momentum

Margin compression post RDR

A white paper from Momentum Global Investment Management

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Executive summary

In a recent survey of wealth managers and independent financial advisers sponsored by Momentum Global Investment Management, margin compression was identified as a dominant trend currently prevalent in the wealth management industry. These market conditions and new regulations are expected to result in a large scale consolidation in the IFA industry. The need for additional qualifications imposed on advisers will also have an effect.

The research highlighted the following key findings:

- Increased costs caused by meeting the qualifying criteria as stipulated in the Retail Distribution Review (RDR) will cause widespread IFA consolidation.
- With RDR eradicating commission based fees, most IFAs are in the process of converting commission and trail based compensation models to fee based models.
- Margin compression is having a dramatic impact on attitudes towards outsourcing requirements.
- Given higher costs and resultant lower margins, IFAs' focus will shift from technical elements of investment selection, management and monitoring to ongoing client advice and service.
- With the added focus on client satisfaction, wealth advisers want to be much more involved in the investment management process, in order to add to their own client value proposition.

Margin compression as a wealth industry trend and its implications are analysed in this paper

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Margin compression

Profit margins have declined considerably in the wealth management industry over the past two years. This is felt throughout the whole supply chain; from the IFAs all the way through to fund managers. At present, advisers are witnessing fund management fees fall from an average of 150 bps to around 100 bps, with most expecting another 25 bps decline in the near future.

With increased competition, decreasing growth rates and increased regulatory scrutiny, margins are being squeezed as costs increase and fees are being kept low to attract demand.

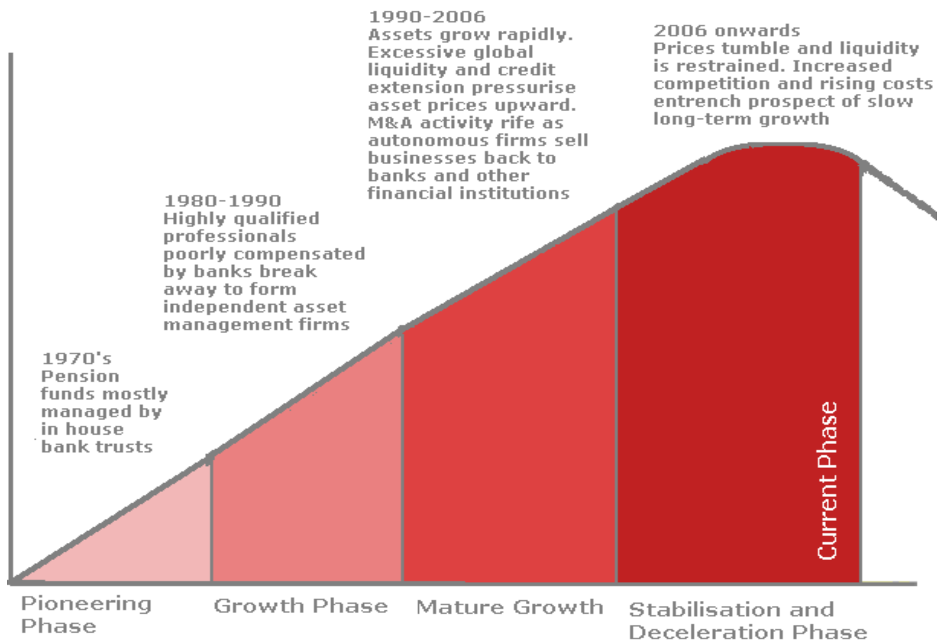
Industry research shows that during 2009 and 2010, the average profit margin in the IFA industry fell significantly, with over a third of IFAs making losses. Only advisers who can attract higher asset flows to absorb increasing costs seem to be succeeding in the current environment.

Causes of margin compression

i) Lifecycle

Wealth management has reached the mature stage in its industry life cycle. This is characterised by increased competition and lower margins, going forward low growth, tough market conditions and increased regulatory oversight will keep revenues under pressure and costs high and will make it harder to generate profits.

Figure 1.



ii) Remnants of 2008

As the financial crisis of 2008-2009 unfolded, customers became more price sensitive and meticulous with regards to the selection of financial products. In order to attract volumes, financial advisers have lowered fees and many providers are launching low cost passive product alternatives. In addition, many advisers are also looking at index trackers, of which a third (according to analysis by the Association of Investment Companies (AIC)) have Total Expense Ratios (TER's) of less than 100 bps.

