORIGINATION OF THE ASSETS THAT ARE GOING TO INTEREST THESE CLIENTS. YOU ARE NOT JUST WANDERING ONTO THE STOCK EXCHANGE TO BUY THESE ASSETS. YOU'VE GOT TO GO AND LOOK ACTIVELY FOR THEM. SO THAT'S PROBABLY BOTH THE GREATEST CHALLENGE AND THE GREATEST OPPORTUNITY."

The search for outcome-oriented solutions more widely is expected to continue in both the institutional and retail space. Multi asset and other outcome-oriented solutions are likely to benefit from this demand, particularly in the growing market associated with the drawdown of DC pensions in retirement. As the population continues to age people will remain invested into older and older ages, adding to the demand for products that deliver income with an element of downside capital protection.

"INCOME IS THE KEY WORD AND WHETHER IT IS IN MULTI-ASSET OR IN PROPERTY, FIXED INTEREST OR EQUITY, INCOME IS WHERE THE ACTION WILL BE FOR THE NEXT GENERATION."

4. RAPID TECHNOLOGICAL CHANGE

Technology is increasingly central to industry delivery, from trading to managing risk, back office operations and customer service. Harnessing technological innovation continued to be a priority for those we interviewed for the Survey this year.

"IF YOU THINK ABOUT SOME OF THE MORE COMPLICATED PROBLEMS LIKE TRADING, PUTTING PIECES OF ARTIFICIAL INTELLIGENCE IN TO DETERMINE THE RIGHT ALGORITHM FOR A PARTICULAR TRADE IS A TRANSFORMATIONAL IMPROVEMENT IN PRODUCTIVITY. CUSTOMERS WILL GET A MUCH BETTER OUTCOME."

"TECHNOLOGY ALLOWS YOU TO FIND OUT WHAT COMPANIES ARE REALLY DOING, INCLUDING FACTORS SUCH AS HOW THEY TREAT THEIR STAFF. IT IS OFFERING US OPPORTUNITIES TO GET MORE DATA ON WHAT GOOD LOOKS LIKE."

There were three areas where technology was considered to be particularly important:

Improving the efficiency of back office systems such as transaction processing. At the cutting edge, this could extend to the use of approaches such as blockchain in transaction processing. 2017 saw the first use of a blockchain-based platform to purchase funds.[21] This process of change is expected to accelerate significantly.

Using big data to improve decision making and achieve better investment outcomes. This might include using information about individual customers for more targeted marketing and to create products that can be customised to a degree that was not possible in the past. From an investment perspective it might also include the use of market data not previously available to help improve investment management strategies. This will likely require the automation of data analysis, with the more detailed information either being used to feed into more sophisticated factor-based quantitative strategies in the smart-beta environment, or to inform the investment decision making of fund managers responsible for active strategies.

Enhancing the investor experience. When it comes to the use of technology in communicating with the end consumer there was still a strong sense among some of those interviewed that when people are investing their own money, even where the amounts are relatively small regular payments, they often want a human connection. It was felt that this was the case even with younger investors who are more technologically confident. Nevertheless a plethora of app-based investment platforms have appeared from the FinTech sector in recent years which aim to meet a range of investor needs, including:

- Allowing individuals to access investments normally only available to institutions (e.g. corporate bonds).
- Amalgamating robo-advice with fund investment, often via ETF investment, with varying choices of ongoing management tailored to cost.
- Analysing spending habits and saving according to the amounts individuals can afford.
- Offering investment portfolios to individuals with lower barriers to entry than would normally be available.
- Rounding up purchases and saving the difference into stocks and shares ISA.
- Facilitating crowdfunding for seeding new businesses.

[21] Natixis AM completes blockchain transaction in fund distribution Investment Europe, July 2017

The speed at which technology is transforming the asset management industry creates opportunities for asset managers to differentiate their business, but also introduces a new type of operational risk, namely cyber security risk. Firms emphasise the extent to which the potential cyber security risks need, as a matter of priority, to be understood, managed and mitigated. In some cases this will require new and innovative approaches to security controls.

