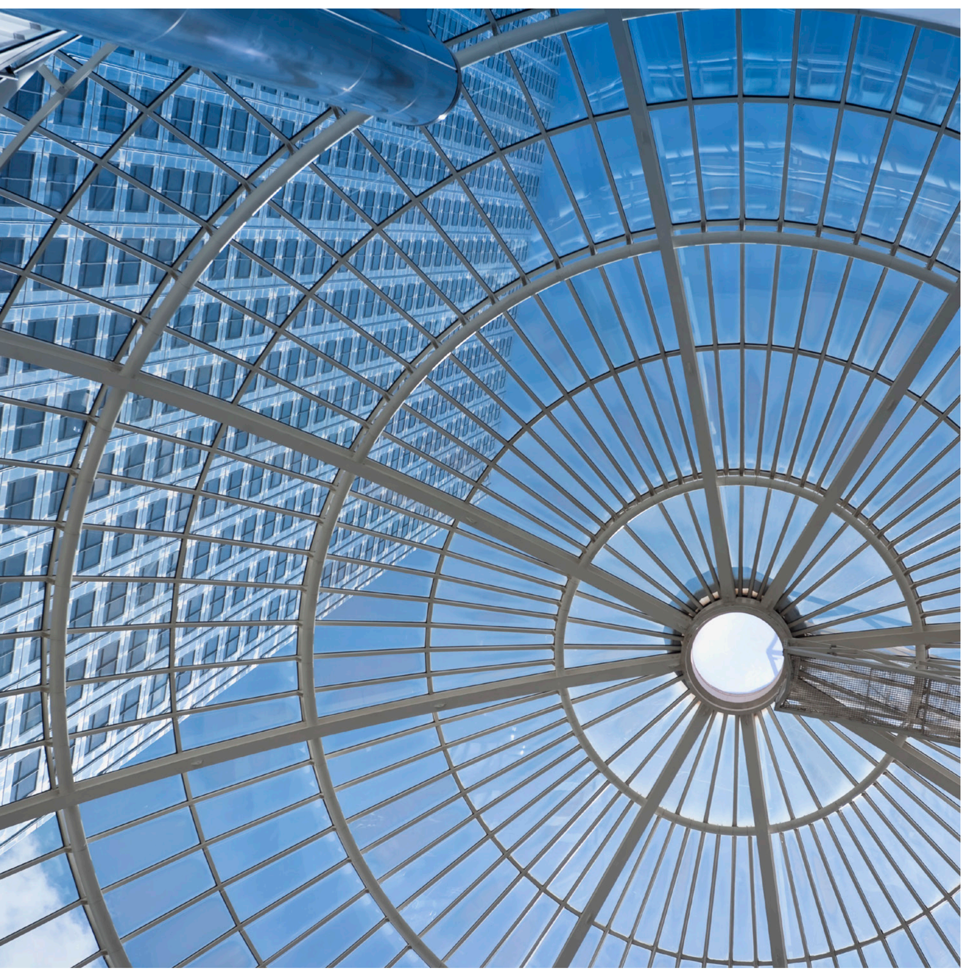
Paul Ellenbogen, US Regulatory and Risk

What portfolio driven distribution means for fund directors



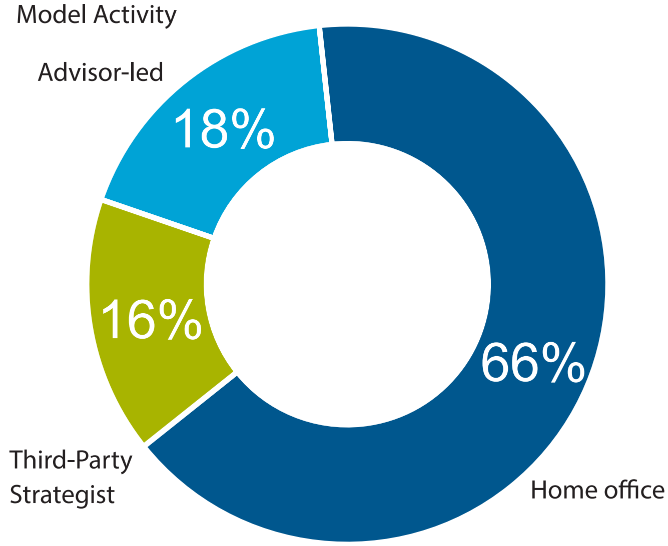
Ready for Next

US mutual fund flows have been dominated by the myriad of decisions made by intermediaries on behalf of individual clients to buy or sell a mutual fund. True, an intermediary might remove (or add) a fund to its platform, resulting in large one-time purchases or redemptions through a given distribution channel, but the main drivers of inflows or outflows were the aggregated decisions of thousands of intermediaries acting on behalf of millions of individual investors. Today, we estimate that $2.7T of the $11.2T in intermediary sold funds that we track are "model-driven," that is, dictated not by an individual advisor acting on behalf of an individual client, but rather resulting from decisions by gatekeepers, third party model makers or other financial institutions, to add, delete, or reallocate portfolio assets. [1]

"The State of Model Portfolios, https://distributioninsight.broadridge.com/#/productSingle/Perspectives

MODEL PORTFOLIO ASSET MIX BY TYPE

Centralized Decision-Making Groups Influence 80% of Model Activity

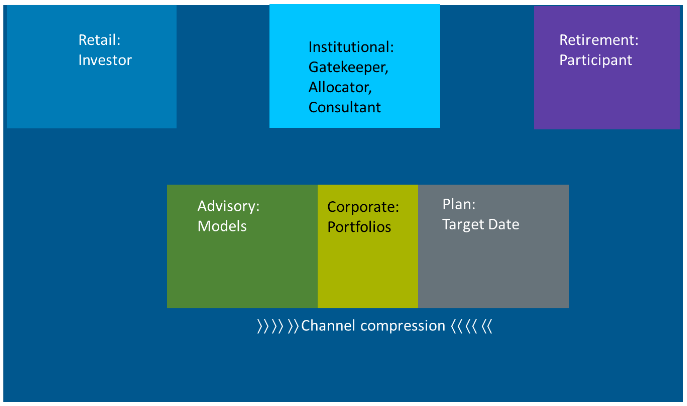


Source: Broadridge Data and Analytics

At Broadridge, we believe the consequences of fund distribution reaching this trillion-dollar model-driven 'tipping point' are significant.

- The phrase "all sales are institutional" takes on even greater emphasis to sales given that the model-maker, not the individual advisor, is becoming the key decision-maker.
