

Bridging the Gap

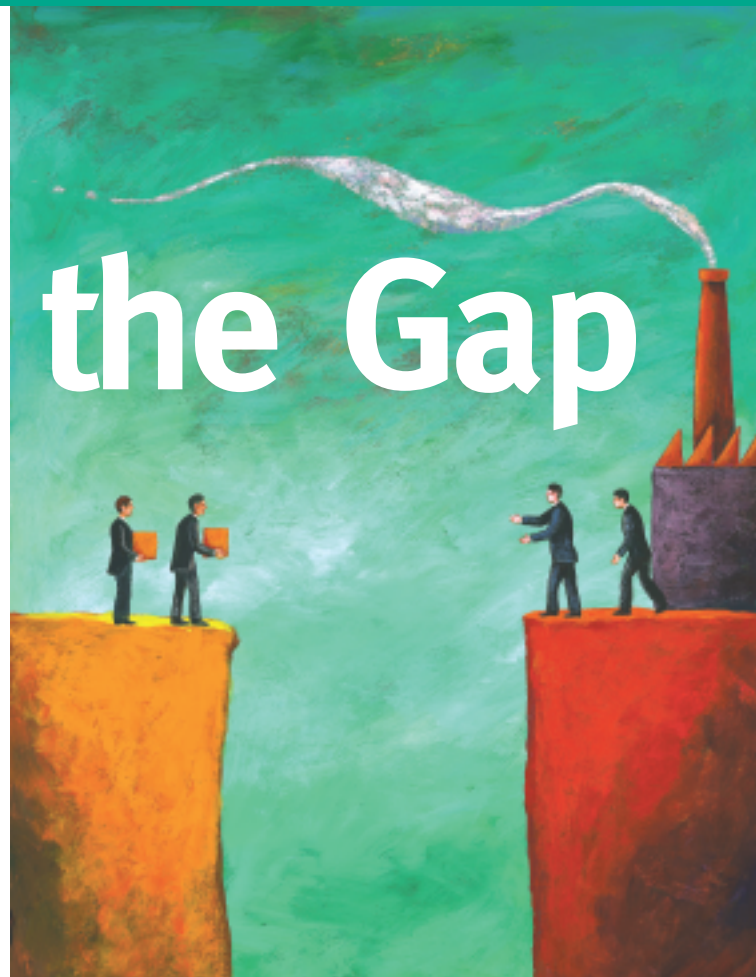
The use of retail funds in institutional investing has become a standard theme in the professional press today. But it was not always so. Markus Hill, a German consultant in the area of investment funds, discusses the factors behind this recent convergence.

As a product category, retail funds is increasingly losing its image as the second best solution. In 2004, discussions were still in terms of the disadvantages of retail funds and the advantages of institutional funds ("Spezialfonds"). In recent discussions, however, a shift has quietly taken place: convergence instead of confrontation.

In a study by the author of this article and the analyst firm RCP/TELOS on the investment consultant market in Germany (2005), these investment trends were also affirmed. It is interesting to note the gradual disappearance of a clear separation between a retail and an institutional sector in the product ranges of institutional investors. A good review of the development in the sector retail funds can also be gained through such surveys (i.e. Institutional Investment), various studies, and practical examples in the area of institutional client sales.

ADVANTAGES OF RETAIL FUNDS

A recent study by "Suedprojekt", a German fund-research house, with 55 participants looks at the reasons (advantages) for the use of retail funds as one of various questions in this field. Interesting in this regard is the priority of asset management criteria. On analyzing recent professional journals, one is tempted to come to the conclusion that one vital factor in the use of retail funds involves the change in accounting regulations (IFRS)



Reasons	Participant's reasons for retail funds (total 29)*	Banks	Insurance Companies	Non-Financial
Higher diversification possible	97% (67%)	100%	100%	92%
Reasonable costs through different classes of shares and fee payback	62% (52%)	73%	50%	58%
Reasonable performance prospects	48% (48%)	45%	50%	50%
Speedy change of portfolio manager possible	48% (52%)	36%	50%	58%
Transparency/Evaluation (i.e. IAS)	38% (38%)	45%	50%	25%
Faster benchmark changes possible	31% (33%)	18%	67%	25%
No "Late Trading" or "Market Timing"	7% (0%)	18%	0%	0%
Other reasons	10% (14%)	18%	0%	8%

Source: "Suedprojekt"
*previous year's values in brackets (2005/2004)

“Suedprojekt” focuses on some factors to be discussed in more detail. In addition to these, there are further advantages which the fund management house Lazard has identified in its own publications.

Institutional funds	Institutional Shares	Retail funds
Minimum volume recommended due to fix costs	Retail funds with share classes for institutional investors	Professional management of new share classes, even with smaller single
Possible liquidity limitations (according to asset)	Adjustment of fees	Very high liquidity
High rate of individual return	Good liquidity	Standardized investment product, no individualized returns
More transparency to “inside” (implementation of investment strategy by fund manager)	Requires large volumes (no financial controls)	Limited reporting possibilities
Building reserves on the balance sheet in accordance with the German law is (still) possible	Standardized (reporting, investment policy, use of earnings)	More difficult transparency and risk control by investors
Minimal publication required	No consolidated balance required	More transparency to “outside” comparability of results
Low fees	No possibility to influence	Higher fees

Source: Lazard (2005)

Some of the results of these two studies seem worth discussing. The consulting firm FAROS has presented the first comprehensive survey on these subjects (I-Shares-Study) in 2005 and comes to similar conclusions. “Suedprojekt” considers itself a “research house” and asset management consultant. Lazard offers products of “everyday practice”. A combination of all three viewpoints permits a well-founded view of the present situation.