Cyber-attacks are most likely to come from organised crime groups or from a malicious insider. Risks can materialise across the entire value chain of an asset manager, including risks to client data processed by third party administrators and custodian banks.

There are key actions which help build an effective cyber security capability.

- Boards engaging fully, having an understanding of cyber security issues, and establishing clear accountability for action.
- Developing technical ability and processes to detect, respond and recover from incidents; and cyber security risks being managed effectively across the supply chain.
- Educating all employees around cyber security risks and good behaviours.

Effective collaboration across the industry can help create economies of scale and pooling of expertise that may be essential in managing this risk.[22]

5. DIVERSE PATTERNS OF CORPORATE M&A ACTIVITY

Investment management acquisition activity may take a variety of forms:

- Outright purchase and rebranding by the new parent of the acquired firms product set.
- A 'multi-boutique' approach where individual brands co-exist and compete with a shared set of common resources provided by a parent company.
- Variations of the above, where groups contain distinct brands with their own separate operations.
- Purchase of specific capabilities through the lift-in of investment teams from rival companies, which some see as much more efficient than purchasing an entire company, which was likely to come with a number of unwanted elements.

Figure 9 shows recent examples of M&A activity with more historic detail in Appendix Four. Purchases of, or mergers with, other asset managers remain the most common type of transaction. However, a number of other themes can be seen, including:

- Access to distribution
- Enhanced private market expertise
- Greater ETF capability
- DFM / advisory focus
- Stronger technological capability
- Private equity / asset manager deals

The distribution theme reflects the reality that the retail funds market in the UK remains heavily intermediated. The key routes to market are:

- Non advised sales either direct to the investor or via a fund platform
- Fully advised sales via financial adviser.

[22] Building cyber resilience in asset management, IA/KPMG, 2018

FIGURE 9: NOTABLE M&A ACTIVITY DURING 2017-2018

ASSET MANAGEMENT CONSOLIDATION

Acquirer	Purchase
Amundi Group	Pioneer Investments
Crux Asset Management	Oriel global and European funds from City Financial
Federated Investors	Hermes Investment Management (majority stake)
Franklin Templeton	Edinburgh Partners
FundRock	Fund Partners
Impax Asset Management	Pax World Management LLC
Natixis Global Asset Management	Investors Mutual Ltd
Nikko Asset Management	ARK Investment Management (minority stake)
RWC	Pensato Capital
Standard Life Investments	Aberdeen Asset Management (merger)

ETF CAPABILITIES

Acquirer	Purchase
Invesco	Source
LGIM	Canvas
WisdomTree	ETF Securities (range of capabilities)

PRIVATE MARKET EXPERTISE

Acquirer	Purchase
BlackRock	First Reserve Energy Infrastructure Funds
Candriam	Tristan Capital Partners (strategic partnership)
Principal Global Investors	Internos Global Investors
Sandaire	Joint venture with Delancey
Schroders	Adveq Holdings AG
	Alonquin
Stonehage Fleming	OmniArte

DISCRETIONARY / ADVISORY FOCUS

Acquirer	Purchase
7IM	Tcam
Brewin Dolphin	Duncan Lawrie Asset Management
Close Brothers	Adrian Smith and Partners
SJP	HJP Independent Financial Advisers
Thesis Asset Management	Cambridge Fund Managers

TECHNOLOGY CAPABILITIES

Acquirer	Purchase
BlackRock	Cachematrix Holdings
	Scalable Capital (minority stake)
BNP Paribas Asset Management	Gambit Financial Solutions (majority stake)
Nomura Asset Management	8 Securities (majority stake)

BROADER M&A ACTIVITY

Acquirer	Purchase
Canada Life Group (UK)	Retirement Advantage
Link Group	Capita Asset Services
Lovell Minnick Partners/Existing Management Team	BNY Mellon Investment Management (CentreSquare Investment Management Real Asset Boutique)
Swiss Re	L&G mature savings business
TA Associates	Old Mutual Global Investors (single strategy funds)

Advised sales continue to account for the majority of sales to UK investors. However, the use of platforms is growing and asset managers are increasingly considering how best to reach retail customers.

