



## Competition in funds management

**Australian Securities & Investments Commission**

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**Deloitte**  
Access **Economics**

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ASIC also consulted with the Treasury and ACCC for this report.



# Acronyms

Acronym	Term
ABS	Australian Bureau of Statistics
ACCC	Australian Competition and Consumer Commission
AFCA	Australian Financial Complaints Authority
AEMC	Australian Energy Market Commission
AFS	Australian financial service
AFSL	Australian financial services licence
APL	approved product lists
APRA	Australian Prudential Regulation Authority
ASIC	Australian Securities & Investments Commission
ASX	Australian Securities Exchange
ATO	Australian Taxation Office
AUM	assets under management
BDM	business development manager
BPS	basis points
CGT	capital gains tax
CSA	commission sharing arrangements
DDO	design and distribution obligations
ESG	environmental, social and (corporate) governance
ETF	exchange-traded fund
ETP	exchange-traded products
FCA	Financial Conduct Authority
FOFA	future of financial advice
FUM	funds under management
GDP	gross domestic product
HHI	Herfindahl-Hirschman index
HNWI	high-net-worth individual
ICR	indirect cost ratio
IDPS	investor-directed portfolio services
IFA	independent financial adviser
LIC	listed investment company
LIT	listed investment trust
MDA	managed discretionary account
MER	management expense ratio

Acronym	Term
MiFID II	markets in financial instruments directive
NAV	net asset value
NTA	net tangible asset
OTC	over-the-counter
PC	Productivity Commission
PDS	product disclosure statement
RE	responsible entity
RIAA	Responsible Investment Association Australasia
SCP	structure-conduct-performance
SMA	separately managed accounts
SMSF	self-managed superannuation fund
SOA	statement of advice
UK	United Kingdom
US	United States

# Glossary

Term	Definition
388 form	Registered schemes and trusts are required to submit a 388 form accompanied by a copy of financial statements annually to ASIC.
Active management	A fund with an objective or strategy to achieve greater than market returns.
Collective investment vehicle	An investment product that pools together funds from multiple investors.
Dealer group	A group comprising a number of financial advisory businesses that operate under a single AFSL (see above in acronyms).
Economies of scale	Occurs where increasing the quantity of a firm's output leads to a decrease in the firm's long-run average total cost of production.
FS70 form	AFS licensees are required to submit to ASIC profit and loss statements and balance sheets for each financial year.
Fund manager	The group of participants involved in the management of funds that includes investment managers, responsible entities and wholesale trustees.
Heterogeneity	Diversity in characteristics. A heterogeneous product can differ significantly from like products due to certain distinguishing features.
Institutional investor	A type of corporate, wholesale investor, including superannuation and pension funds, life insurance and other trust types, that invests either on behalf of themselves or individuals.
Investment manager	The person(s) or entity that is responsible for buying and selling of assets on the investor's behalf.
Listed fund	A fund that makes units available for purchase on an exchange, such as the ASX.
Managed fund	One type of collective investment vehicle structure, in which a fund manager pools together and invests money on behalf of a number of investors. Managed funds can be registered or unregistered, with registration status affecting required governance structures (see responsible entity). A managed fund must register with ASIC if the fund has more than 20 members, is actively promoted or if ASIC determines that the fund should be registered for another reason.
Passive management	A fund with similar portfolio characteristics to the underlying index benchmark in an effort to achieve a market return.
Platform	A class of product that provides investors and financial advisers with access to managed funds through an online portal. Includes both wraps and masterfunds.
Principal-agent relationship	A situation in which an 'agent' acts on behalf of a 'principal' to perform a task for the principal.

Term	Definition
Responsible entity	The appointed governance structure for a registered fund, responsible for the overall management of a fund. Must be an Australian public company and hold an AFSL.
Retail investor	An investor that does not qualify as a wholesale investor. Typically refers to individuals and households.
Unlisted fund	A fund that is not listed on an exchange and must be acquired from an adviser, platform or directly from the fund manager.
Wholesale investor	A class of investor that is not subject to the same protections as a retail investor due to a greater assumed sophistication. Investors are classified as wholesale if they meet a certain minimum investment amount, minimum net asset or income amount or can demonstrate they are professional investors acting on behalf of an entity with expertise or access to professional advice.
Wholesale trustee	The appointed governance structure for an unregistered fund, responsible for the overall management of the fund. Must hold an AFSL.

# Executive summary

The managed funds sector plays a crucial role in securing better outcomes for Australian investors, including retirees, through its role in maximising returns for Australia's \$2.5 trillion managed funds sector. Managed funds have also long been an important services export for Australia. Ensuring the sector is competitive is crucial to delivering better outcomes for individuals and the economy as a whole.

In light of the significant role the sector plays, the Australian Securities and Investments Commission (ASIC) has engaged Deloitte Access Economics to produce an objective assessment of competition in the managed funds industry. The purpose of this analysis is to consider competition in the context of the outcomes that the industry is delivering for investors in retail managed investment products.

This report seeks to facilitate an understanding of six key questions:

- how fund managers compete to deliver value
- the features of a fund that make it competitive in its type/class
- how features of funds are promoted or communicated to potential investors and to what extent potential investors rely on these features when making investment decisions
- how retail investors choose between fund managers and products (e.g. on the basis of quality, service or price)
- the extent of correlation between fees charged and performance achieved
- how the current market structure and regulations affect competition between fund managers
  - how charges and costs differ along the value chain
  - the extent to which fund managers are willing and able to control costs and quality along the value chain.

A structure-conduct-performance framework is used to assess competition in the funds management industry and shed light on these key questions. This framework is commonly adopted for assessing competition by Australian regulators and policy agencies. This report structures the analysis around these three pillars; seeking to identify the extent to which market concentration exists (structure), the extent to which market power is used (conduct) and the extent to which market power benefits incumbents (performance).

In March 2021, Deloitte Access Economics released the Interim Report which outlined findings based on:

- data analysis, including publicly available information sourced from ASIC and industry data providers; non-public information obtained from ASIC including PDF submissions of 388 forms and FS70 forms (covering the period between 2009 and 2020); and non-public databases acquired through Plan For Life Actuaries and Researchers (1991 to 2019), Lonsec (2014 to 2019) and FE fundinfo (2009 to 2020)
- consultation with industry, including fund managers, financial advisers and platforms (undertaken from February to July 2020)
- desktop review of existing literature and published research (conducted from January to August 2020)
- survey analysis from a survey of 14 industry participants (fielded from May to July 2020).

This Final Report builds on the findings presented in the Interim Report with additional insight provided from:

- four written submissions in response to the Interim Report
- seven additional consultations with industry participants.

Where appropriate, the Final Report has updated findings from the Interim Report and conducted additional research and analysis based on the insights from these submissions. The final findings of this review are summarised below.

## Findings

### Managed funds industry

The managed funds industry connects investors with a range of investment opportunities. Managed funds are a collective investment vehicle, offering investors a return on investment as well as greater access to diversified assets and the benefits of scale.

Fund managers create, market and sell managed funds. These funds are sold to two types of investors: retail investors (including self-managed superannuation funds and self-directed individual investors), and wholesale investors (including superannuation funds and other institutions).

Retail investors account for approximately 5% of overall funds under management and are the focus of this report.<sup>i</sup> However, the managed funds industry has a large impact on the wealth and financial wellbeing of millions of Australians. Data indicates that 54% of all superannuation assets, accrued through the compulsory and voluntary contributions of working Australians, are invested in managed funds (as opposed to other asset or investment types).

**Finding 1:** Retail investors account for a small fraction of aggregate funds under management. However, the number of retail investors is not insignificant, and the managed funds industry affects the wealth and financial wellbeing of a much larger number of Australians through superannuation. Superannuation makes up more than half (57%) of the managed funds industry by funds under management, with the remainder being held by other investor types (including retail, government and other institutional investors).

Investors have diverse preferences, shaped by their objectives. As such, fund managers offer a wide variety of funds. The managed funds industry (as measured by funds under management) has grown strongly and consistently over the last 30 years. The industry now manages almost \$2.5 trillion in consolidated assets, with 5% of this (\$133.3 billion)

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<sup>i</sup> This is based on the Australian Bureau of Statistics Managed Funds data release and refers to direct retail ownership only (not indirect ownership through superannuation).

provided by overseas investors. Industry growth is due mainly to growth in superannuation, which is expected to continue, creating opportunities for new and incumbent fund managers in the future.

Like other financial services, funds management is a regulated industry. These regulations seek to improve outcomes for investors and support financial stability, without significantly affecting competition or innovation. Yet they do affect the structure, conduct and performance of the industry. In the past decade, regulations affecting the managed funds industry have changed as a result of investigations and reforms, including the *Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry* ('the Hayne Royal Commission') (2018–19)<sup>ii</sup> and the Future of Financial Advice reforms. In addition, this year Design and Distribution Obligations will come into effect that may further affect how products are marketed and sold to consumers.

### Industry structure and performance

The structure and dynamics of the industry provide evidence of competition in the managed funds industry:

- there are more than 3,700 funds on offer
- there is innovation in product offerings and distribution, for example, the emergence of managed accounts
- there are more than 300 competitors in the industry and evidence of recent market entry and exit<sup>iii</sup>
- retail managed fund fees are low by global standards (average of 87 basis points (bps) in 2020)
- this report finds no evidence of active funds charging higher fees while following passive investment strategies.

Effective competition delivers benefits to consumers. In the managed funds industry, these benefits are measured by investor outcomes.

**Finding 2:** The evidence in this report suggests the managed funds sector has effective competition, as evidenced by new market entrants, innovation, and low fees by global standards. Industry outcomes and fund performance are also broadly consistent with competitive behaviour.

Investor outcomes vary according to investor preferences. These include, but are not limited to, risk-adjusted investment returns net of fees ('performance'). Econometric analysis finds that the most significant drivers of fund flows include ratings from research houses and past performance. A 'highly recommended' rating will, on average, deliver a 16% increase in funds under management (FUM) in the subsequent year compared to an unrated fund. This implies that investors (retail and wholesale) respond to new information about a fund's expected performance.

Fund management fees in Australia are some of the lowest in the world. This report finds no evidence of funds charging higher management fees but pursuing passive investment strategies.

The analysis in this report finds that higher fee active funds do not necessarily achieve significantly different risk-adjusted returns after subtracting fees than lower fee active

<sup>ii</sup> Commonwealth of Australia *Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry: Final Report* (Final Report, February 2019) <<https://www.royalcommission.gov.au/sites/default/files/2019-02/fsrc-volume-1-final-report.pdf>>.

<sup>iii</sup> The number of fund managers is taken from ASIC data showing the number of Australian Financial Service Licence holders with funds under management. Due to data limitations, this report is unable to fully assess the level and effect of common ownership among competitors (see Chapter 3).

funds.<sup>iv</sup> This suggests that active funds with higher fees were, on average, able to achieve slightly higher gross returns (returns before fees) than lower fee, active funds but any risk-adjusted performance improvement was largely offset by higher fees.<sup>v</sup> The report notes that research by the Productivity Commission has found that higher fees have a strong, negative correlation with returns in the superannuation sector, however, acknowledges that these are different, but related, industries.<sup>vi</sup>

In any case, performance is only one aspect of the value that investors receive when purchasing managed funds. Moreover, past performance is not a reliable predictor of future performance. As such, historical performance alone cannot be used to assess fund quality.

