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Trends in Wealth and Asset Management

*An Interview with T. Neil Bathon, Founder and Partner
of FUSE Research Network*



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The wealth and asset management industries have experienced substantial changes in practice evolution, product innovation, and technological advances during recent years, and the global pandemic has accelerated many of these trends.

Investments & Wealth Monitor asked T. Neil Bathon, founder and partner of FUSE Research Network, to comment about these trends.



T. Neil Bathon

Bathon's insights have been described as inspirational, thought-provoking, and iconoclastic. The following is a summary of his recent wide-ranging interview with Tony Davidow, chair of the Investments & Wealth Monitor editorial advisory board.

Davidow: Neil, given your unique vantage point, what do you see as the big transformative trends? What will be the stories of 2021 and beyond?

Bathon: The overarching catalyst for change is personalization, and this extends to all facets of the investor's life. The most noteworthy development is in the growth of direct indexing (aka customized portfolios). The foundations of direct indexing are firmly in place—basically taking a standard index and making adjustments based on specific inputs from the client (existing holdings, ESG [environmental, social, governance] preferences, etc.). Operational improvements and fractional share accounting have allowed this capability to come

downmarket at an accelerated pace. But it is not going to stop at just index modifications. Expect to see a surge in growth in the number of customized portfolios being delivered in a separately managed account (SMA) wrapper. The SMA structure offers better tax efficiency, generally lower fees, and full transparency. The momentum may build slowly in 2021, but ultimately I expect the use of customized SMAs to be a sea change for advisors and a jolt to investment firms that rely solely on their '40 Act offerings.

One rationale for the creation of non-transparent exchange-traded funds [ETFs] is to prevent disclosing the asset manager's secret sauce. I have found this to be a bit odd given that most managers make their individual buys and sells known on a daily basis through SMAs. It seems to me that non- or semi-transparent ETFs are a solution in search of a problem. There will be great interest in actively managed non-transparent ETFs. However, this particular structure will not gain meaningful traction as measured by asset-gathering capabilities.

There are, once again, all kinds of speculation—often led by investment banking firms—that we are about to see (finally) a big uptick in M&A [mergers and acquisitions] transactions. However, I think the idea of scale for scale's sake has been somewhat discredited. Large-scale acquisitions are displaced by the lift-out of successful portfolio management

teams that are able to fill in the gaps in an investment lineup or shore up performance-challenged mandates.

Apps and tools are ineffective ways for asset managers to distinguish themselves to their wealth management clients and prospects. BlackRock has a huge competitive advantage with their Aladdin offering and has added to it with the acquisition of Aperio. Only a handful of firms can compete at this level, and they are the ones that will pull away from the pack.

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Finally, an asset manager's diversity and inclusion practices and its ability to fully integrate ESG into firm-wide investment processes will be far more important and impactful than the manufacture of stand-alone retail product offerings.

Davidow: Products have evolved a great deal over the past decade or so. Some helped transform the industry, and others failed to fulfill their promise. What products today will transform the

industry—direct indexing, registered funds (e.g., interval, tender offer, business development companies, non-traded real estate investment trusts), or ESG?

Bathon: We expect that there will be little genuine product transformation. Overall, we expect that there will be several hundred fewer mutual funds at the end of 2021 than there were at the beginning of the year. It is really hard to succeed with new product developed in '40 Act wrappers because the minimum asset level and track record requirements make platform access extremely difficult to achieve. Against that backdrop of mutual funds being challenged, product structures in the winning column include SMAs, ETFs, closed-end funds, and private placement offerings. Interval funds are attractive for less-liquid securities, but they are a brokerage product in an advisory platform world. Business development companies have sold well at second-tier broker-dealer firms, but the high commissions are certain to raise sales practice issues at some point. Closed-end funds flew a bit under the radar last year, but we expect at least 12 initial public offerings in 2021 that amass at least \$1 billion each—mostly with credit strategies.

Davidow: We have seen a rapid adoption of traditional and smart beta (factor) ETFs. Will we ever see similar adoption of active ETFs and non-transparent active ETFs? If they are successful, will it be at the expense of ETFs or mutual funds?

Bathon: Let's first talk about what ETFs are and are not. ETFs are not a separate industry; they are technically mutual funds with different features, and a large percent of ETF assets are simply share class extensions of mutual funds operated by Vanguard. The success of ETFs is due almost entirely to low-cost beta, which is achieved with indexed strategies. The ETF structure does have a few advantages over the traditional mutual fund—greater tax efficiency and no need for a transfer agent (and the accompanying

fee). But when Vanguard's patent runs out in 2023, I suspect you will see the ETF share class structure begin to displace the stand-alone format.

We struggle with figuring out the problem that non-transparent ETFs are solving. This structure will not stanch the asset bleed that we blame on poor performance. In addition to my earlier comment about constrained asset growth, non-transparent ETFs have several inherent limitations. By necessity product manufacturing must focus on mid- and large-cap equity mandates, which are not capacity constrained. (Transparency is not an issue on the fixed income side.) Only domestic products can be introduced because the Securities and Exchange Commission has not yet authorized international securities in non-transparent ETF offerings.

We are observing accelerating demand for sustainable/ESG funds with one important distinction—only for those funds that are able to deliver top-quartile performance.

Strategic beta products have not been particularly successful from an asset-gathering perspective. This is a highly concentrated investment category with only two firms controlling 70 percent of the category, and our data show that only 17 funds control 50 percent of assets under management. This profile suggests that strategic beta strategies do not present an opportunity for new entrants.

Davidow: The demand for alternative investments has been on the rise, especially with substantially lower capital market assumptions in the future. Will private markets be more of a mainstream solution? How will they be delivered (feeder fund, interval fund, tender offer fund)?