Those interviewed for this Survey believed that the greatest change in the next few years is likely to be in the nature of distribution. Scale continues to be important in the context of fee compression and increasing regulatory complexity. Consolidation activity may lead to a smaller number of very large managers with significant distribution capability, whether within the group or through third party relationships.

"IN THREE YEARS' TIME, IT MIGHT NOT HAVE CHANGED THAT MUCH BUT IN TEN YEARS IT PROBABLY WILL HAVE CHANGED RADICALLY. YOU'LL HAVE A NUMBER OF VERY BIG FUND MANAGEMENT BUSINESSES WITH GREAT ACCESS TO DISTRIBUTION IN AREAS LIKE WORKPLACE PENSIONS OR WEALTH CHANNELS. THE MODEL OF A FUND MANAGER JUST BEING BRILLIANT AT WHAT THEY DO AND EXPECTING THAT OPEN ARCHITECTURE PLATFORMS WILL FIND THEM MIGHT CHANGE. THEY MIGHT HAVE TO BE CLOSER TO THE DISTRIBUTORS WHO INFLUENCE GUIDED ARCHITECTURE SO THAT THEY GET THEIR PRODUCT PUSHED THROUGH THE RIGHT PIPES."

"I THINK THE DISTANCE BETWEEN ASSET MANAGERS AND INVESTORS MAY HAVE INCREASED IN THE LAST TEN YEARS, BE IT PLATFORMS OR OTHER INTERMEDIARIES. THAT MAKES OUR JOB AS FUND MANAGERS INCREDIBLY DIFFICULT BECAUSE SOMETIMES YOU'RE HAVING CONVERSATIONS WITH THREE PEOPLE BEFORE YOU ACTUALLY GET TO THE PERSON THAT OWNS THE PRODUCT. SO I DO THINK THAT WHETHER THROUGH CONSOLIDATION OR PARTNERSHIP, ASSET MANAGERS NEED TO GET CLOSER TO THE CLIENT AND THERE MAY BE MORE INTEGRATED DISTRIBUTION."

There is likely to be continued blurring of roles as this consolidation continues, with asset managers playing a greater role in distribution and distributors moving ever more into the area of asset allocation. It is also not yet clear where advice will fit into the future delivery model.

Although a growing proportion of investors may no longer seek financial advice from traditional sources, the need for advice is likely to grow in a world of multiple employments, pension freedoms and varied savings habits.

"ADVICE WILL NOT GROW BACK TO THE LEVELS PRE RDR, BUT IT IS NOT GOING TO DISAPPEAR. MORE AND MORE PEOPLE NEED THAT TOUCH POINT. IT'S HOW TO DO IT AT A COST EFFECTIVE PRICE THAT IS THE TRICKY BIT. IT ALWAYS LOOKS GOOD WHEN YOU SAY ROBO-ADVICE, BUT IT ONLY GETS SO FAR. MANY PEOPLE'S PORTFOLIOS ARE COMPLICATED. THEY HAVE SEVERAL PENSIONS, ONE HERE, ONE THERE. SOMEONE MAY HAVE LEFT THEM SOME MONEY. IT'S JUST NOT SOMETHING YOU CAN PLUG INTO A MACHINE THAT EASILY."

6. SIGNIFICANT REGULATORY AND POLICY SCRUTINY

The regulatory and policy environment continues to reflect a mixture of significant challenge and opportunity for the asset management industry, both in the UK and globally. Figure 10 shows how the questions about the role played by the asset management industry fall broadly into two categories – first, delivering for customers; second, serving the broader economic system.