Although the industry structure appears competitive, there are barriers to new fund managers entering the industry. These have resulted, in part, due to regulations, such as licensing, that are appropriate and designed to protect the best interests of investors. Distribution channels, which also provide important consumer protections, restrict the ability of new fund managers and new funds to reach retail investors. Further, economies of scale (of funds under management) can reduce the ability of new entrants to compete with incumbents and there has been a decline in new entrants in the past five years.

**Finding 3:** There are legal and structural barriers to entry. Distribution channels and other supply chain participants can also create barriers to entry, reflecting both commercial considerations, such as technology functionality, and regulatory considerations, such as required due diligence processes.

However, industry concentration has declined, with new entrants from overseas markets and divestments by financial institutions. Three of the largest fund managers in Australia by funds under management in 2019 were international managers who were not among the top 10 fund managers in Australia in 2009. Overall, industry concentration is similar to the United Kingdom; approximately 50% of FUM is held by the top 10 managers in each country. Nonetheless, recent research has pointed to the impact of common ownership on concentration in a range of sectors of the Australian economy including funds management.<sup>vii</sup> The extent of common ownership is not included in estimates of market concentration in this report.

### Conduct and consumer outcomes

Conduct differs across consumers. Investors choose funds according to their own preferences. In accordance with varying preferences, fund managers offer funds with different characteristics. This report considers how fund managers compete across three dimensions:

- fund characteristics such as asset class, listed status and product differentiation
- fund manager characteristics such as brand, reputation and advertising
- historical returns, fees and discounts.

**Finding 4:** Funds are differentiated across a range of dimensions. Retail investors have different preferences over these dimensions.

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<sup>iv</sup> Consistent with other research, this analysis focused on active funds since the performance of passive funds is determined by the underlying index and therefore not expected to be related to the fees charged. Equity funds were chosen since they have the largest individual samples and also represent the most common product.

<sup>v</sup> Active, equity funds were selected for this analysis as they are the most common fund and are the most likely to carry the expectation that higher fees equate to higher performance.

<sup>vi</sup> Productivity Commission, *Superannuation: Assessing efficiency and competitiveness* (December 2018), < <https://www.pc.gov.au/inquiries/completed/superannuation/assessment/report/superannuation-assessment.pdf> >

<sup>vii</sup> Leigh, A. and Triggs, A., *Common Ownership of Competing firms: Evidence from Australia* (2021), *Economic Record* (forthcoming).



Information on managed funds under each of these dimensions is readily available to retail investors in most instances. There are some exceptions: discounts are less transparent, for example. The information that is available is complex and voluminous. Fund managers use advertising to inform and attract retail investors. The content of advertisements often does not allow direct comparison between funds. In some instances, advertisements can be misleading. Approximately 27% of complaints made regarding 'investments and financial advice' pertained to misleading product or service information in 2019–20.

**Finding 5:** There is no single source of truth that allows for direct comparison between funds. Fund managers use advertising to inform and attract retail investors. In some instances advertising is misleading, despite that being illegal.

Many investors use information from research houses to assess funds. Evidence suggests that research houses' recommendations are, on average, an indicator of future fund performance. Funds that have favourable recommendations receive higher net inflows, and vice versa.

There is limited evidence on how frequently retail investors change funds. Economic transaction costs, such as capital gains tax (CGT) and buy-sell spreads, may affect investor willingness to switch, although these costs are not unique to managed funds. However, analysis of flows data indicates that market shares are dynamic, and investors are sensitive to the performance of funds. In 2019, inflows and outflows represented 24% and 23%, respectively, of FUM from 2018.

**Finding 6:** Investors are sensitive to the performance of funds. Economic transaction costs affect investors' decisions to buy, sell and change managed funds. These transaction costs are not always transparent and may lead to investors remaining in underperforming funds.

## Intermediation

The funds management industry is heavily intermediated, particularly for retail investors. Many retail investors do not have the capacity, capability or willingness to engage directly with fund managers. This results from factors including high search and transaction costs. It is difficult for retail investors to assess information. Transaction costs tend to be lower where retail investors use an intermediary.

**Finding 7:** Retail investors are not highly engaged with funds management. There are many intermediaries between fund managers and retail investors. This long, complex value chain creates issues regarding incentive alignment, transparency and the potential for conflicts of interest.

Retail investors primarily access managed funds through financial advisers — in 2018, 86% of retail inflows came through advisers. Financial advisers strongly influence retail investor choice of managed funds. Investment platforms also influence retail investors' access to managed funds, and platforms usually only include a selection of available managed funds. Regulations require financial advisers and investment platforms to conduct due diligence on funds. Many use research houses to inform this process. Due diligence aims to protect retail investors but has implications for choice and competition in funds management.

Intermediation creates a series of principal-agent relationships: intermediaries act as agents for retail investors or other intermediaries. This can lead to suboptimal outcomes. For example, advisers may not have sufficient incentives to negotiate discounts on behalf of investors or they may be influenced by relationships with fund managers. While it is possible for advisers to recommend funds that are not available on platforms they commonly use, internal systems and processes may discourage this.

**Finding 8:** There is competition between fund managers on fees and discounts. However, retail investors may not receive the full benefits of competition over discounts. This is a result of principal-agent problems and a lack of transparency.

Conflicts of interest can arise where intermediaries are vertically integrated or have a financial relationship. Conflicts can inhibit competition if preference is given to in-house products, for example, a 2018 study found that 91% of retail funds invested in platforms were invested in in-house products. However, intermediaries are becoming less vertically integrated over time. Regulations have changed to reduce conflicts of interest where entities are vertically integrated.

**Finding 9:** Some participants in the managed funds industry have conflicts of interest. This could affect outcomes for retail investors.

Fund managers have limited control over intermediaries across the supply chain. However, these intermediaries will affect outcomes for retail investors. For example, retail investor fees include advice fees, platform fees and fund management fees, with the management fee about half of the total fee paid by retail investors. Fund managers do not control advice or platform fees, nor do they have bargaining power when paying fees to intermediaries such as platforms.

Further, fund management fees include costs associated with a range of third-party services, including custody, fund administration and unit registry. These costs can represent 50% of the total costs of managed funds companies, and approximately 40% of the annual management fee to investors. These parties have bargaining power. As such, while fund managers have incentives to scrutinise the cost and quality of third-party services, they are often not able to control these costs.

#### **This report and competition in intermediary markets**

Fund managers compete to sell managed funds to investors within a supply chain which includes platforms, research houses, advisers and dealer groups, and third-party services. Competition in these intermediary markets, for example, between platforms, is not within the scope of this report.

Rather, this report considers the behaviour of intermediaries in affecting competition between managed funds. This report identifies a range of competitive issues in the markets for the distribution of managed funds and analyses these where there are implications for the way fund managers compete and access investors. However, these issues warrant further investigation and analysis of their wider implications beyond retail investors.

Fund managers have responded to intermediation through product innovation. Exchange-traded funds can bypass traditional distribution channels and are associated with lower fees for retail investors. Managed accounts provide a new mechanism for fund managers to access retail investors.

#### **Areas for future research**

The Final Report identifies several important issues where Deloitte Access Economics could not form a definitive position based on available data and in the absence of a retail investor survey. These areas include the level of retail switching, determinants of retail fund selection, the appropriateness of fund manager profits, the level of retail investor sophistication and product awareness, and the level of retail investor satisfaction. In some cases, the report proposes ways in which this analysis could be conducted or improved in future research. As noted in several places throughout this report, it is not always possible with current data to separate the retail sector from the wholesale sector. Therefore, future research may seek to use new data to provide insights that deal more

specifically with retail investors and allow for a better understanding of the nature of competition in the retail segment.

**Deloitte Access Economics**

# 1 Introduction

The funds management industry provides investment management services to retail and wholesale investors. In Australia, the consolidated assets of managed funds institutions were worth nearly \$2.5 trillion in March 2021.<sup>8</sup>

Funds management is a dynamic and complex industry involving multiple products, providers and investor types whose requirements and characteristics are not uniform across the industry. The outcomes investors receive depend on several factors. One of these is the extent of competition in the managed funds industry.

Recent Australian government reviews have highlighted that competition in some parts of the financial system is not delivering optimal outcomes for consumers. In 2017, the United Kingdom conducted a review suggesting that competition in the market for managed funds may have been suboptimal.

ASIC has a mandate to consider how the performance of its activities and the exercise of its powers will affect competition in the financial system, including in the funds management industry. Deloitte Access Economics has been engaged by the Australian Securities and Investments Commission (ASIC) to consider the effectiveness of competition in the (retail) funds management industry using a structure-conduct-performance analysis.

In March 2021, Deloitte Access Economics released the Interim Report that presented initial findings and sought to elicit views from the funds management industry and other stakeholders. This document presents findings that take into consideration the responses and consultations that followed release of the Interim Report.

This chapter discusses the purpose of this report, its scope, key definitions for the funds management sector and sets out the structure of the remainder of this report.

## 1.1 Purpose of this report

Most of the \$2.5 trillion operated by resident managed funds institutions is held in long-term investments, to provide income in retirement to individual investors and households. A number of factors influence the outcomes that the funds management industry provides to investors. One of these is the extent of competition in the industry.

Effective competition can provide benefits to all market participants:

- For investors, effective competition brings a range of benefits, including increased choice and better-quality products.<sup>9</sup>
- For an industry, effective competition provides more incentives for innovation, as well as supporting international competitiveness.
- For the economy more broadly, competition can ultimately improve productivity and growth by driving efficiency and innovation and contributing to wealth creation.<sup>10</sup>

Regulators typically focus on the extent to which competition is delivering positive (long-term) market outcomes for consumers.

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<sup>8</sup> Australian Bureau of Statistics, *Managed Funds, Australia, Mar 2021*, cat. no. 5655 (3 June 2021).

<sup>9</sup> Harper, Ian et al. *Competition Policy Review* (The Australian Government Competition Policy Review, 2015) <[https://parliament.nt.gov.au/\\_data/assets/pdf\\_file/0006/436119/Appendix-Bii.-Competition-Policy-Review~Professor-Ian-Harper,-Peter-Anderson,-Su-McCluskey,-Michael-OBryan,-March-2015.PDF](https://parliament.nt.gov.au/_data/assets/pdf_file/0006/436119/Appendix-Bii.-Competition-Policy-Review~Professor-Ian-Harper,-Peter-Anderson,-Su-McCluskey,-Michael-OBryan,-March-2015.PDF)>.

<sup>10</sup> Australian Government Department of the Prime Minister and Cabinet *Guidance Note: Competition and Regulation* (February 2016) <<https://www.pmc.gov.au/sites/default/files/publications/010-Competition-Regulation.pdf>>.

“Competition principles should be based around the central idea that competition policy, laws and institutions should promote the long-term interests of consumers. ... legislation or government policy should not restrict competition unless the benefits of the restriction to the community as a whole outweigh the costs and the objectives of the legislation or government policy can only be achieved by restricting competition.” – Harper Review, 2015.<sup>11</sup>

The purpose of this analysis is to consider competition in funds management, in the context of the outcomes the industry is delivering to investors in retail managed investment products.

### **1.1.1 Motivation for the review**

ASIC recognises that competition between service providers in funds management needs to work effectively to deliver optimal outcomes to retail and institutional investors.