Whilst the recession of 2008 was a result of a combination of factors, both public and political perception and consequential rhetoric created a general perception that the financial sector was the root cause. This led the UK's financial services regulator to take action. As the sector's biggest participant, the banking industry saw the biggest impact from the FSA's reform plans, however as their review extended to other consumer service / product areas, the wealth management industry also saw some major regulatory developments. These developments, which include the Retail Distribution Review (RDR) and Markets in Financial Instruments Directive II (MiFiD II) have led to an increase in the cost of compliance at wealth managers, both from an initial implementation perspective and on an ongoing basis. This additional cost, along with the continual pressure on fees, is likely to further stress the profit margins experienced by wealth managers.

iii) Retail Distribution Review (RDR)

Main requirements of the Retail Distribution Review:

a) In order to be identified as "independent" under the RDR, advisers will need to advise on the whole universe of financial products and funds or risk being called "restricted".
b) Elimination of all commission related fees paid by fund managers/platforms and product providers to advisers.
c) All investment advisers need to hold qualifications at QCF level 4 or above.

In order for advisers to properly review an investor's savings and cash flows, while retaining their independent status and ensuring minimum qualifications are achieved, costs will inevitably escalate. This is expected to result in large segments of advisers closing down, merging or moving offshore.

Transforming a commission and trail based fee system to an advice-based structure could decrease advisers' revenues and margins further, as many affluent clients with less than GBP250,000 in assets will be precluded from advice, given that current fees are not justifiable at this level.

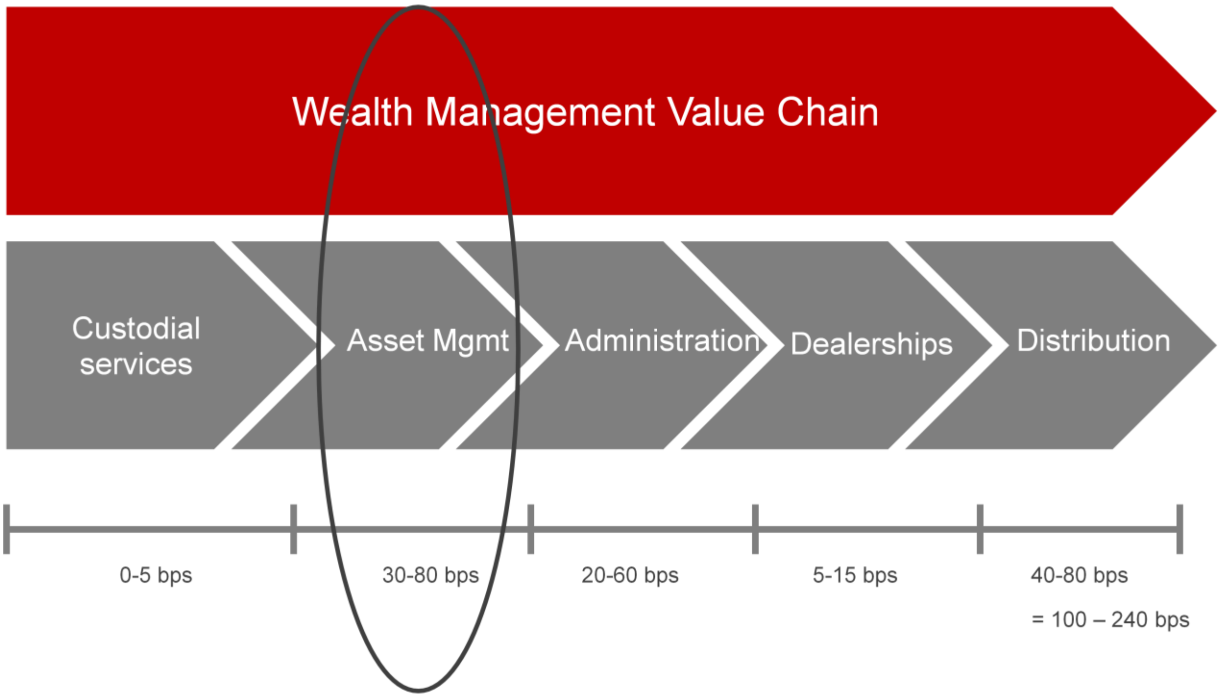
Moreover, with RDR, advisers are better aligned to client interests. This will inevitably put some pressure up the supply chain as advisers lobby for lower charges by platforms and fund managers.