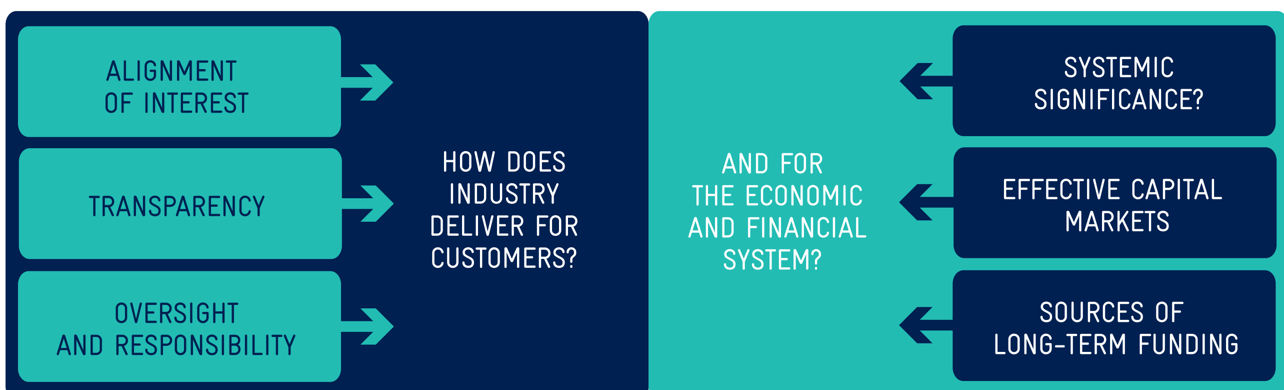
Broadly, policymakers and regulators are asking:

- How can the value of asset management to its customers be demonstrated, broadened and maximised?
- How can the needs of the broader economy be met from asset management activity (directly through market-based finance and effective capital markets, or more indirectly through minimisation of systemic risk)?

Compared to the very different operating context of the 1980s and 1990s, these questions reflect a number of factors:

- Weakened traditional sources of finance, notably banks and Government.
- Increasing individual dependence on financial markets for life-time savings needs (particularly in the context of automatic enrolment in the United Kingdom post-2012).

FIGURE 10: REGULATORY OVERVIEW



- Subdued economic growth, declining productivity and constrained wages.
- Lower equity market returns since the end of the dot com bubble of the late 1990s.
- Significant regulatory worries about further destabilisation emanating from within the financial system following the 2008 global financial crisis.

EU-LEVEL CHANGE: IMPACT OF MIFID II

Against such a backdrop, the industry has faced increased scrutiny in domestic, European and international regulatory and policy fora. Arguably the most significant, and certainly the largest, single regulatory initiative is MiDII II / MiFIR (see Box 3).

BOX 3: WHAT IS MIFID II / MIFIR?

Implemented on 3 January 2018, this provides the framework of EU legislation for investment intermediaries providing services to clients in relation to shares, bonds, units in collective investment schemes, derivatives and the trading of financial instruments. At a high level the Directive sets out Europe-wide conduct of business (COB) and organisational requirements for investment firms; authorisation requirements; regulatory reporting; transparency obligations; and rules on admission of instruments to trading.

The new regulation includes a range of themes that have come to define the post-2008 environment for financial services. A particular focus is greater customer protection through transparency and alignment of interest (eg. aggregation of fees and costs and prohibition of bundled research provision), and a focus on market behaviour that uses the tool of transparency (eg. pre- and post-trade disclosure requirements, transaction reporting) alongside harder constraints on aspects of investor activity (eg. volume caps).

PERSPECTIVES ON MIFID II

"MIFID II WAS A GOOD EXAMPLE OF HOW REGULATION CAN DRIVE POSITIVE CHANGE AND POSITIVE DEBATE WITH THE INDUSTRY. THE IMPLEMENTATION WAS CHALLENGING BUT IT MOVED US TO A WORLD WHERE WE CAN BE BETTER FIDUCIARIES TO OUR CLIENTS."

"MIFID II HAS BROUGHT A DEGREE OF FURTHER TRANSPARENCY FOR THE CLIENT WHICH IS A POSITIVE IN TERMS OF THE SEPARATION OF RESEARCH COSTS. HOWEVER, RESEARCH PROVIDERS NEED TO WORK OUT HOW TO CLEARLY PRICE RESEARCH. THAT REMAINS A BIG ISSUE."

"IT'S TOO EARLY TO TELL IF IT WAS WORTH IT. THERE IS QUITE A TIME LAG BETWEEN TRANSPARENCY AND THE IMPACT ON BEHAVIOURS SO I THINK TIME WILL TELL."

Asset managers interviewed for this survey felt MiFID II to have been a huge but generally manageable change process.