The Financial Conduct Authority (FCA) market study into Asset Management conducted from 2015 to 2017 suggested that competition in the market for managed funds may have been suboptimal in the United Kingdom (UK).<sup>12</sup> Productivity Commission (PC) reviews of Superannuation (2016–18)<sup>13</sup> and Competition in the Financial System (2017–18),<sup>14</sup> and the *Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry* (‘the Hayne Royal Commission’) (2018–19)<sup>15</sup> highlighted that competition in some parts of the financial system in Australia was not delivering optimal outcomes to investors.

At the same time, Australian financial regulators have been implementing a number of substantial reforms, including recommendations from the PC reviews, the Hayne Royal Commission, and a number of other official reviews, with the express purpose of addressing the shortcomings of the financial system. The impacts of these reforms are still evolving. Consequently, ASIC is seeking to understand the current state of competition in the funds management industry. Box 1.1 highlights the objectives of regulation in terms of promoting competition.

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<sup>11</sup> Harper, Ian et al. *Competition Policy Review* (The Australian Government Competition Policy Review, 2015) <[https://parliament.nt.gov.au/\\_\\_data/assets/pdf\\_file/0006/436119/Appendix-Bii.-Competition-Policy-Review~Professor-Ian-Harper,-Peter-Anderson,-Su-McCluskey,-Michael-OBryan,-March-2015.PDF](https://parliament.nt.gov.au/__data/assets/pdf_file/0006/436119/Appendix-Bii.-Competition-Policy-Review~Professor-Ian-Harper,-Peter-Anderson,-Su-McCluskey,-Michael-OBryan,-March-2015.PDF)>.

<sup>12</sup> Financial Conduct Authority *Asset Management Market Study Interim Report* (Market Study 15/2.2, November 2016) <<https://www.fca.org.uk/publication/market-studies/ms15-2-2-interim-report.pdf>>.

<sup>13</sup> Productivity Commission *Superannuation: Assessing Efficiency and Competitiveness* (Inquiry Report No 91, 21 December 2018) <<https://www.pc.gov.au/inquiries/completed/superannuation/assessment/report/superannuation-assessment.pdf>>.

<sup>14</sup> Productivity Commission *Competition in the Australian Financial System* (Inquiry Report No 89, 29 June 2018) <<https://www.pc.gov.au/inquiries/completed/financial-system/report/financial-system.pdf>>.

<sup>15</sup> Commonwealth of Australia *Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry: Final Report* (Final Report, February 2019) <<https://www.royalcommission.gov.au/sites/default/files/2019-02/fsrc-volume-1-final-report.pdf>>.

## Box 1.1: Regulation and competition

The 2014 Financial System Inquiry described an effective financial system as one which is resilient, efficient and fair. This framework can also be used to describe the goals of financial system regulation:

- **resilience:** prudential supervision to ensure stability of the financial system
- **efficiency:** facilitation of effective competition, to prevent the misuse of market power and deliver efficiency
- **fairness:** consumer and investor protections, to ensure that consumers make informed decisions given the complexity of information, primarily through disclosure and standards.<sup>16</sup>

The regulations that apply to the funds management industry primarily relate to efficiency and fairness. There can be trade-offs between these two goals. Financial regulators have thus noted that their task is to “balance safety [of investors and other financial system participants] with, amongst other things, competition...”<sup>17</sup>

The funds management industry offers complex products, with high asset values and the potential for high risk. As such, there are a multitude of regulations that seek to protect consumers and investors. However, these can have a direct impact on competition. Regulation can limit the number of businesses, the ability or incentives of businesses to compete or the choice and information available to consumers.<sup>18</sup> For example, fund managers are required to hold an Australian Financial Services Licence, creating a direct barrier to entry.

This is not to say that regulations necessarily have a negative effect on competition. A market with complex regulation can nevertheless encourage competition by enabling new entry, facilitating consumer choice and information, and imposing compliance costs that are commensurate with the sizes of businesses.<sup>19</sup>

This report focuses on competition in the context of the current regulatory framework. It does not assess the appropriateness of the current regulatory framework. Instead it examines competition within the industry, given the current regulatory settings, within a structure-conduct-performance framework.

<sup>16</sup> Reserve Bank of Australia, *Objectives and Types of Financial Regulation* (6 September 1996) <<https://www.rba.gov.au/publications/submissions/financial-sector/financial-system-inquiry-1996/objectives-and-types-of-financial-regulation.html#:~:text=This%20form%20of%20regulation%20%E2%80%93%20consumer,to%20make%20informed%20decisions%3B%20and%20>>.

<sup>17</sup> Byres, Wayne, *Achieving a stable and competitive financial system* (29 April 2015) Australian Prudential Regulation Authority <<https://www.apra.gov.au/news-and-publications/achieving-a-stable-and-competitive-financial-system>>.

<sup>18</sup> Australian Government Department of the Prime Minister and Cabinet *Guidance Note: Competition and Regulation* (February 2016) <<https://www.pmc.gov.au/sites/default/files/publications/010-Competition-Regulation.pdf>>.

<sup>19</sup> Australian Government Department of the Prime Minister and Cabinet *Guidance Note: Competition and Regulation* (February 2016) <<https://www.pmc.gov.au/sites/default/files/publications/010-Competition-Regulation.pdf>>.

### **1.1.2 Objectives of this report**

ASIC has outlined six key questions which they have asked Deloitte Access Economics to address in this report:

- how fund managers compete to deliver value
- the features of a fund that make it competitive in its type/class
- how features of funds are promoted or communicated to potential investors and to what extent potential investors rely on these features when making investment decisions
- how retail investors choose between fund managers and products (e.g. on the basis of quality, service or price)
- the extent of correlation between fees charged and performance achieved
- how the current market structure and regulations impact competition between fund managers
  - how charges and costs differ along the value chain
  - the extent to which fund managers are willing and able to control costs and quality along the value chain.

In the context of these six questions, this report seeks to detail the state of competition in funds management with particular focus on the outcomes delivered to retail investors. At the end of this process, there remain areas of the industry where, either due to information and data limitations or the scope of the report, findings remain inconclusive. Where applicable, this report highlights these areas for consideration in future research.

### **1.1.3 Use of this report**

In consultation with the Treasury, the information in this report will inform ASIC's future considerations of the exercise of the following set of its powers and functions under the ASIC Act:

"s1(2) In performing its functions and exercising its powers, ASIC must strive to:

- (a) maintain, facilitate and improve the performance of the financial system and the entities within that system in the interests of commercial certainty, reducing business costs, and the efficiency and development of the economy; and
- (b) promote the confident and informed participation of investors and consumers in the financial system; and

s1(2A) Without limiting subsection (2), ASIC must consider the effects that the performance of its functions and the exercise of its powers will have on competition in the financial system."<sup>20</sup>

## **1.2 Defining the scope of the research and key definitions**

The focus of this report is on competition in the market for retail managed investment products, managed in Australia or provided and marketed to Australian investors — principally, competition between fund managers to sell their managed funds to retail clients.

This section includes an overview of some of the key concepts and definitions used throughout the report.

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<sup>20</sup> *Australian Securities and Investments Commission Act (2001).*

Table 1.1: Key concepts and definitions

Term	Definition
Managed fund	<p>A managed fund is one type of managed investment scheme, in which a fund manager pools together and invests money from a number of investors.</p> <p>This report uses managed fund as a generic term to describe the group of retail managed investment products that include managed funds, exchange-traded funds, listed investment companies and managed accounts.<sup>21</sup></p>
Fund manager	<p>The group of participants involved in the management of funds that includes investment managers, responsible entities and wholesale trustees.</p> <p>Fund managers, like other providers of financial services, are subject to Australian Financial Service (AFS) licensing administered by ASIC.</p>
Investment manager	The investment manager refers to the person(s) or entity that is responsible for buying and selling of assets on investors' behalf. <sup>22</sup>

Source: Deloitte Access Economics, sources cited in table.

### 1.2.1 The market

Typically, competition analysis focuses on a market, defined by a product and a geographic space in which competition takes place. It is not easy to draw a line around the 'market' for retail managed investment products, because the products are not all substitutes for one another, and not all products are available to all investors.<sup>23</sup>

Investors typically hold a portfolio of financial assets with different risk and return characteristics, for example, shares, bonds, property and cash, as well as other financial products. Although rivalry can and does exist between different asset classes, not all funds are perfect substitutes for one another. For the purposes of a balanced portfolio, a rational investor will seek exposure across numerous asset classes and, although there is some degree of substitutability at this level depending on the environment — an investor may increase their exposure to a particular asset class to capitalise on market conditions, such as higher or lower interest rates — a fund is likely to consider a competitor within the same class as more direct competition.

Furthermore, there is a clear distinction, enshrined in regulation, between products for retail investors and products for wholesale investors. This report adopts ASIC's definition of a managed fund as outlined in Table 1.1. The main products and participants in the funds management industry are listed below and described in more detail in Chapter 2.

### 1.2.2 Products

Managed funds can come in a number of forms including retail or wholesale as well as unlisted or listed (for example exchange-traded funds). There are also other types of managed investment vehicles including listed investment companies (LICs), listed investment trusts (LITs) and managed accounts that operate similarly (these are defined in Section 2.4).

<sup>21</sup> Australian Securities and Investments Commission, *MoneySmart: Managed fund* (2020) <<https://moneysmart.gov.au/glossary/managed-fund>>.

<sup>22</sup> Australian Securities and Investments Commission, *MoneySmart: Fund manager* (2020) <<https://moneysmart.gov.au/glossary/fund-manager>>.

<sup>23</sup> Australian Competition & Consumer Commission *Merger guidelines* (November 2017) <<https://www.accc.gov.au/system/files/Merger%20guidelines%20-%20Final.PDF>>.



### 1.2.3 Investors

Retail investors in managed funds include individuals and households and self-managed superannuation funds (SMSFs). Typically, retail investors purchase from the range of products on offer but do not select the assets in the managed fund.

Wholesale investors include superannuation funds and other institutional investors.<sup>24</sup> They invest in products that have higher minimum investment stakes and often operate discrete mandates with fund managers that allow them to select the assets to be managed (see Section 2.4.1).

'Investor' may be used interchangeably with 'consumer', as discussed in Box 1.2.

Most individuals' and households' exposure to managed funds is indirect, via their institutional superannuation fund. Consequently, this report considers superannuation at various stages since outcomes pertain to retail investors. However, the nature of competition between superannuation funds and the relationship between superannuation funds and their members is outside the scope of this report.

#### **Box 1.2: Terminology for 'investors'**

The terms 'investor' or 'investors' are used throughout the report to refer to the individual or individuals investing in managed funds. These terms are often used interchangeably with 'customer', 'consumer' and sometimes 'client', as investors purchase and consume managed funds and are the clients of fund managers and other intermediaries such as financial advisers.

### 1.2.4 Suppliers

The product providers or suppliers in the market — responsible entities, wholesale trustees and investment managers — are referred to collectively as fund managers. They compete to sell managed funds to investors.

Investment managers act as the 'manufacturers' in the industry by deploying the funds and managing the overall investments. For their services, investment managers attract fees depending on the characteristics of the particular fund. Investment managers typically operate a range of funds that accommodate different investor types as well as different investors' preferences, risk appetites and timeframes.

### 1.2.5 Third-party and ancillary services

Suppliers are supported by fund administrators and custodians, and a range of other ancillary service providers and fund administrators. These market participants are partially in scope because fund managers buy products from them and may pay for the products out of investors' funds. However, the report does not analyse competition in the markets for third-party and ancillary services.