Impact on fund managers

Theoretically, fund managers should not be affected by RDR. A typical fund used to levy an annual management charge of 150 bps, with 50 bps being paid to the IFA and up to a further 25 bps to the fund platform. This leaves the net margin to the asset manager on new business somewhere between 75 bps and 100 bps.

Under RDR, the 50 bps to the IFA will not be permitted. So, from the asset manager perspective, restructuring an existing fund or launching a new fund with a 100 bps annual management charge should not result in any change to the net revenue margin in respect of fund distribution via IFAs.

Figure 2. Wealth management value chain



However, significant IFA groups and IFAs with bargaining power may well attempt to reduce annual management charges in order to soften the impact of the new requirements on them. Emergence of more influential IFAs is probable as the continuation of the consolidation trend in the IFA industry persists.

Moreover, asset managers are likely to experience an increase in costs, as heightened due diligence, increased risk monitoring and other regulatory requirements come into play.

As a result of the changing landscape, fund managers will need to work harder to tailor solutions to suit these needs of the wealth managers and their clients and rely less on existing 'on the shelf' products. This will also lead to the acceptance by fund managers that existing fee levels and margins are not sustainable.

Therefore, fund managers are not unscathed by the margin compression trend.

Likely impact on IFAs

i) Outsourcing – high collaboration between IFA and manager

In an attempt to keep costs low while offering clients access to bespoke portfolio construction and asset allocation services, IFAs are outsourcing more and more of these services. This is also happening as a by-product of increased market volatility and the need to offer specialist advice and products from the fund management community. Given the disappearance of trail fees, IFAs are likely to demand services for less. This includes higher collaboration between IFAs and managers as asset allocation could become a crucial capability for advisers looking to keep costs down while benefiting from market opportunities.

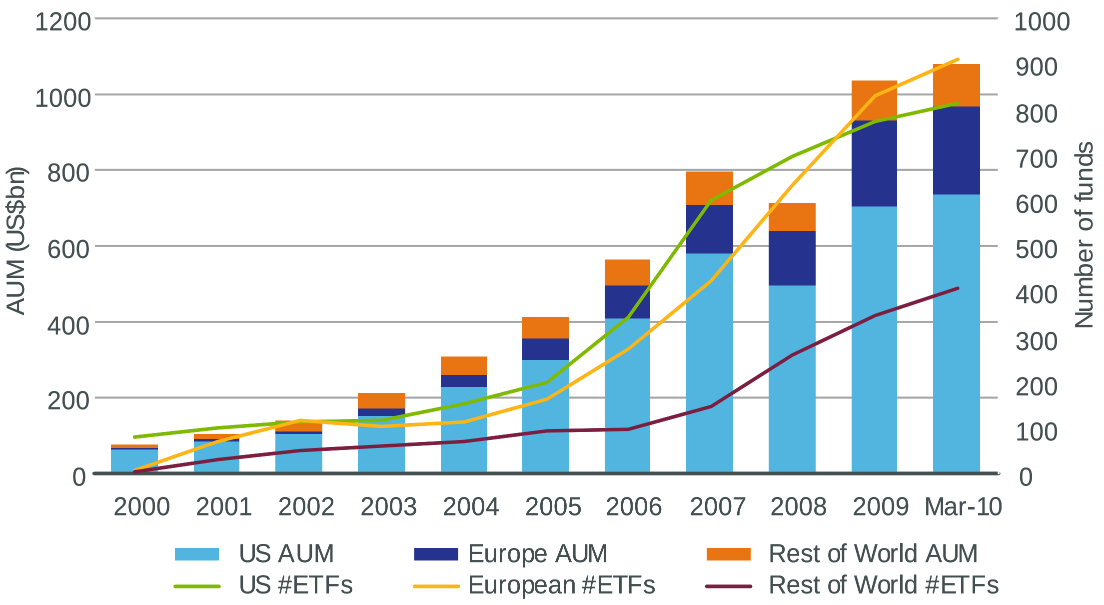
In a survey sponsored by Momentum Global Investment Management across 40 independent wealth institutions, 65% of advisers indicated that in the future they will select discretionary fund managers that are able to work in partnership with them, in order to shape and tailor the investment proposition and consciously align the investment offering to the client's overall financial plan.