The scale and technical demands were emphasised by all participants, with respondents pointing to the challenge of complex internal project management as well as significant dependence on third party suppliers. For global firms, ensuring consistency across their business internationally was a particular issue.

The separation of research payments from execution was recognised to be one of the most significant outcomes from MiFID II. Firms were generally cautiously positive, but emphasised considerable uncertainties relating to future pricing and availability of research for some parts of the market – eg. smaller companies. Again, the challenge of international consistency is evident (see Box 4).

For some participants, it was clearly still too early to make a judgement on the overall outcome for markets and customers.

BOX 4: ASSET MANAGERS AFFECTED BY MIFID II RESEARCH RULES IN OVER A THIRD OF KEY NON-EU JURISDICTIONS

MiFID II has had a significant impact on arrangements for the receipt and payment of research requiring the complete separation of payment for execution and research. This new regulation not only affects activities within the European Union (EU), but also situations in which managers have delegated asset management activities to jurisdictions outside of the EU. A Global Survey on Payment for Research published by the IA in March 2018 provided information on whether separate payment for research is permitted in a range of non-EU jurisdictions. The Survey was intended to assist firms to implement the new research requirements across their global operations which may cover multiple legal entities.

Of the 33 jurisdictions covered in the Survey:

- Two jurisdictions did not permit hard payment – this included Indonesia and the United States. The United States is included in this category as the Securities and Exchange Commission's no-action relief letter is a temporary measure.
- Eleven jurisdictions permitted separate hard payment under certain conditions – this included Hong Kong, China, Bermuda, India and Brazil, amongst others.
- Twenty jurisdictions permitted hard payment for research, including jurisdictions such as Japan, Canada and Singapore.

From a customer disclosure perspective, MiFID II, combined with PRIIPs, represents a paradigm shift for the asset and fund management industry. There are three particularly significant elements of this shift:

- The inclusion of all transaction costs incurred during the investment process, both explicit (brokerage, taxes) and implicit (seen in the difference between buy and sell prices in different markets as well as market impact).
- The aggregation of all costs (including product charges, transaction costs and distribution charges) into a single number accounting for overall economic experience of monies invested.
- The replacement of past performance in point of sale retail disclosure in the PRIIP Key Information Document with a range of (future) performance scenarios.

While the industry has been strongly supportive of the move towards enhanced transparency across all products and services, teething difficulties with MiFID and PRIIPs have been particularly evident in the area of transaction cost reporting and the construction of performance scenarios. Here, opinions were generally quite critical of the methodologies being deployed, with particular concern about the outcome being greater complexity and opacity, rather than simpler information on costs and performance. These areas have already been the subject of a call for evidence by the UK regulator, the Financial Conduct Authority (FCA).

"I WANT TRANSPARENCY OF WHAT IS GOING ON. A SINGLE FIGURE FOR THE COST OF DEALING IN SECURITIES THAT INCLUDES MARKET IMPACT IS CHALLENGING BECAUSE THERE IS NO SINGLE MEASURE OF MARKET IMPACT. IT IS MUCH BETTER TO ACTUALLY TELL PEOPLE ABOUT THE VOLUME OF TRANSACTIONS: IE. HOW MUCH DEALING DOES A FUND DO. DO YOU WANT A FUND THAT TURNS ITSELF OVER TEN TIMES OR A FUND THAT HOLDS LONG TERM AND WHERE TURNOVER IS VERY LOW. THAT IS USEFUL INFORMATION FOR THE INVESTORS."

2

UK CONTEXT

In the UK market specifically, the FCA has financial services competition powers that are concurrent with those of the wider competition regulator, the Competition and Markets Authority (CMA). These have been increasingly exercised in recent years and as at summer 2018, the UK asset management industry was the subject – directly and indirectly - of three studies:

- FCA Asset Management Market Study (AMMS), in implementation phase.
- FCA Investment Platforms Market Study (IPMS), in interim phase.
- CMA Investment Consultants Market Investigation (ICMI), in interim phase.