### 1.2.6 Distribution

While most retail investors access managed funds via their superannuation funds, there are other distribution channels. Most investments made by retail non-superannuation investors occur via an investment platform, based on the recommendations of a financial adviser. Investment advisers, stockbrokers and research house are also involved in distribution.

The role of distribution channels in competition between fund managers is examined, with a focus on platforms. However, competition between platforms and competition between financial advisers is out of scope.

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<sup>24</sup> Invesco, *What is an institutional investor?* (2020) <<https://www.invesco.com.au/home/frequently-asked-questions/what-is-an-institutional-investor>>.

The products and participants in the funds management industry covered in the scope of this report are discussed in Appendix A.

### **1.3 Approach to the research**

In a perfectly competitive market, no individual buyer or seller can exert market power. However, in practice, perfectly competitive markets do not exist and it is possible for players to operate with some degree of market power without significant adverse outcomes. Misuse of market power occurs when market participants are able to engage in conduct that is designed to, or likely to, substantially lessen competition.<sup>25</sup> For example, if firms possess a mechanism to exclude competitors from reaching their customers, this weakens competition and allows incumbents to extract higher prices at the expense of consumers. Such behaviour is prohibited under the *Competition and Consumer Act 2010*.

Therefore, in assessing the degree of competition, the funds management industry can be examined in terms of structure – the existence of market concentration – conduct – how market power is used – and performance – how players extract rents.

#### **1.3.1 Consumer outcomes**

In considering whether a consumer outcome is 'positive', it is important to note that there are many dimensions to this assessment, financial and non-financial (see Section 4.1). For example, a product may be high quality but not well suited to a particular consumer's needs or preferences. A positive outcome is thus achieved where the best financial outcome is achieved, given the client's particular financial (for example, risk appetite) and non-financial (for example, sustainability) preferences. In contrast, it is worth noting that superannuation funds are now subject to a "best financial interests duty".

In general, fees charged for services should be commensurate with the value of the services provided. Financial advice and information provided should be of high quality to ensure that the financial system caters for consumer needs. Agents (for example fund managers) should also act in the best interests of principals (for example investors).

At the individual level, each investor has different needs and preferences. These vary according to factors such as age, number of dependents and lifestyle expectations. Investors also have different appetites for risk and different investment horizons. This has implications for defining what constitutes an optimal consumer outcome.

For example, consider prices. Where two products are identical but have different prices, the lower price product is a better outcome for consumers. However, where products are differentiated, fee dispersion does not necessarily imply a lack of competition.

In the case of funds management, there is a range of products available at a range of fees. Investors' outcomes will be best if they purchase the product that best reflects their preferences and needs. Providing a tailored product to meet the individual's best interests may add to costs and be reflected in a higher fee. If higher fees bring a level of management and advice that is more closely aligned with the individual consumer's preferences, then this would represent an optimal outcome.

Recognising this, the report considers consumer outcomes by examining the value for money of the services provided.

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<sup>25</sup> *Competition and Consumer Act*, Commonwealth, (2010)

### **1.3.2 Sources of information used in the Interim Report**

The information used in the Interim Report was gathered from a range of sources, including:

- targeted interviews with 15 industry participants, including domestic and international fund managers, industry representative groups, investment platforms, institutional investors, dealer groups and independent financial advisers, ratings and research providers, and ASIC (undertaken from February 2020 to July 2020)
- official reviews and academic papers of competition in funds management and investor preferences and choice
- a bespoke survey sent to industry participants (fielded from May 2020 to July 2020, see Box 1.3 below)
- publicly available information sourced from ASIC and industry data providers, to analyse long-term trends in fund performance, pricing, profitability and drivers of fund flows
- non-public information obtained from ASIC including PDF submissions of 388 forms and FS70 forms (2009 to 2020)
- non-public databases acquired through Plan For Life Actuaries and Researchers (1991 to 2019), Lonsec (2014 to 2019) and FE fundinfo (2009 to 2020).

### **Box 1.3: The survey conducted for the Interim Report**

A bespoke survey was sent to industry participants via industry groups that represent fund managers. The survey was fielded from May 2020 to July 2020. Replies were received from 14 respondents including:

- nine investment managers
- three platform operators
- one institutional investor
- one responsible entity/trustee.

There are not sufficient responses to the survey to provide certainty that the survey's findings are representative of the broader industry. The current sample size implies a confidence interval of  $\pm 25$  at a 95% confidence level. As a result, this report does not strongly rely on the survey to inform findings. However, survey analysis is used throughout to provide further insights where applicable.

The survey asked participants questions on:

- how fund managers compete
- costs and fees along the value chain
- distribution channels and third-party services
- fund governance
- innovation
- barriers to competition and innovation.

The nine investment managers who responded to the survey represented, in total as at 30 June 2019, funds under management of \$303 billion across 268 managed funds. Each investment manager in our sample managed a median of 29 managed funds and had \$3.6 billion in funds under management.

Seven of the nine participating investment managers managed funds that are available to retail investors. Respondents were asked to provide data and information for up to three funds. As a result, data and information was collected for 17 retail managed investment products. The majority of these funds were unlisted, active equities funds. Responding investment managers also answered questions related to their funds that service institutional and wholesale investors.

The three platform operators that responded to the survey operated five platforms in total as at 30 June 2019. This represented \$186 billion in funds under administration, or \$62 billion on average per platform. Summary information is not provided on other groups as only one institutional investor and one responsible entity responded to the survey.

### **1.3.3 Sources of information used in the Final Report**

The Final Report relies heavily on the analysis and findings conducted in preparation for the Interim Report. In addition, Deloitte Access Economics received submissions and conducted a further round of consultations after the release of the Interim Report. These are outlined below:

- Four submissions in response to the Interim Report were received from:
  - Institute of Managed Account Professionals (IMAP) on behalf of members
  - Property Council of Australia on behalf of members
  - Financial Services Council (FSC) on behalf of members
  - Affluence Funds Management
- Seven consultations were held with a range of industry participants:
  - Two fund managers
  - Three industry bodies
  - One platform operator
  - One regulatory body

The views expressed in these submissions and consultations have been carefully considered and, to the extent possible, they have been cross-checked and verified with other participants and industry data. Where applicable, Deloitte Access Economics has updated findings to reflect the feedback received on the Interim Report.

### **1.4 Structure of this report**

This report examines structure (Chapter 2 and Chapter 3), conduct (Chapters 4–7) and performance (Chapter 8) in turn, to answer the key research questions. The remainder of the report is structured as per Table 1.2.

Table 1.2 Report structure, content and key questions

Chapter	Content	This chapter seeks answers to key questions:
Chapter 2	Introduction to the funds management industry	
Chapter 3	Structure of the industry	<ul style="list-style-type: none"> <li>How the current market structure and regulations impact competition between fund managers</li> </ul>
Chapter 4	Price and non-price strategies of fund managers	<ul style="list-style-type: none"> <li>How fund managers compete to deliver value</li> <li>Features of a fund that make it competitive in its type and class</li> </ul>
Chapter 5	Third-party services	<ul style="list-style-type: none"> <li>How charges and costs differ along the value chain</li> <li>The extent to which fund managers are willing and able to control costs and quality along the value chain</li> </ul>
Chapter 6	Distribution and gateways	<ul style="list-style-type: none"> <li>How the current market structure and regulations impact competition between fund managers</li> <li>How charges and costs differ along the value chain</li> <li>The extent to which fund managers are willing and able to control costs and quality along the value chain</li> </ul>
Chapter 7	Retail investor engagement	<ul style="list-style-type: none"> <li>How retail investors choose between fund managers and products</li> <li>How features of funds are promoted or communicated to potential investors and to what extent potential investors rely on these features when making investment decisions</li> </ul>
Chapter 8	Performance of fund managers and investor outcomes	<ul style="list-style-type: none"> <li>The extent of correlation between fees charged by fund managers and performance achieved</li> </ul>

Source: Deloitte Access Economics (2021).

The report also includes Appendices with additional information on the Terms of Reference, the structure-conduct-performance framework and quantitative analysis used throughout the report. Technical appendices include additional information on performance metrics and methodologies for determining the relationship between research house ratings and fund returns and flows, and performance and fees.

# Part I: Structure

The structure of an industry can affect the ability to develop market power. Players with market power have more ability to engage in exclusionary conduct.

Structural features that may indicate market power include the extent of entry, barriers to entry, market concentration, vertical integration, and the presence of countervailing power.



## 2 The funds management industry in Australia

### **This chapter finds that:**

The funds management industry is large and growing. As at March 2021 the industry had \$2,465 billion in funds under management.

These funds come from retail investors (households and individual investors), as well as wholesale investors (including superannuation funds and other institutional investors). This report focuses on retail investors. The best available measure for the retail share of investment indicates that retail investors account for only 5% of the total market for funds management.

The funds management industry provides a wide range of products to cater to investors' needs. Funds management organisations comprise essential governance and investment management components, as well as a range of ancillary functions. Many of these functions are outsourced.

Fund managers rely on intermediaries to reach investors. These include investment consultants, advisers and platforms. Retail investors typically access managed funds through financial advisers and/or platforms.

The industry is undergoing some change as a result of technology, innovation, regulation and changing investor preferences, but the main features of the industry are stable.

This chapter introduces the funds management industry in Australia, as context for the analytical chapters that follow.

The chapter draws on a review of published reports on the funds management industry, and data from the official sources and specialist providers, to describe the role of the funds management industry, the factors driving the growth of the industry, and the key participants and products in the industry.

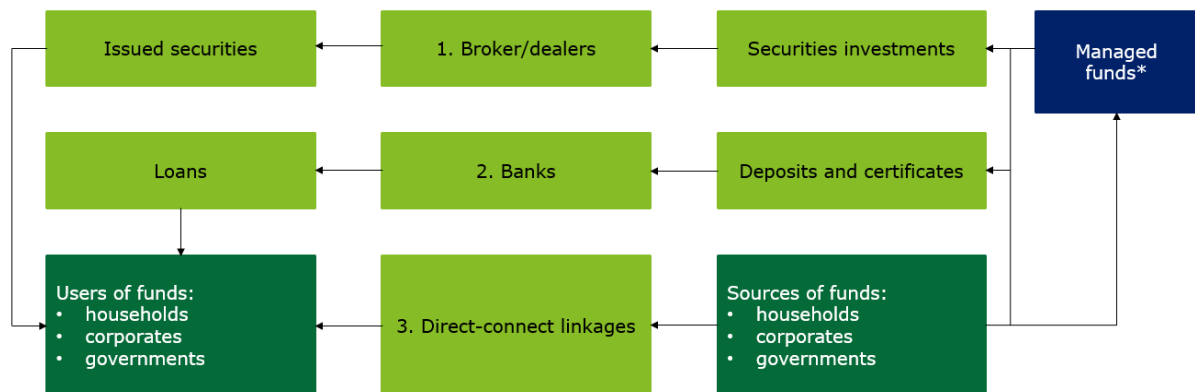
This chapter includes:

- Section 2.1 – the role of the funds management industry
- Section 2.2 – size of the industry
- Section 2.3 – investors in managed funds
- Section 2.4 – products and investments
- Section 2.5 – legal structure of the funds management industry
- Section 2.6 – industry dynamics

## 2.1 The role of the funds management industry

The funds management industry plays an important role in the financial system, bringing together investors and those who need capital. In doing so, fund managers create liquidity and play an important role within the broader function of financial services. Fund managers compete with, and complement, other forms of investment that also perform this role, namely banking and direct investing (Figure 2.1).