Despite some IFAs launching their own discretionary funds (discretionary influenced funds – DIF), not many have the expertise or resources to focus on active asset allocation. Given the increased scrutiny such funds would attract from the FSA post RDR, it seems more likely that advisers will seek partnership opportunities with fund managers as they visibly try to add some material value justifying the explicit advice-based fees.

ii) Cheaper funds – lower cost alternatives like Index Linked and Exchange Traded Funds (ETFs)

The survey indicated that over 50% of wealth advisers have introduced passive investment solutions into their client portfolios during the past three years. ETFs are potentially attractive options in capturing beta at a low cost. The survey also showed that using passives to gain exposure to alternatives such as commodities and property, will become more commonplace as part of a low cost strategy.

Figure 3. The rise of Global ETFs



Source: BlackRock

The above chart shows the dramatic rise of the Global ETF Market. We have seen a significant increase in the number of funds available as global investment managers look to capitalise on the increase in demand for low cost investment. This increase has led to the Global ETF market rising to USD1.06 trillion as at the end of 2011.

The increase in appetite for low cost investing can also be directly linked to the UK retail market. The Investment Management Association (IMA) recently announced that retail sales of Index Tracker funds for 2011 totalled GBP1.9 billion, an increase of 594% since 2009.

Although there has been a significant increase in the issuance of Exchange Traded Products (ETP), advisers should be aware that lower cost opportunities such as ETFs currently narrow potential asset class coverage and therefore reduce potential exposure to all probable investment strategies by their nature. They also reduce opportunities for outperformance – the alpha opportunity will be gone forever. In addition, wealth managers may find it more difficult to charge clients at the same levels when providing ongoing advice that restricts its recommendations to a purely passive strategy.

iii) Consolidation of IFAs

According to a recent survey by Plimsoll, price sensitive consumers and rising costs are forcing IFAs into unsustainable losses. Wary to let consumers carry some burden of increasing costs, one in three IFA companies face financial distress. More than half have seen gross margins fall, and research shows that 15% of advisers have made losses for a second year in a row in 2010. Given the more stringent requirements to be implemented with inception of the RDR, many advisers could struggle in the new regulatory environment, and widespread consolidation is to be expected. With the definition of independence under the RDR, it will be difficult to remain a UK based IFA, and the market will either shrink or many will move toward restricted advice.

Widespread consolidation is already taking place. Perspective Financial Group, a company launched at the start of 2008 as a consolidation vehicle within the financial services industry, has acquired over 30 IFA businesses to date. In addition, another firm, Moneygate Wealth Management, has acquired four firms since April 2010, and is considering the acquisition of another seven in the near future. This is in addition to all the other “smaller” mergers and acquisitions regularly reported on in the financial press. As the deadline for RDR creeps closer, it is expected that at least 10% of IFA firms will change ownership.

Apart from consolidation, many will close down or search for a more promising future outside the UK. The true number of advisers leaving the industry will not been known until well into 2013, when some may decide their business models cannot cope with the new regulatory pressures they face. In addition to this, an advisory recruitment website has revealed that over 2000 advisers have made known their interest of working abroad in the last 18 months.

iv) Add to value proposition – seeking increased transparency and more frequent and thorough reporting

In an attempt to better serve and justify advice-based fees to the client, IFAs will be compelled to offer a detailed client service agreement which clearly outlines all of the services the client will receive for the fees charged. The adviser is likely to offer different levels of service at different costs to present their clients with a range of options available to them. This may also include an execution-only offering as those with lower AUM may opt for a “light touch” option.

Likely impact on consumers

In a recent report by Lipper it was noted that the general trend of rising fund fees over the past decade in the UK has been interrupted by the financial crisis, but 2011 has seen some price increases again. Identification of the fund managers and advisers who can afford to raise fund fees shows that it is the larger players in the market managing to push through price hikes; while this is something that will be pushed through to the consumer by larger IFA groups as the consolidation trend persists. We believe that this is unsustainable.

The resulting impact on the actual consumer once the impending reforms are realised is likely to be very different dependant on which segment the client falls into. Users of wealth managers and advisers, who meet the minimum asset levels as determined by the industry over the next 12 months, should be a beneficiary of these reforms. Reduced product fees, IFA consolidations, greater adviser qualifications, the removal of commission incentives and the creation of efficiencies should over time see an increase in the quality and appropriateness of the advice given and at a cost that is relevant and fair.

At the other end of the spectrum, those users who fall short of the minimum asset levels will potentially find they are unable to find an adviser or will potentially pay an uneconomic fee for advice. The alternative available to this segment of the market will be 'off the shelf' products which may result in many consumers having to hand pick their investment product without any professional advice. This, coupled with difficult market conditions due to current economic circumstances, will result in this type of consumer being hardest hit.

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