Bathon: In FUSE's view, the preferred structure will be private placements. The asset manager sponsoring a closed-end fund now must front all costs (e.g., commissions and structuring fees), which limits the number of participants. In the past the investor would take a 6-7-percent net asset value haircut but now that comes out of the investment manager's pocket in advance. Even so, 2020 was a successful year for new closed-end funds managing credit strategies and we expect the momentum to build in 2021.

Gatekeepers tell us that they like the interval fund structure. However, these structures do not fit into the firms' operational platforms for rebalancing, which may constrain growth.

Davidow: Asset managers have developed a plethora of sustainable/ESG products in recent years. We have started to see the demand rise. Will sustainable/ESG funds become mainstream?

Bathon: We are observing accelerating demand for sustainable/ESG funds with one important distinction—only for those funds that are able to deliver top-quartile performance. The ESG moniker does not provide a halo for lackluster performers.

Most importantly, asset managers are quickly integrating ESG principles as a vital element in their overall investment process. Incorporating these principles will distinguish managers. Absent this hardwiring, we expect that the demand for stand-alone ESG products will fade.

Davidow: We have started to see an acceleration of M&A activity, asset managers buying asset managers (Janus and Henderson), wirehouses buying asset managers (Morgan Stanley and Eaton Vance), and RIA [registered investment advisor] aggregators (e.g., Mariner, Mercer, HighTower, Focus Financial). Will we see this trend continue? Will other types of transactions emerge?

Bathon: There isn't any question in my mind that the benefits of scale are playing out regularly on the advisor side of the equation. The arrangement worked out through Macquarie whereby the financial advisors of Waddell & Reed will become connected to LPL was expected for some time. Unless you have a special place in the market (e.g., Commonwealth), I think the smaller broker-dealers simply are unable to compete—if only on technology spend. Also, it seems as if I read about another big RIA rollup every week with more and more private equity money coming into the mix to add fuel to the momentum. Larger advisor platforms appear determined to offer the latest and best fintech solutions that enhance engagement, recruitment, retention, and more.

With regard to investment managers, there have been many more misses than hits. Scale for scale's sake is being challenged as a worthwhile pursuit given the disruption that occurs and, as is often the case, the large outflows of assets. This hit to revenues obviously can be factored into the agreement, but the bigger problem remains—two average firms coming together sometimes just creates a bigger average firm. I do believe that the hype around M&A often exceeds the reality, but the rumors persist about deals waiting to be done for big firms such as Wells Fargo Asset Management, State Street Global Advisors, and Russell Investments.

I see a higher likelihood of positive impact for the acquirers of truly differentiated investment strategies—which increasingly means looking into the illiquid space. A twist here might be a focus on lift-outs of portfolio manager teams as opposed to buying the entire operation (see the recent announcement by Diamond Hill¹).

Davidow: Due to fee compression and lagging sales, many asset managers have had to reimagine their wholesaling models, and COVID has accelerated this transformation. What does the future hold for asset manager sales organizations?

Bathon: We challenge your premise about fee compression because most of our clients with actively managed product suites are not experiencing this squeeze. An asset manager's expenses have grown in areas such as information technology, data, and cyber, but thanks to market appreciation (78 percent of asset growth over the past 10 years) increases in operating costs are below the rate of revenue expansion. This points to steady or expanding margins. Managers do not lower fees in their strong-performing funds and are cautious about doing so for their poor performers. For funds with strong performance and asset growth, breakpoints may be instituted. And for strategies that are a bit down and out, why give back dollars when there is no business reason to do so?

We believe that the wholesaling model of the past had been flawed largely as a function of the management of the field salesperson. What the past year has demonstrated is the worth of advisor relationships. If wholesaling is defined as senior salespeople with productive, profitable top-tier relationships with advisors, retention of these alliances is more important than ever. Their compensation structure should focus on the maintenance and expansion of those essential relationships because a wholesaler's top 100 clients typically will account for 60 percent of sales.

Hybrid wholesalers and internal wholesalers (the phone desk staff) do not bring anywhere near the same impact to the asset manager because advisors question the likely value proposition. Hybrid wholesalers have limited success in establishing lasting relationships with advisors, and internal wholesalers generally are unable to proactively engage advisors.

Another change in the wholesaling model will be with the product specialist role. Expect that the focus will be expanded beyond that narrow remit to include portfolio construction support

in its many forms (i.e., tax-loss harvesting).

Davidow: Is there anything else that we have not covered? Are there other trends that we should be paying attention to?

Bathon: Our impression is that advisors are too reactive as it relates to clients' concerns and fears. They should be focusing on behavioral issues that bias investor decision-making, but they may need to learn the lessons for themselves first in terms of their own inherent predispositions. I do appreciate the fact that many advisors are still in the process of evolving from an investment management orientation to one of holistic financial planning. During this transition, I believe that many advisors have shown themselves to be a bit uncertain about the perception of their value by clients. Consequently, I feel we have drifted into an overly accommodative mode out of a desire to hold on to client accounts. I point to the fact that nearly \$400 billion has been poured into corporate bond funds over the past three years while the index moved up a cumulative 16 percent. Compare this to the \$100 billion in net outflows of large-cap domestic equity offerings all while the S&P 500 moved up 49 percent during the same three-year period. Behavioral finance is back in vogue and I believe this time around it will stick because the negative impact on outcomes from emotionally driven portfolio adjustments can be quite profound as baby boomers work their way further into their retirement years.

Davidow: Thank you Neil for your insights. We will be following these trends in the coming years. ●

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ENDNOTE

1. "Diamond Hill Capital Management Refines Strategy Lineup," Press release (February 3, 2021), <https://www.marketwatch.com/press-release/diamond-hill-capital-management-refines-strategy-lineup-2021-02-03>.



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