- For retail investors, as for traditional (corporate) institutional investors, the era of the isolated fund could be ending; any given fund now either is a portfolio (fund of funds) or is part of a portfolio. If in the 2010's the "super star manager" was replaced by the more stable, if less idiosyncratic, management team, might the upcoming decade reduce the status of individual fund managers relative to the asset allocator?
- The implication for directors is that performance standards are now trending toward risk/return within the model, relative to potential peers that could also occupy that "slice" of the asset allocation pie. In this environment, which investor's viewpoint are directors meant to represent? There are now compelling claims that directors will need to consider the perspective of the asset/allocator fund selector's perspective; to look more closely at perhaps a separate performance peer group; and better understand third-party assessments that are used to build and evaluate models.

Are all sales institutional?



- Could the ascendance of models make the "team player" type fund, which increases the Sharpe ratio of a portfolio, more revered than the benchmark-beating individual fund? Could factors such as consistency, downside risk-protection, and degree of diversification start to displace returns relative to a category median as measures of outperformance? Will qualities such as "style purity" and non-correlation count more than traditional ratings and rankings?

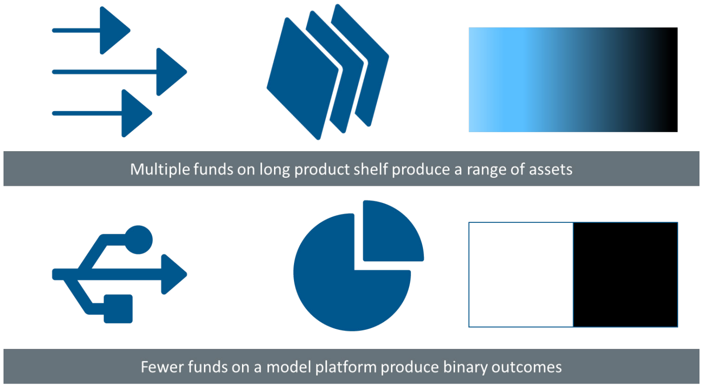
- Could passive funds receive yet another boost relative to active funds because they succeed in their role within an allocation fund or model portfolio, i.e., match the performance pattern of the asset class?