Figure 2.1: Financial services sector – flow of funds



\* Managed funds are part of a broader investment category of 'collective investment vehicles' (such as trusts) that play a similar role of creating liquidity in the financial system.

Note: Contents of the Figure are described in the paragraph above in Section 2.1.

Source: Deloitte Access Economics (2021).

From a retail investor's perspective, managed funds provide a return on investment on savings or superannuation assets. Two main characteristics distinguish managed funds from other types of investment.

1. **Professional investment management services.** Fund managers are experts with specialist skills that make investment decisions, research and monitor investments, and manage administration and paperwork on behalf of investors.
2. **Pooling with other investors' funds.** For investors with smaller amounts to invest, pooling their funds with other investors provides access to a wider range of asset classes and opportunities to diversify their investment portfolio. It may also reduce costs to the individual by transacting as a larger unit (scale economies).

## 2.2 Size of the industry

This section provides information on the size of the funds management industry in Australia, and the forces that are shaping the industry. There are various ways of measuring the funds management industry, and valuations can fluctuate dramatically over time.

The managed funds industry is difficult to measure because of the many inceptions and windings up of funds each quarter, due to the large number of financial interactions between managed funds institutions and investment managers, and between investment managers themselves.<sup>26</sup>

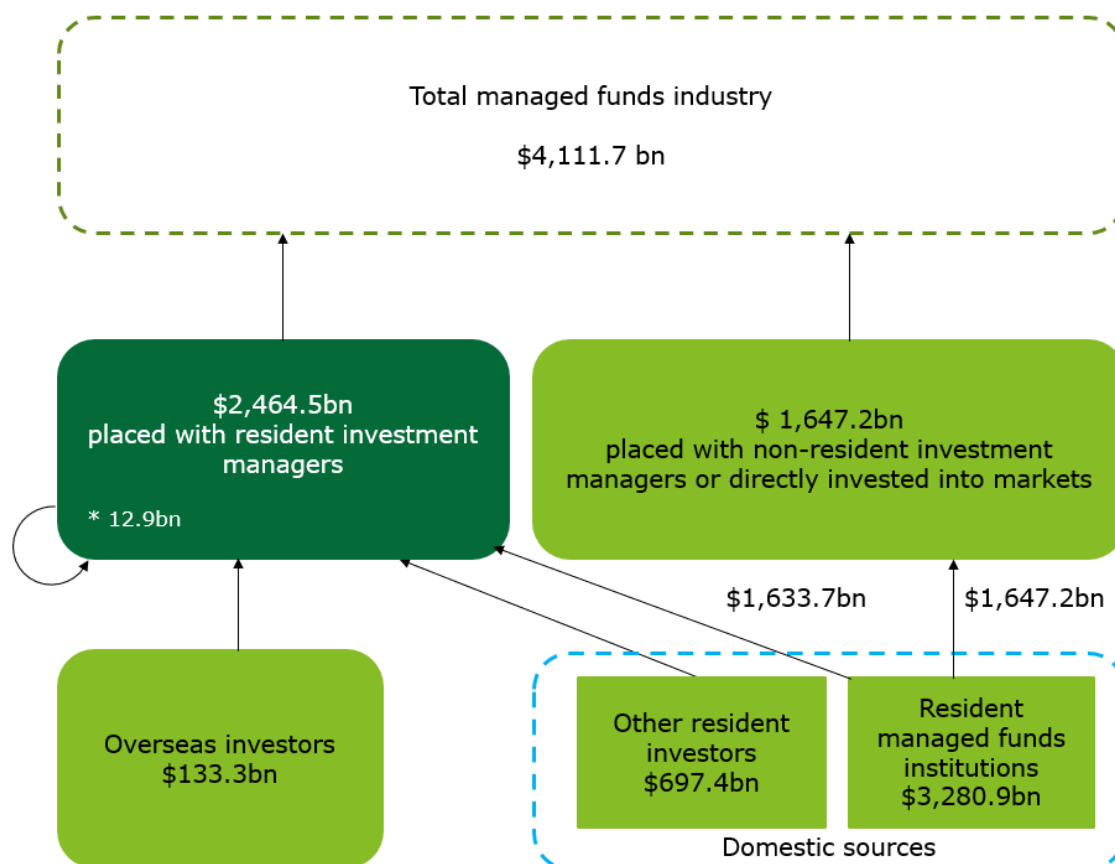
The Australian funds management industry had \$2,464.5 billion of funds under management (FUM) as at March 2021 (Figure 2.2).<sup>27</sup> This included approximately

<sup>26</sup> This report considers funds 'placed with resident investment managers' as the amount relevant to the Australian managed funds industry. Australian investors or institutions investing in offshore managed funds are not included in this total.

<sup>27</sup> Australian Bureau of Statistics, Managed Funds, Australia, Mar 2021, cat. no. 5655 (3 June 2021).

\$1,633.7 billion of domestic funds provided by Australian institutions and \$830.7 billion from individual investors in Australia and overseas.<sup>28</sup> The domestic component of the Australian managed funds sector alone was 7%<sup>29</sup> larger than the entire domestic equity market (\$2,306 billion in March 2021).<sup>30</sup>

Figure 2.2: Australian managed funds industry (March 2021)



Note: \* Indicates funds invested by resident investment managers with other resident investment managers. These are deducted to derive the total managed funds industry to avoid double counting. Dark green box indicates the measure used in this report for the size of the Australian managed funds industry.

Note: Contents of Figure are described in the paragraph above in Section 2.2.

Source: ABS (2021).<sup>31</sup>

In 2018, Australia's funds management industry was the fifth largest in the world based on FUM. Relative to gross domestic product (GDP), Australia ranked third, after Luxembourg and Ireland.<sup>32</sup> Australia was the largest hub for managed funds in the Asia Pacific region, just ahead of Japan and China.

<sup>28</sup> Australian Bureau of Statistics, *Managed Funds*, Australia, Mar 2021, cat. no. 5655 (3 June 2021).

<sup>29</sup> This percentage has decreased since the publication of the Interim Report, since the Interim Report used ASX statistics from March 2020, which were considerably lower due to the emerging COVID-19 pandemic.

<sup>30</sup> Australian Securities Exchange, *Historical market statistics* (March 2021) <<https://www.asx.com.au/about/historical-market-statistics.htm>>.

<sup>31</sup> Australian Bureau of Statistics, *Managed Funds*, Australia, Mar 2021, cat. no. 5655 (3 June 2021).

<sup>32</sup> Statista, *Value of Assets of mutual funds in selected countries worldwide in 2018* (2020) <<https://www.statista.com/statistics/270289/amount-of-fund-assets-in-selected-countries-of-the-world/>>.

## 2.3 Investors in managed funds

This section describes the types of investors in managed funds.

As mentioned in Section 2.2, fund managers manage the savings of most Australians, through superannuation and private savings. However, different investor groups have different relationships with fund managers.

There are two broad types of investors that participate in the market for managed funds. These investor groups are defined as:

1. **Retail investors**, comprising most individuals and households
2. **Wholesale investors**, split into:
  - **Institutional investors**, including corporate clients, superannuation and pension funds, life insurance and other trust types.
  - **Private clients**, who are individual investors defined as wholesale either by having a high-net-worth or by their participation in financial markets as professional investors.

### 2.3.1 Institutional investors are the largest buyers of managed funds

Institutional investors are a type of wholesale investor whose primary function is investing assets, either on behalf of themselves or others for whom they hold assets in trust.<sup>33</sup>

#### 2.3.1.1 The majority of institutional investors' funds are invested in managed funds

In Australia, the main institutional investors are superannuation funds. Other institutional investors include insurance companies, governments and other types of public and private trusts.

Approximately 54% of superannuation assets (not including SMSF) are invested in managed funds.<sup>34</sup>

Institutional investors have a different relationship with fund managers than retail clients. Institutional investors are more likely to have their assets segregated and managed separately from other pooled investors (see Section 2.4.1.2). Institutional clients typically play a more active role in the management of a fund by directing the fund manager towards specified asset allocations, products, industries, investments and risk appetite.

#### 2.3.1.2 Institutional investors represent the largest share of funds under management

Chart 2.1 shows the contributions of various investors within the total managed funds industry. Institutional superannuation, as distinct from self-managed superannuation, investors account for the largest share of FUM, equivalent to 72% of Australia's GDP.<sup>35</sup> Other non-super wholesale investors account for the equivalent of 16% of GDP whereas retail investments account for only 6% of GDP. Retail and wholesale shares have been relatively stable over time.

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<sup>33</sup> Invesco, *What is an institutional investor?* (2020) <<https://www.invesco.com.au/home/frequently-asked-questions/what-is-an-institutional-investor>>.

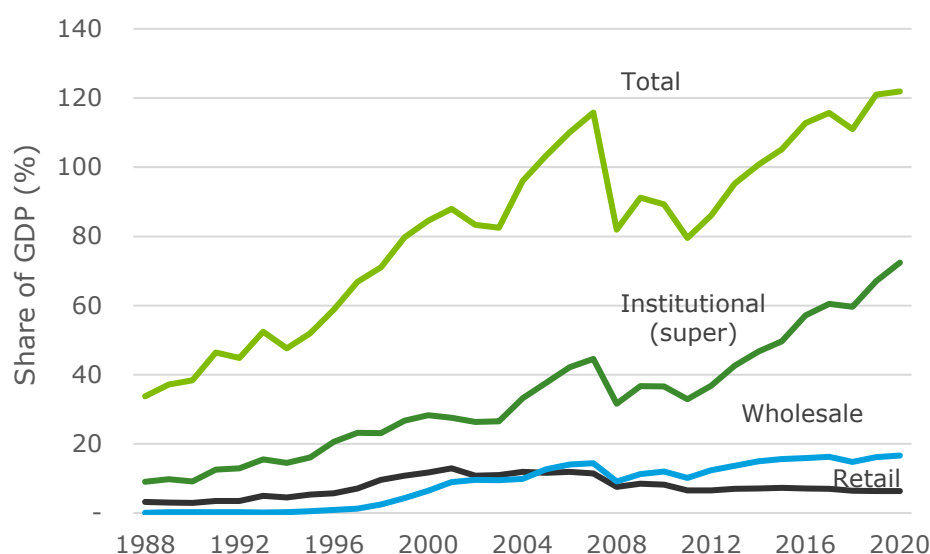
<sup>34</sup> \$946 billion of a total of \$1,742 billion of superannuation assets with more than four members are placed with investment managers.

ASFA, *Superannuation statistics* (June 2020)

<<https://www.superannuation.asn.au/ArticleDocuments/269/SuperStats-Jun2020.pdf.aspx?Embed=Y>>. <sup>35</sup>

Australian Bureau of Statistics, *Managed Funds*, Australia, Mar 2021, cat. no. 5655 (3 June 2021).

Chart 2.1: Australian funds under management as share of GDP



Note: Not all sources of funds are included in this chart. Other sources reported by the ABS include life and general insurance as well as national, state and local government and charities.

Note: Contents of the chart are described above in Section 2.3.1.2.

