CHARGES » Wrap platforms were designed to make the life of an IFA easier, but they are actually one more additional cost

The next evolution in design

Architectural revolution: instead of saving, wraps increase the cost of accessing investment expertise

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With more funds available in the UK than companies listed on the London Stock Exchange, it would be reasonable to assume that the asset management industry is highly competitive and the need to differentiate would result in annual management charges being spread across a fairly broad range.

But recent Morningstar research illustrated how far from reality that is. Consider the facts: more than 60 per cent of UK domestic equity funds levy an annual management charge of 1.5 per cent as seen in the first chart. A simple explanation might be that 1.5 per cent merely reflects the optimum cost of production and delivery.

A brief look at international marketplaces suggests this is not the case. Morningstar conducted a similar review of US domestic equity funds and showed that while the average AMC was 0.75 per cent – half that of the UK – no price increment accounted for more than 27 per cent of funds, as seen in the second chart, a clear indication of a more competitive market.

There is no obvious reason why the cost of managing assets varies significantly between the two markets, which led Chris Traulsen, head of UK fund research for Morningstar, to conclude that UK fund managers are not operating in a fully competitive market. He said: "Further evidence of this has come over the past two years as large groups have raised their annual management charges. In some cases, the fee raises came in spite of poor performance at the firm's funds. When a company can raise the price of a clearly inferior offering, the system is broken."

But does price matter? It is an age-old question and it is certainly not the whole story when considering investment strategies, but investors and advisers are increasingly aware of the compounding effect of costs on returns. When this is combined with the difficulties advisers and investors have in identifying which actively managed funds will deliver consistent performance over time, what results is the increasing use of passive funds and ETFs – both of which allow flexible asset allocation and deliver consistent returns linked to transparent indices at low cost.

Actively managed funds continue to be in high demand, but they are increasingly coming under pressure to differentiate themselves from passive investment strategies. In the effort to do so, the profile of individual fund managers is higher than it has ever been and the marketing of more innovative strategies that cannot be replicated in passive funds has increased. But to continue to compete, costs must be reduced and clarity as to how the professional expertise of the fund manager is delivering returns above benchmarks demonstrated. To date, UK fund managers and distribution channels have not had the tools at their disposal to address this issue. That is about to change through the next evolution of platform technology, the separately managed account.

That's a wrap

Wrap platforms and the cost to the customer is an interesting issue. Wraps were designed to improve the life of the IFA by easing their administration burden, enabling more time to be spent on value-added tasks and less on non-productive administration. Wraps were not designed to directly reduce the cost of investment products to the customer. In fact, the reality is that in the vast majority of instances, wraps actually result in an increase in the cost of accessing managed investment expertise.

Why do platforms add cost to the client, not reduce it? The increase in cost comes from the fact that the current generation of fund supermarkets and wrap platforms are an inherently inefficient means of accessing managed investments. The platform, the fund manager and the custodian each undertake registry functions, creating unnecessary duplication and increasing cost.

This is where the SMA platforms come in. By purchasing the fund manager's intellectual property – the investment model - rather than units in their fund, and investing in the underlying assets directly, the SMA is able to bring together in one place the registry functions normally undertaken by the fund manager and platform. This also means that the fund managers are now left to do what they actually want to do: research and design investment products.

The fund manager no longer needs to directly manage unit administration and all those other tiresome back office functions involved in running a fund. Essentially they outsource this administration to the SMA provider, who also provides a reporting and analysis portal for clients and advisers, which enables the fund manager to concentrate on their key differentiating factors – performance and service. International experience tells us that fund managers will deliver their investment strategies inside SMA's for between 30 to 50 basis points – compared with 75bps for cost of accessing a traditional managed fund through a platform.

SMA platforms also deliver operational cost savings. Rather than each fund manager placing their own trades to market for each security, the SMA is able to net these transactions across multiple managers and models so that only one transaction for each security is put out to market. The effect is that as assets in the SMA increase, trading costs for individual clients begin to trend towards zero. Given that Lipper Fitzrovia estimates that portfolio turnover of 100 per cent per year equates to trading costs of approximately 1 per cent, and that a quarter of actively managed equity funds in the UK have annual portfolio turnover above 94.7 per cent, cost efficient trading can have a real impact on the net performance of the fund. The obvious question is why fund managers would provide their intellectual property if it means less revenue for them?

There are two reasons. Firstly, it can be quite a cost-efficient means to launch new funds and effectively outsource administrative functions. Secondly, the product is delivered through a platform which provides valuation, performance reporting and tax analysis that improves service to the investor.

Most importantly however, it provides fund managers with access to distribution, particularly attractive to the boutiques and smaller houses - whatever their performance or cost no product provider can survive without distribution.

Some of the larger and less innovative fund managers may initially be reluctant to provide their investment models to SMAs, not least because they need their high margin retail funds to cover extensive administration and distribution operations. As boutique, specialist and innovative fund managers see the opportunity presented to them by SMAs, pressure will slowly mount to shift the dinosaurs of the funds management industry into the new world. In most cases, the reluctant managers already provide their models through SMAs in the United States and are starting to do so in Australia – so it will only be a matter of time before they do so here.

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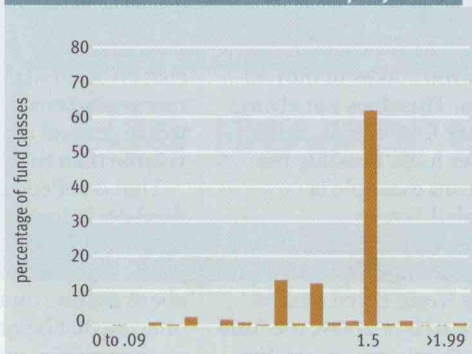
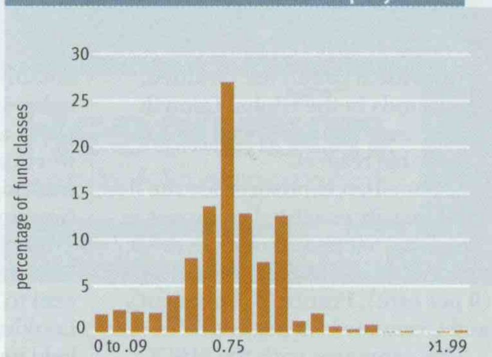
AMC of UK-domiciled domestic equity funds



Source: Morningstar

AMC of US-domiciled domestic equity funds



Source: Morningstar