- Will there be additional pressure on investment management fees for both active and passive funds as the acquiring fund or model constructor (and not the individual underlying fund managers) are seen as the source of alpha? Could there be further pressure on operational fees of individual funds as distributors pay more to model makers who assemble (and are responsible for the performance of) portfolios, and less for the suppliers of "parts," that is, increasingly commoditized individual strategies?

- If funds come to be known "by the company they keep" and performance evaluated at the portfolio level, will directors start to see lesser funds in better allocations outgrowing outstanding funds that are underrepresented in models?

- Will distribution concerns shift from "getting on the shelf" (being made available for sale) to "getting off the shelf," that is going from eligible for models to being in the model, and thus likely to receive the bulk of flows from a given distributor?

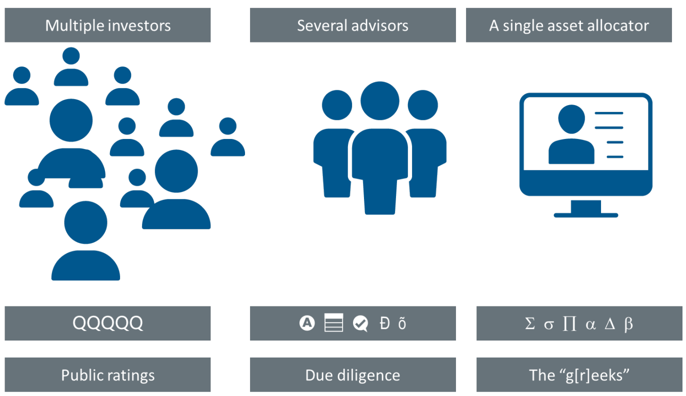
What the rise of models means for distribution and sales



- If allocators are the end investor, how do "know your customer" rules apply? Allocators use funds differently; being part of a tactical allocation might mean one thing for a passive ETF, and another thing for an active equity fund. Will fund companies need to treat different customers differently, based on the nature and extent of their inflows and outflows?

- Given that most allocators use only a subset of the 150+ Morningstar/Lipper groupings, if a fund is not in one of those, it may not be considered for most models, limiting distribution to accounts with greater discretion. Moreover, investors seeking funds for an asset allocation tend to have a dim view of funds that do not sit neatly in their assigned category due to style drift, large cash holdings, overconcentration, or pronounced sector bets, as these practices tend to complicate the portfolio's asset allocation, require more frequent rebalancing, and make performance harder to assess and explain to clients.

Who's the decider?



- "Share of wallet" means something different in a model-driven world. While most allocation series use the same funds in each of their three-, or five-, or seven-year models, the proportion of each fund in a diversified model can vary. This means market sizing is more about slice(s) — e.g., 60/40 portfolio means 36% US equity >>> 24 % large cap >>> 12% large-cap value; more for more aggressive portfolios; less for less aggressive, etc. PS: some allocators use >1 fund for core categories, further restricting market share of even a top-performing fund.

A bigger pie, but smaller slices

The Model Business						
			Model Assets	Funds per "slice"		Number of model providers
			$10,000,000,000			10
		Average weighting	Total market		Addressable market	Potential Market Share
Equity	US Large Cap	24%	$2,360,000,000	3	$786,666,667	$78,666,667
	US SMID	12%	$1,180,000,000	2	$590,000,000	$59,000,000
	Non-US Developed	12%	$1,180,000,000	1	$1,180,000,000	$118,000,000
	Emerging Markets	12%	$1,180,000,000	1	$1,180,000,000	$118,000,000
Bond	Core	25%	$2,500,000,000	3	$833,333,333	$83,333,333
	Core Plus	10%	$1,000,000,000	1	$1,000,000,000	$100,000,000
	High Yield	10%	$1,000,000,000	1	$1,000,000,000	$100,000,000
	Non-$	5%	$500,000,000	1	$500,000,000	$50,000,000

- What happens to alternative funds trying to gain a slice of an already full asset allocation pie? On the one hand, sophisticated asset allocators might be more inclined to hear about the diversifying effects of alternatives. On the other hand, other allocators have already decided that, in a portfolio that already has more than 15 sub-asset classes, alternative funds are unnecessary to improve portfolio efficiency, too difficult to evaluate, and add cost beyond their value. The once-touted goal of 10% of every portfolio may have to be replaced with a more modest estimate of market size.