Source: ABS (2021) and FSC (2019).<sup>36</sup>

Since 1992, when compulsory superannuation was introduced, superannuation's share of the managed fund industry has more than doubled from 27% of FUM to 57%, as at March 2021.<sup>37</sup> In comparison, national government, life insurance companies and other institutional investors each make up less than a 6% share of managed funds.

As of March 2021, the retail segment constitutes approximately 5% of FUM (130 billion).<sup>38</sup> Although this proportion is small, and noting potential limitations in the measure, retail investment in Australia, more generally, is high. Approximately 60% of Australians hold investments outside their superannuation, and 37% of Australians hold investments available only through exchange (shares, derivatives and other exchange-traded products).<sup>39</sup>

### 2.3.1.3 Retail investors buy pooled funds through intermediaries

One of the primary differences between retail and wholesale investors is the distribution networks for each investor type. Retail investors can access managed funds directly; however, it is more common to access them through a platform and/or a financial adviser (see Section 3.3).

### 2.3.1.4 Retail investors predominantly invest their money in other assets

Chart 2.2 shows that managed investments (including listed and unlisted trust structures) account for approximately 23% of assets in self-managed superannuation funds (SMSFs). The largest components of SMSFs are listed shares (26%) and cash

<sup>36</sup> Australian Bureau of Statistics, *Managed Funds, Australia*, Mar 2021, cat. no. 5655 (3 June 2021); Financial Services Council, *State of the Industry 2019* (2019) <<https://www.fsc.org.au/resources/fsc-state-of-the-industry-2019>>.

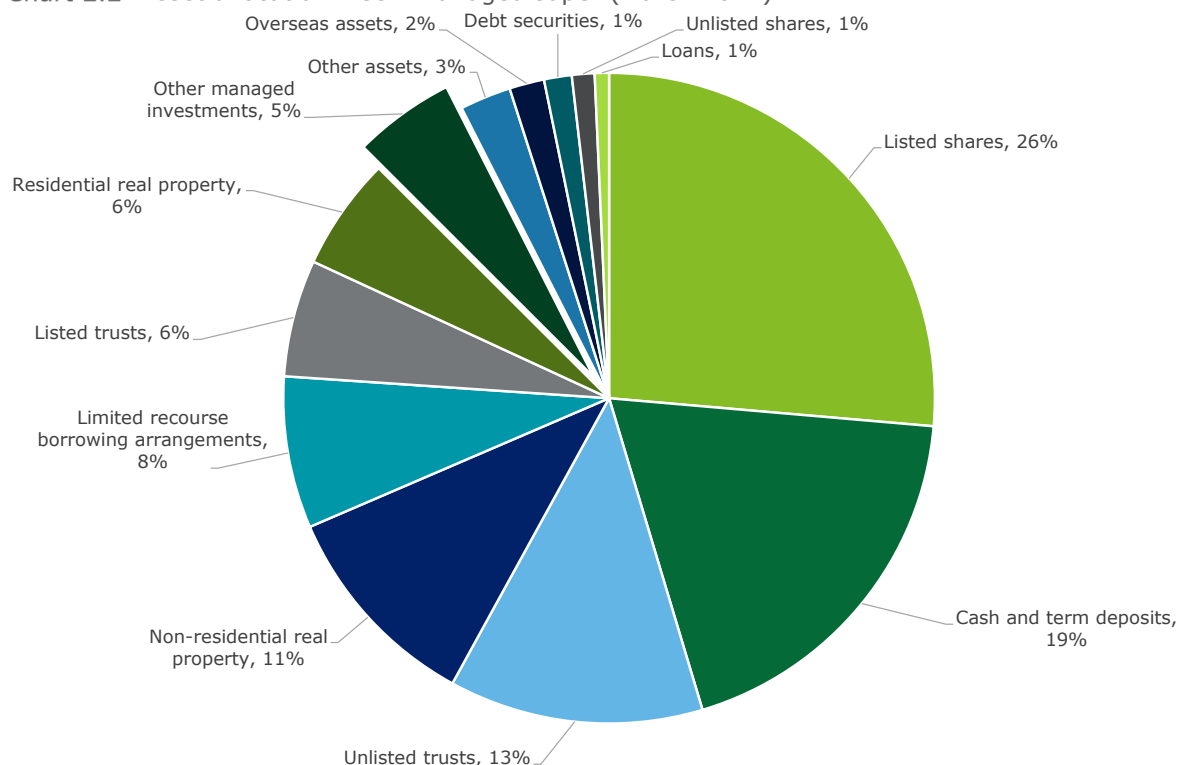
<sup>37</sup> Australian Bureau of Statistics, *Managed Funds, Australia*, Mar 2021, cat. no. 5655 (3 June 2021).

<sup>38</sup> Australian Bureau of Statistics, *Managed Funds, Australia*, Mar 2021, cat. no. 5655 (3 June 2020).

<sup>39</sup> Deloitte Access Economics, *ASX Australian Investor Study* (report commissioned by Australian Securities Exchange, 2017) <<https://www2.deloitte.com/au/en/pages/economics/articles/asx-australian-investor-study.html>>.

(19%) with other assets including real estate and other forms of debt occupying the remaining shares of assets.

Chart 2.2: Asset allocation – self-managed super (March 2021)



Note: Contents of the chart are described in the paragraph above in Section 2.3.1.4. A table form of this chart also appears in Appendix F.

Source: ATO (2021).<sup>40</sup>

Outside of superannuation, the share of retail investors portfolios allocated to managed funds is low. In 2017, approximately 92% of personal non-super investments were held directly rather than through investment products, such as managed funds.<sup>41</sup> This goes to show that, in the context of the investor's portfolio of assets, managed funds face competition from a range of substitutes. Direct investments, such as property, listed equities and deposits, represent the largest source of competition to managed funds, accounting for approximately 70% of the typical retail investment portfolio.

## 2.4 Products and investments

Managed funds are a bundled service; in purchasing a managed fund, an investor implicitly purchases additional services that are part of the overall managed fund product. These bundled services are discussed in more detail in Chapter 4.

This section provides a brief discussion of managed funds and other common forms of collective investment.

<sup>40</sup> Australian Taxation Office, *Self-managed super fund quarterly statistical report - March 2020* (May 2020) <<https://www.ato.gov.au/About-ATO/Research-and-statistics/In-detail/Super-statistics/SMSF/Self-managed-super-fund-quarterly-statistical-report---March-2020/>>.

<sup>41</sup> Bowerman, Robin, *Outside super: Our other personal investments* (March 2018) Vanguard <<https://www.vanguardinvestments.com.au/retail/ret/articles/insights/research-commentary/retirement-and-superannuation/outside-super.jsp>>.

Managed funds are one type of 'pooled' or 'collective' investment vehicle. Managed funds take a variety of forms and cater to a wide range of investors, with different investment needs. Managed funds typically fall into different categories based on:

- whether funds are pooled or segregated (Section 2.4.1)
- the type of investor the fund is sold to (Section 2.3)
- how the product is structured (Section 2.4.2)
- the asset/s that the fund invests in, such as equities, fixed income, property, infrastructure or alternative assets (Section 2.4.4)
- the investor's risk appetite (Section 2.4.3)
- if the funds are actively or passively managed (Section 2.4.5).

#### **2.4.1 Managed funds can be pooled or segregated**

A managed fund typically includes funds sourced from multiple institutions and individuals with a common investment objective. However, some large institutional investors, such as superannuation funds, may elect to operate a segregated mandate where the investments are managed separately from other investors that are not aligned with the institution. Segregated mandates still qualify as managed funds although they represent a different method of investing.

##### **2.4.1.1 Retail investors typically invest in pooled investments**

In a pooled investment scheme, client funds are aggregated together and invested as one portfolio. This allows individual clients to benefit from scale economies achieved by combining assets with others.

Pooled schemes can be set up in a variety of ways, for example, as a trust or a company. A unit trust is the most common set up in Australia, with the investors owning units in the pool.<sup>42</sup> The trustee has a fiduciary duty to the beneficiaries of the trust (the investors) and administers the pool on their behalf.<sup>43</sup>

Retail investors typically invest in public offer unit trusts offered by a fund manager, with a minimum investment of less than \$50,000.<sup>44</sup>

##### **2.4.1.2 Institutional investors typically invest in discrete or segregated mandates**

The alternative to a pooled scheme is an individual investment portfolio, known as a discrete or segregated mandate. Under this structure, a fund manager operates the investment on behalf of the client; however, the client retains ownership of the underlying assets. Superannuation funds and other wholesale investors benefit from this approach because they have a more direct influence over the investment strategy, fees and reporting requirements for the fund.<sup>45</sup>

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<sup>42</sup> Dickson, Paul, *The Asset Management Review* (Law Business Research Ltd, Eighth Edition, 2019) <<https://corrs.com.au/site-uploads/images/PDFs/Insights/article-financial-sponsors-the-asset-management-review-eighth-edition-australia.pdf>>.

<sup>43</sup> Ibid.

<sup>44</sup> Financial Services Council & Morningstar, *Australian Managed Funds Industry* (19 July 2016) <<https://www.fsc.org.au/resources-category/publication/791-2016-fscmorningstar-austnmanagedfundsindustryreport/file>>.

<sup>45</sup> Dickson, Paul, *The Asset Management Review* (Law Business Research Ltd, Eighth Edition, 2019) <<https://corrs.com.au/site-uploads/images/PDFs/Insights/article-financial-sponsors-the-asset-management-review-eighth-edition-australia.pdf>>.

## 2.4.2 There is a range of managed investment product structures

As at June 2021 there were 3,622 managed funds registered with ASIC.<sup>46</sup> This includes 168 exchange-traded funds and 102 listed investment trusts and companies.<sup>47</sup> This section expands on Section 2.4.1 by describing the main product structures.

Managed funds can be classified according to whether they are listed or not.

**Unlisted** managed funds cannot be purchased on an exchange and are typically acquired through an adviser, platform or through the fund manager.<sup>48</sup> Unlisted products are priced by determining the net asset value (NAV) of the underlying investments. Certain unlisted funds (mFunds) use the ASX settlement system to conduct transfers between investors and the managed fund provider but are not listed on the exchange.<sup>49</sup> This report does not distinguish between unlisted funds and mFunds.

**Listed** managed funds are available on an exchange and can be acquired through a broker or trading portal. As with listed equities, the price of a listed fund will depend on supply and demand in the market. As a result, the price can be higher or lower than their NAV. There are three types of listed structures:

- Exchange-traded funds (ETFs) are open-ended funds; the issuer may increase or decrease the number of units on the market in accordance with supply and demand.<sup>50</sup>
- LICs are a type of closed-ended fund with the same legal structure as an incorporated company.<sup>51</sup>
- LITs are also closed-ended funds but they are incorporated as a trust rather than a company. As at March 2020, LICs and LITs accounted for approximately \$40.5 billion in market capitalisation.<sup>52</sup>

### 2.4.2.1 Exchange-traded funds have grown in popularity

In Australia, ETFs have experienced a surge in popularity over the last decade as investors view them as an easy, effective and cost-efficient vehicle for achieving a diversified, passive portfolio.<sup>53</sup> As well as being exchange-traded, most ETFs do not have a minimum investment amount, making them more liquid and accessible to retail investors.<sup>54</sup> Similarly, as ETFs generally track an index, a retail investor may find them more appealing relative to the alternative of individually researching and choosing individual companies or funds. As at March 2021, there were 168 ETFs traded in the ASX with a total market capitalisation of \$78 billion (see Chart 2.3). The size of ETFs in Australia accounts for a small portion of the equity market in Australia, approximately 2.3% of market capitalisation. Chart 2.3 shows funds under management in ETFs more than doubling between 2017 and 2021.