The themes raised by the FCA in the AMMS focus fundamentally on value delivery with the remedies falling broadly into the three categories outlined in Figure 10:

- **Alignment of interest.** Strengthened duties are being placed on Authorised Fund Managers (AFMs) to act in the best interest of investors, in particular through the use of a published value assessment by AFM Boards. This borrows elements from the 15(c) process and the US Gartenberg Principles for 1940 Act mutual funds.[23] There are also more specific requirements, notably on box profits and legacy share classes.
- **Transparency.** The FCA reinforces the MiFID requirements (see above) with a significant emphasis on greater granularity in the UK institutional market[24]. It also calls for greater industry focus on clarity of objectives, use of benchmarks, and reporting of performance. As part of this focus, the UK industry is undertaking an initiative on clearer use of language across all fund documentation.
- **Oversight.** As part of the new emphasis on alignment, AFM Boards will be required to have at least two independent directors (or a minimum of 25% of total Board). These independent directors will have commensurate responsibilities at Board level, including the new value assessment.

The interim findings of the FCA IPMS, published on 16 July 2018, raised a number of comparable themes, notably:

- Transparency and comparability of different forms of platform fee
- Clarity of objectives, benchmarks and risk in model portfolios sold on platforms
- Treatment of 'Orphan clients', where customers may be paying advisory fees on a services no longer provided.

The CMA Provisional Decision Report, published on 18 July 2018, noted a weak demand side, with trustees relying heavily on investment consultants but having limited ability to assess their services, relatively low levels of concentration in both investment consultancy and fiduciary management, barriers to expansion restricting new consultants developing their business and vertically integrated models creating conflicts of interest.[25]

[23] A long-established U.S. legal standard to determine whether a mutual fund adviser has breached its fiduciary duty under Section 36(b) of the Investment Company Act by allowing a fund to charge excessive fees.
[24] Asset Management Market Study Final Report, 1.26: Remedies which will drive competitive pressure on asset managers. June 2017.
[25] See Appendix Three

STEWARDSHIP AND CORPORATE GOVERNANCE

Alongside the FCA Market Study, stewardship and corporate governance have continued to be key areas of UK policymaker and regulatory focus:

- **BEIS corporate governance reforms.** Through 2017, the Department for Business, Energy and Industrial Strategy (BEIS) completed an exercise designed to strengthen UK corporate governance and competitiveness, with three key themes: executive pay; employee and customer voice; and corporate governance in large private firms. As part of the BEIS package, the IA delivered a new public register on shareholder voting, aimed at increasing accountability and transparency of those listed companies that see significant shareholder dissent during the AGM season.

- **FCA supervisory focus.** In the spring of 2018, the FCA confirmed a new focus on stewardship as part of its supervisory activity. While this still remains to be defined in detail, it means the FCA now looks at asset managers through three lenses (role as good agents to their customers, good market participants and good stewards of investment).

With the intensifying focus on ESG, the stewardship and corporate governance themes are extending further in a number of ways. At Government level, the DWP has been consulting this year on new rules that will clarify and strengthen duties on pension scheme trustees to consider and report against ESG factors (to be mirrored by the FCA for Independent Governance Committees for workplace pension schemes).

BROADER ECONOMIC CONTRIBUTION

The emphasis on stewardship and corporate governance links to changing expectations of the role that the UK industry plays in the domestic economy. Although this starts from a relatively low base, this is particularly seen in increasing activity in corporate funding through private markets, and infrastructure funding (see page 26). Some of the areas within the economy are not historically associated with asset management activity, eg. social housing (see page 23).

At the same time, both UK and international regulators continue to look at a range of themes linking to the wider stability of capital markets and the economy. Following the property fund suspensions in the aftermath of the Brexit referendum, the FCA initiated a policy discussion about the wider issues raised. Although the FCA focus was particularly on customer impacts, it noted the wider relevance to the global debate on risks to the financial system. Notably, IOSCO has been focusing more closely on liquidity mismatch and the use of leverage in open-ended funds as these two issues were identified, among others, by the Financial Stability Board as structural vulnerabilities arising from asset management activities. Alongside this, the Bank of England has also been pursuing a range of initiatives to look at the wider issue of system vulnerabilities.