Five models can cover >90% of investors with <≈ 20 funds

Sample Model Allocations						
		Model				
		Conservative	Moderate	Moderate Growth	Growth	Aggressive
	Equity	20%	40%	60%	80%	95%
	Bond	80%	60%	40%	20%	50%
Equity	US Large Cap	8%	16%	24%	32%	38%
	US SMID	4%	8%	12%	16%	19%
	Non-US Developed	4%	8%	12%	16%	19%
	Emerging Markets	4%	8%	12%	16%	19%
Bond	Core	40%	30%	20%	10%	25%
	Core Plus	16%	12%	8%	4%	10%
	High Yield	16%	12%	8%	4%	10%
	Non-$	8%	6%	4%	2%	5%

Nobody puts alternative investments in the corner? Actually, many asset allocators do.

WHO HOLDS THE KEYS TO THE KINGDOM?

- If gatekeepers, rather than individual advisors, increasingly determine which funds go into (or out of) a client portfolio, then directors may need to know more about which models the funds they oversee are in, which models they are not in, and where they stand on the watch list or bench of various gatekeepers or model-makers.

- The case for passive grows stronger in an asset allocation framework. The core asset classes that make up the bulk of an asset allocation tend to overlap with parts of the market where active funds have struggled to add value. Compounding the challenge, the easiest way to reduce the weighted average expense ratio of a multi-fund portfolio is to swap passive for active for large-cap equity and investment-grade bonds.

- On the other hand, the value of active management and satellite asset classes can become more apparent in a down market in an asset allocation framework, perhaps justifying the higher costs associated with these fund types.

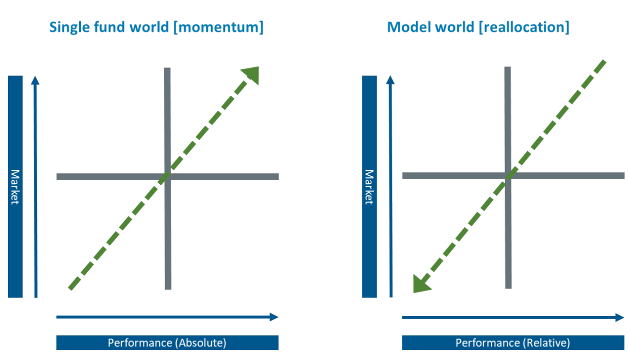
ISSUES FOR DIRECTORS

- In an asset allocation framework, the universe of competitors narrows to include only funds with the most similar mandates, which may include subsets of a category or classification, but broadens to include advisors that may not (yet) operate in the same distribution channel, as well as product types (such as ETFs) that would not ordinarily be considered peers. A new or revised performance-focused peer group may be in order.

- In a model-driven environment, consistency of performance can matter more than absolute outperformance. Does the 15(c) report include measures of consistency as well as performance over standard time periods? Does the board have a way to see if the funds it oversees are good "team players" as well as strong individual performers? How is the fund viewed in an asset allocation framework (… "role in a portfolio"…) and does its mandate or investment style present any obstacles to being considered as part of a portfolio?

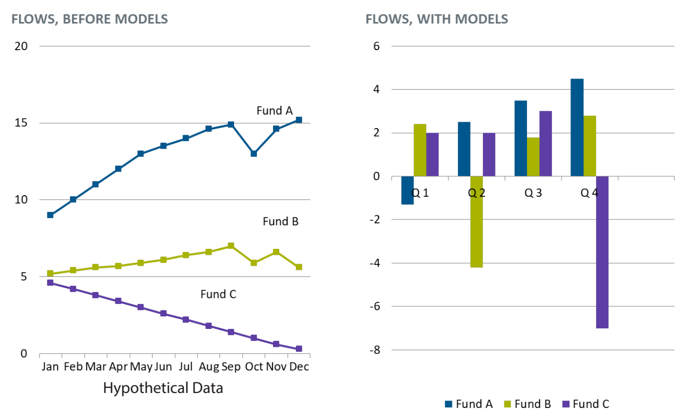
- As models proliferate, asset flows become more "chunky," or institutional in nature, as large outflows and inflows tend to occur at once, around quarter- or month-end. Such big movements may adversely affect the operations and portfolio management of the fund, if it is not set up to receive and execute large orders without causing forced sales, missed opportunities, or other liquidity-related concerns. How will these large-scale flows be reported to and monitored by the board?