<sup>46</sup> Australian Securities and Investments Commission 'Annual report 2018-2019' (October 2019)

<<https://download.asic.gov.au/media/5314396/asic-annual-report-2018-19-full.pdf>>.

<sup>47</sup> Australian Securities Exchange, *ASX investment products monthly update* (March 2021)

<<https://www.asx.com.au/products/managed-funds/market-update.htm>>.

<sup>48</sup> Australian Securities and Investments Commission, *Choosing a managed fund* (2020)

<<https://moneysmart.gov.au/managed-funds-and-etfs/choosing-a-managed-fund>>.

<sup>49</sup> Australian Securities Exchange, *Frequently asked questions: what is the difference between an mFund, an ETF and a share?* (2020) <<https://www.asx.com.au/mFund/frequently-asked-questions.htm#:~:text=There%20are%20more%20than%202%2C000,from%20a%20range%20of%20investo>

rs.>.

<sup>50</sup> Kemp, Michael, *ETFs vs LICs* (March 2015) Australian Securities Exchange

<<https://www.asx.com.au/education/investor-update-newsletter/201503-etfs-versus-lics.htm>>.

<sup>51</sup> Australian Securities Exchange, *Listed investment companies and trusts* (2020)

<<https://www.asx.com.au/products/managed-funds/lics-lits.htm>>.

<sup>52</sup> Australian Securities Exchange, *Investment product summary* (February 2020)

<[https://www.asx.com.au/documents/products/ASX\\_Investment\\_Products\\_February\\_2020.pdf](https://www.asx.com.au/documents/products/ASX_Investment_Products_February_2020.pdf)>.

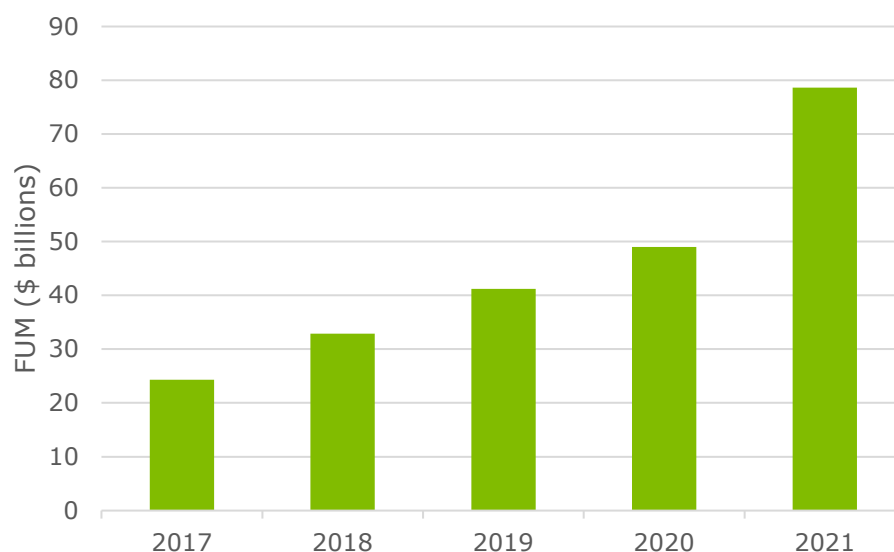
<sup>53</sup> Australian Securities Exchange, *Investment product summary* (February 2020)

<[https://www.asx.com.au/documents/products/ASX\\_Investment\\_Products\\_February\\_2020.pdf](https://www.asx.com.au/documents/products/ASX_Investment_Products_February_2020.pdf)>.

<sup>54</sup> Financial Services Council, *State of the Industry 2019* (2019) <<https://www.fsc.org.au/resources/fsc-state-of-the-industry-2019>>.



Chart 2.3: Funds under management - Exchange traded funds



Note: FUM calculated as of March each year.

Note: Contents of the Chart are described in the paragraph above in Section 2.4.2.1.

Source: ASX (2021).<sup>55</sup>

During 2020, ETF trading activity (measured by daily turnover) increased 159% between February and April, compared to an 86% increase across the broader securities market.<sup>56</sup> Among this spike in activity, retail investors increased their share of daily turnover to 61%, up from 58% prior to February 2020.<sup>57</sup> Retail investment trends and behaviours during COVID-19 are explored further in Sections 2.6.1.2 and 7.1.3.

#### 2.4.3 Managed accounts allow the provider to manage money on behalf of investors without regular statements of advice

Managed accounts represent a relatively new form of product and service innovation and have been growing rapidly since they were introduced in 2004 to approximately \$95 billion in FUM.<sup>58</sup> Although there are different structures, managed accounts authorise investment decisions to be made on the investors behalf, subject to agreed instructions or product statements. Managed accounts have different naming conventions, however, they are typically separated into:

- Managed Discretionary Account (MDA)
- Separately Managed Accounts (SMA)

This report uses the term 'managed accounts' to collectively refer to MDAs and SMAs and acknowledges that, although there are many terms used in the industry to describe an MDA or SMA structure, the more common terminology is used for consistency and simplicity.

**Managed discretionary accounts** have aspects of both a product and a service whereby the investor authorises an MDA provider (typically a financial adviser) to manage a portfolio on their behalf and without regular approval, in accordance with a

<sup>55</sup> Australian Securities Exchange, *ASX Funds Statistics: ASX Investment Products Monthly Update* (March 2020) <<https://www.asx.com.au/products/managed-funds/market-update.htm>>.

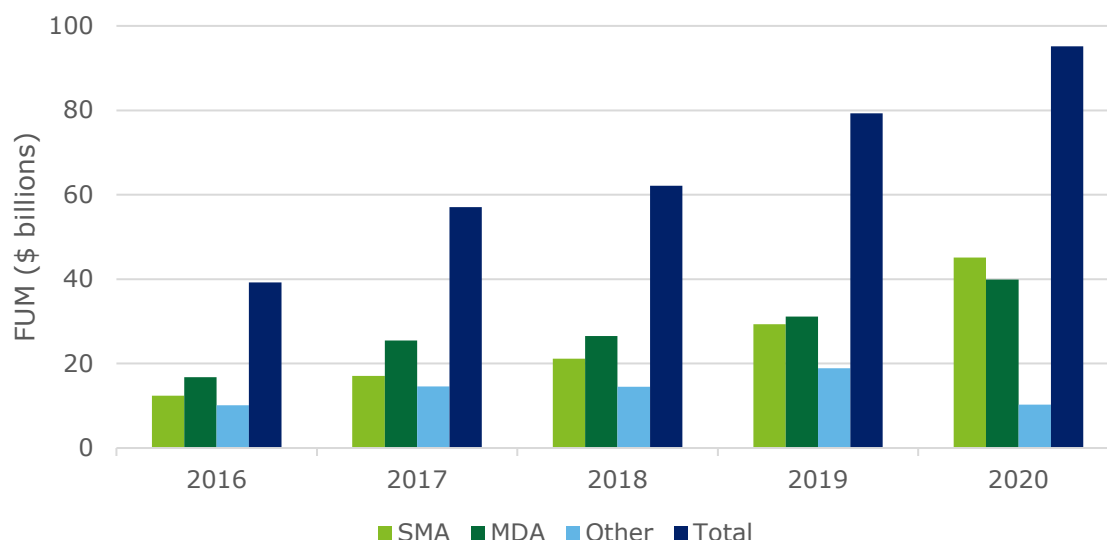
<sup>56</sup> ASIC, *Retail investor trading during COVID-19 volatility* (May 2020), <<https://download.asic.gov.au/media/5584799/retail-investor-trading-during-covid-19-volatility-published-6-may-2020.pdf>>

<sup>57</sup> Ibid.

<sup>58</sup> IMAP, *IMAP Milliman Managed account FUM census as at 31 December 2020* (March 2020).

mutual and pre-determined investment mandate.<sup>59</sup> With an MDA structure, the MDA provider holds a portfolio of investments and the investors (clients) buy units in this portfolio. To offer MDA advice and to act as an investment manager, the MDA provider must hold an AFSL with a specified 'dealing by issue' licence.<sup>60</sup> Many MDA providers will choose to outsource the investment management responsibility and instead only provide MDA advice. Since MDAs are generally provided together with personal advice, they are subject to best-interest obligations as for all other forms of financial advice. Chart 2.4 shows that MDAs have grown to account for around \$40 billion FUM as of December 2020 (42% of total FUM in managed accounts).<sup>61</sup>

Chart 2.4: Funds under management - managed accounts (2016- 2020)



Note: The contents of this chart are discussed above and below in Section 2.4.3.

Source: IMAP (2021)<sup>62</sup>, Deloitte Access Economics (2021)

**Separately managed accounts** are non-unitised managed investments held with a fund manager.<sup>63</sup> Unlike an MDA, an SMA is a financial product that is registered like a managed fund and managed by a professional investment manager. Financial advisers can offer their clients 'off-the-shelf' products that are designed and managed by an investment manager.<sup>64</sup> With these products, like other managed funds, investors are not typically able to select individual investments although they can select an overall strategy.<sup>65</sup> As of December 2020, SMAs represented approximately \$45 billion in FUM (see Chart 2.4).<sup>66</sup>

<sup>59</sup> MLC, *Investment concepts – Managed discretionary account (MDA)* (April 2020)

<<https://www.mlc.com.au/content/dam/mlc/documents/pdf/advice/Managed-Discretionary-Accounts-MDA.pdf>>

<sup>60</sup> ASIC, *I8-292MR All managed discretionary account providers now required to be licensed* (October 2018), <<https://asic.gov.au/about-asic/news-centre/find-a-media-release/2018-releases/i8-292mr-all-managed-discretionary-account-providers-now-required-to-be-licensed/>>

<sup>61</sup> IMAP, *IMAP Milliman Managed account FUM census as at 31 December 2020* (March 2020).

<sup>62</sup> Institute of Managed Account Professionals, *Results out for IMAP Milliman Managed Account FUM Census as at 31 Dec 2020* (2021), <<https://www.imap.asn.au/component/content/article/106-perspectives/perspectives-autumn-2021c/1007-md-a-census-results-dec2020?Itemid=101>>

<sup>63</sup> Perpetual, *Separately managed accounts set to grow* (June 2019)

<<https://www.perpetual.com.au/insights/separately-managed-accounts-set-to-grow>>.

<sup>64</sup> BT, *BT Managed Portfolios* (2020) <<https://www.bt.com.au/professional/solutions/portfolio-construction/managed-portfolios-sma-professional-investment-managers.html>>.

<sup>65</sup> BT, *BT Managed Portfolios* (2020) <<https://www.bt.com.au/professional/solutions/portfolio-construction/managed-portfolios-sma-professional-investment-managers.html>>.

<sup>66</sup> IMAP, *IMAP Milliman Managed account FUM census as at 31 December 2020* (March 2020).