TRANSPARENT EVALUATION (IFRS)

This criteria is the major point in many present discussions. Without going into details here: possible pressure to publish each item of an institutional fund (“Spezialfonds”) in the company’s balance sheet may cloud the present advantages, for example, the possibility of building book reserves. This is one factor enhancing the attractiveness of retail funds. German institutional funds are unknown in the Anglo-Saxon market, whereas retail funds (I-shares) make out a considerable share of institutional investments. A supremely important advantage of I-Shares as compared to standard retail funds is lower prices in the

cost structure of management fees. It is interesting to note that in the “Suedprojekt” study this factor clearly ranges behind the advantage factor “diversification potential”, a classic asset management theme.

DIVERSIFICATION POTENTIAL (ASSET MANAGEMENT ELEMENT)

In combination with a high flexibility in buying and selling, diversification potential is a decisive factor. Many product salesmen today speak of a “core-satellite-construction”. The arguments of retail funds advocates frequently refer to ETF (Exchange Traded Funds) examples. Relatively inexpensive ETFs can often be used as core investments. Broad markets such as the US and European markets can be covered at a small cost. Even an institutional fund may seem more expensive in comparison, which is a question of company philosophy in the sense of active versus passive management.

In this context, satellites are seen as the game of active betting (under- or overweighting), using retail funds for special fields such as emerging markets, small caps Europe or high yield bonds. For such smaller investment volumes, so-called investment boutiques are increasingly coming into use next to the established ones – managers such as Lupus Alpha (Small Caps) and Principal Global Investors (Preferred Securities).

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THE COST FACTOR

The high liquidity of ETFs strengthens the advantages of retail fund solutions as compared with conventional institutional fund solutions. Higher management fees of actively managed equity retail funds – often more than 30 basis points higher than on institutional funds – are frequently presented as decisive disadvantage in professional commentaries. When looking at the volume of retail funds in the hands of established asset managers (for example DWS) in the various satellite product ranges, one is surprised at this cost phenomenon. However, many asset managers have already reacted by introducing a range of institutional funds with more

reasonable costs in the institutional classes of shares, such as the DWS Invest SICAV in Luxembourg, which is especially designed for institutional investors. It seems hard to believe that retail funds must necessarily be more expensive than institutional funds.

The reduction of fees following the introduction of I-Shares as well as individual solutions (volume gradation of prices) confirms this line of reasoning. It is standard practice that investors pay higher management fees in satellite investments for management expertise in narrow markets entailing extensive research. A higher profit potential is being bought here. However, the investor pays this higher management fee in an institutional fund and in a multi-management solution alike.

The classic separation of retail (private clients, white-socks business) and institutional clients (institutions, company clientele) is beginning to disappear.

It is a general question when choosing an asset manager: could it be that the decisive criteria for an institutional fund charge is that it is 30 base points cheaper than the retail fund? Should not the main point in such a decision be the outperformance potential? This then, of course, allows a higher fee. In this case we come back to the question of active versus passive management.

OUTLOOK: COSTS, FUND OF FUNDS/MULTI-MANAGEMENT AND CHOICE OF MANAGEMENT

It is interesting to note that the fund research company "Suedprojekt" is known in the retail funds sector for its consulting mandate for fund of funds. In fact, "Suedprojekt" does multi-management. Various fund managers who are represented under the general heading of retail funds, are voted "out" or "into" the selection of the fund of funds. Siemens does this in a similar form for its management selection, but under the heading "Multi-Management Mandate". Although the instruments of choice are often different: there are more aspects in common than differences. Nowadays the first banks are buying seemingly "expensive" fund of funds solutions into their own books, since the flexibility advantage supersedes the disadvantage of higher fees. Fund of funds boutiques like Bernd Greisinger, who themselves choose and implement retail funds, are introducing I-Shares for institutional clients.

Both product headings have their strengths and weaknesses. Whereas one client values flexibility as uppermost aspect, another client may prefer an optimum of systematic choice. What is clear is that the classic separation of retail (private clients, white-socks business) and institutional clients (institutions, company

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clientele) is beginning to disappear. This applies to the sector of portfolio management as well as sales. Many investment companies offer not only institutional funds to their clients but fund of funds and retail funds as well. Fund boutiques are increasingly crowding into the market with their retail funds or Master-KAGs (for example: Consultant FERL acts as consultant for multi-management mandates under the heading of retail funds for Master-KAG-market leader Universal. Sales are done by consulting company MMFC). Besides consultancy firms with excellent connections, a further pool of satellite outperformance potential is developing which last but not least serves the best interests of institutional clients.

It will be interesting to see, when the first product sellers shift to offering retail fund solutions at institutional funds costs, whether investors buy high volumes.



Markus Hills works as independent investment fund consultant in Frankfurt (marketing, sales, PR). He helped initiate the first "Suedprojekt" study and therefore had the opportunity to implement the first nationwide consultancy survey in cooperation with RCP/TELOS.

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