Due to reallocation and a focus on relative performance, flow patterns for model funds can be the reverse of single funds



- In a model framework, flows may reverse and become countercyclical: a fund that outperforms will likely be trimmed, and one that underperforms may receive inflows to maintain its allocation percentage, contrary to normal single-fund patterns. What measures does the board have in place to distinguish "good" from "bad" outflows? Are further steps necessary to distinguish market timing from tactical purchases and sales?

In a model driven world, flows are "chunkier."

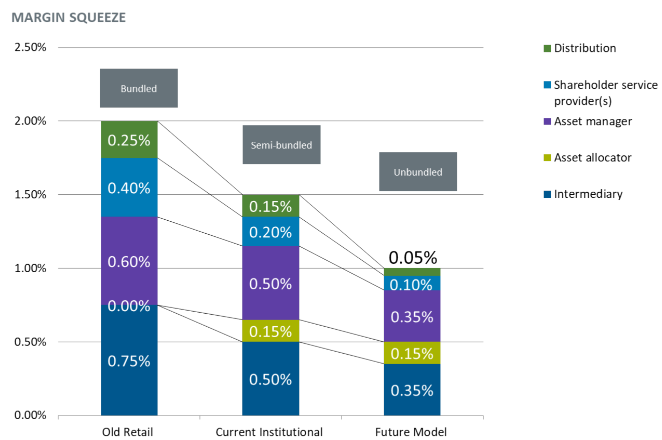


- While directors are charged with representing the perspective of investors, in the new model environment, that term may be better applied to the model makers and gatekeepers than (or in addition to) individual shareholders. How will the board view cost comparisons in this more institutional environment? Is a further look at institutional pricing in order since asset allocators could switch from a fund of funds to a manager of managers (sub-advisory) model to improve expected pricing?

- While it is generally good for a fund to become part of an allocation fund or part of a model, there can also be "guilt by association" with other funds or an unsuccessful allocation. What measures are in place to ensure that every allocation is a good 'host' for the subject fund? Could the fund, or the family, suffer reputational risk by association with a dubious strategy, or excessive purchases and sales from an overly dynamic allocation? Conversely, could a fund incur risk by having too great a proportion of its assets in a single allocation series or set of model portfolios?

- Finally, while funds are generally priced relative to one another, it is important to recognize that even clean share pricing is still part of a stacked bar, with distribution, administrative, and advice costs on top.

As Total Investor Cost declines, who makes how much less?



To see how Broadridge can help your board begin to address these concerns, contact:

Scott Arndt
Senior Account Manager
Scott.Arndt@broadridge.com

Brady Hattery
Account Manager
Brady.Hattery@broadridge.com

Josh Walker
Account Manager
Josh.Walker@broadridge.com

CONCLUSION

TAKEAWAYS FOR DIRECTORS

- Consider adding a "role in a portfolio" description of each fund and information about a fund's "model" competitors.
- Review risk and return statistics from the perspective of the model maker, readjusting the balancing between consistency and outperformance.
- Expect reports that represent fund performance against its 'modeling' benchmark, which may or may not be its primary prospectus benchmark.
- (Re) consider expenses in terms of portfolio efficiency-- what value does a fund bring to a portfolio in terms of diversification?

FOOTNOTES

[1]The Rise of Model Portfolios, Broadridge Asset Management Solutions, January, 2019. https://www.broadridge.com/article/the-rise-of-model-portfolios.

Broadridge, a global Fintech leader with over $4 billion in revenues and part of the S&P 500® Index, provides communications, technology, data and analytics. We help drive business transformation for our clients with solutions for enriching client engagement, navigating risk, optimizing efficiency and generating revenue growth.

broadridge.com

Ready for Next

Communications
Technology
Data and Analytics

AM_00270_WP_19