Managed accounts provide managed account providers with the freedom to make more timely investment decisions by removing the need for separate authorisation (statement of advice) for each transaction. Consultees noted that this significantly reduces the administration burden on financial advisers and allows them to better operate in the interest of their clients in a timely manner. For the investor, less interaction with financial advisers results in fewer payments for the issue of a statement of advice, and greater certainty that the financial adviser is making timely investment decisions subject to a 'best interest' clause. Investors in managed accounts also benefit from ownership of the underlying asset. This generates tax efficiencies since the investor is entitled to franking and does not inherit tax positions (capital gains), which often occurs in pooled investments.<sup>67</sup>

While managed accounts can hold multiple asset types, information provided in consultation indicates that the majority (44%) of MDA assets are held in managed funds, with other major asset types including listed shares and fixed interest (30%) exchange traded products (12%) and cash (6%).

Managed account professionals indicated that, to their knowledge, there are no managed account structures that are available direct to retail investors. Investors access managed accounts through platforms, which generally require adviser intermediation.

#### **2.4.4 Managed funds provide investors with access to a range of asset classes**

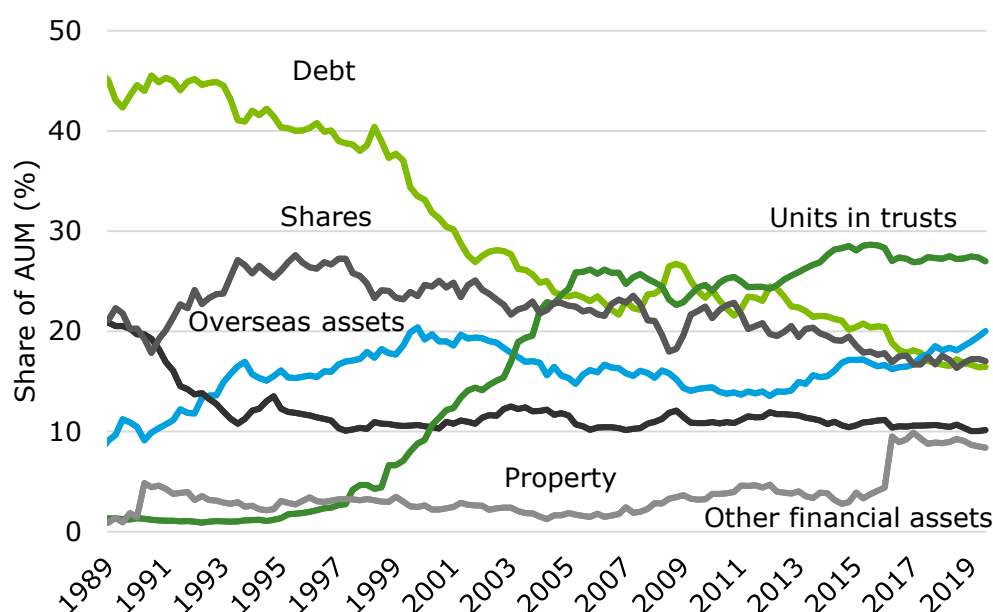
Managed funds provide retail investors with access to asset classes they may not otherwise be able to access.

Chart 2.5 shows that managed funds are invested in a range of asset classes. Further, it shows that there has been some degree of balancing between asset classes over time (as measured by the proportion of FUM — or assets under management (AUM) — within each asset class). Chart 2.5 shows that in 1989, approximately half of all assets were held in debt with units in trusts representing only 1%. Overtime, units in trusts have grown to between 25–30% while debt has declined to around 20%. Shares in property, overseas assets and shares have been more stable overtime.

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<sup>67</sup> Macquarie, *A quick guide to managed accounts* (2021), <<https://www.macquarie.com.au/advisers/the-simple-guide-to-managed-accounts.html>>

Chart 2.5: Asset allocation – share of total assets under management (AUM)



Note: Debt includes debentures, bonds and other forms of debt instruments. Increase in 'Other financial assets' in 2016 is due to a change in reporting requirements of public sector superannuation entities recognising these assets for the first time in September 2016.<sup>68</sup>

Note: Contents of the chart are described in the paragraph above in Section 2.4.4.

Source: ABS (2020) and FSC (2019).<sup>69</sup>

The ability to invest in a range of asset classes helps retail investors better satisfy their investment preferences. Investors have varying tolerances for risk. Each asset class has different risk characteristics. As such, greater access to more asset classes makes it easier for retail investors to find a product that meets their risk and return preferences.

Another gradual trend that is observable in this chart is the impact of globalisation of financial markets and financial services in supporting overseas investments. Since 1990, the share of investments in overseas assets has doubled from 10% to 20% in 2019 (see Chart 2.5).

#### 2.4.5 The investment style of a managed fund can be active or passive

The investment style of a product reflects how it is managed. Products may be managed actively, or passively, or combine elements of both.

Active fund managers aim to outperform the benchmark index for the asset class by buying securities the manager thinks will provide a better return. Investors pay a fee for this service on the expectation that fund manager expertise will enable them to make a better decision.

Passive fund managers aim for a return close to the benchmark index being tracked. These funds are also known as index funds. They are generally cheaper than actively managed funds because less investment expertise is required. The fund manager buys and sells securities as required to track movements in the index.

<sup>68</sup> Australian Bureau of Statistics, *Managed Funds, Australia, Mar 2020*, cat. no. 5655 (4 June 2020).

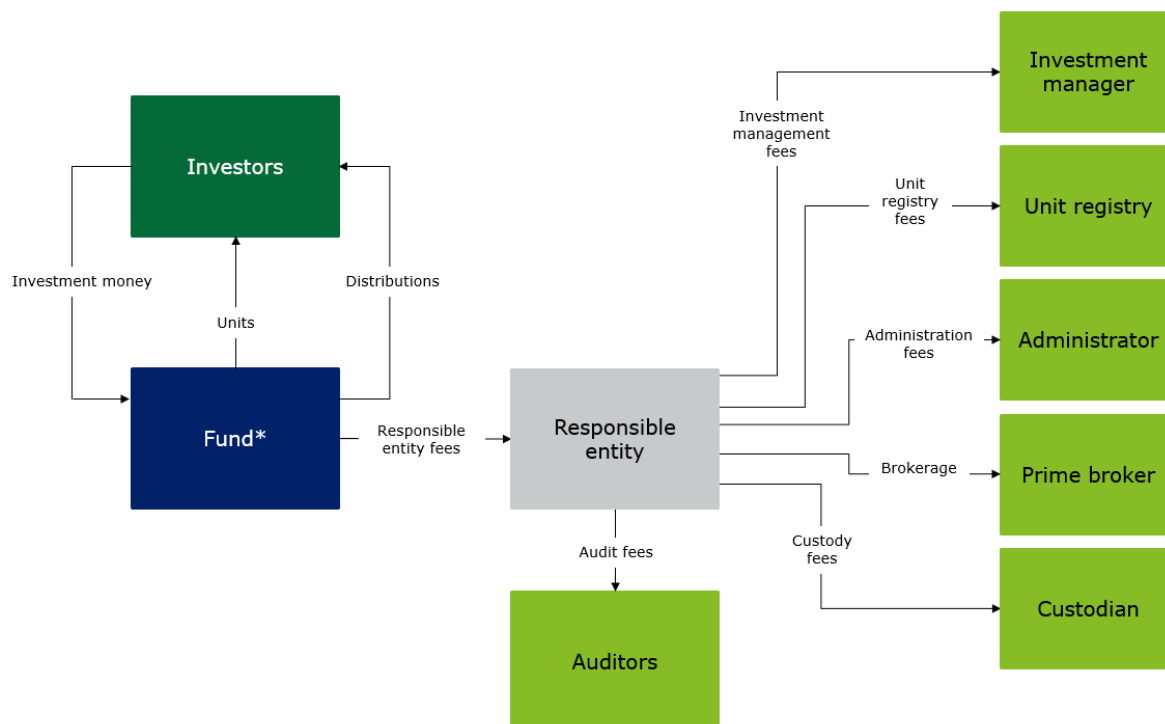
<sup>69</sup> Australian Bureau of Statistics, *Managed Funds, Australia, Mar 2020*, cat. no. 5655 (4 June 2020); Financial Services Council, *State of the Industry 2019* (2019) <<https://www.fsc.org.au/resources/fsc-state-of-the-industry-2019>>.

Despite increasing popularity of passive funds, the majority of managed funds in Australia (approximately 70%) are actively managed.<sup>70</sup>

## 2.5 Legal structure of managed funds in Australia

This section describes the organisational structure of a managed fund, since the term 'fund manager' often refers collectively to a group of participants that may or may not be the same legal entity (See Box 2.1). Figure 2.3 depicts the structure of a fund including the direction of flows and fees, demonstrating relationships between the responsible entity, investment manager, fund, investors and third parties.

Figure 2.3: Organisational structure of a fund manager



Note: \* Fund assets are held by the custodian. This chart may not represent the full range of third-party services.

Note: Contents of the Figure are described in the paragraph above in Section 2.5.

Source: Munro Partners (2019).<sup>71</sup>

All Australian funds require an appointed governance structure depending on registration status: a **responsible entity** for registered funds or a **wholesale trustee** for unregistered funds. Both responsible entities and wholesale trustees must hold an Australian Financial Services Licence (AFSL), but responsible entities must also be an Australian public company.<sup>72</sup> Wholesale trustees are also typically public companies, however, proprietary limited companies may also qualify.<sup>73</sup> This has implications for offshore fund managers seeking to reach Australian customers, as it means they must operate through an Australian business with an AFSL. This requirement has limited

<sup>70</sup> Emma Rapaport, *Moment of truth for active funds*, Morningstar (online), 28 April 2020, <<https://www.morningstar.com.au/funds/article/moment-of-truth-for-active-funds/201895>>

<sup>71</sup> Munro Partners, *Munro global growth fund: Product disclosure statement* (March 2019) <<https://munropartners.com.au/wp-content/uploads/2019/03/Munro-Global-Growth-Fund-Ordinary-mFund-PDS-25-Mar-2019-SEC.pdf>>.

<sup>72</sup> OneInvestmentGroup, *Registering a managed investment scheme* (2020) <<https://www.oneinvestment.com.au/registering-a-managed-investment-scheme//>>.

<sup>73</sup> OneInvestmentGroup, *Registering a managed investment scheme* (2020) <<https://www.oneinvestment.com.au/registering-a-managed-investment-scheme//>>.

international competition in the Australian funds management industry to large offshore institutions with sufficient scale to justify obtaining and registering as a business in Australia. However, these set up costs are not required should an organisation simply seek to provide advice to MDAs or SMAs.

Both responsible entities and wholesale trustees are responsible for the overall management of the fund, including legal and financial reporting, overseeing of investment decisions, and appointment of third-party services, including custodians, fund administrators and, occasionally, investment managers.<sup>74</sup> Third parties are discussed in Chapter 5.

### **Box 2.1: Terminology for ‘investment managers’**

In this report, the term ‘investment manager’ refers solely to the entity responsible for the asset selection and portfolio management (see Figure 2.3). This report uses the term ‘fund manager’ when referring more generally to the broader entity (including responsible entity) that is responsible for delivering a service to investors. These terms are often used interchangeably in the industry.

#### **2.5.1 The investment manager and responsible entity are often integrated**

A responsible entity or wholesale trustee can operate as both trustee and investment manager for a managed investment scheme. While providing greater efficiency in the provision of funds management services to investors, this may create tension where a responsible entity may be conflicted in both acting in self-interest as the investment manager, and in the best interests of investors as trustee. Section 5.3.1 discusses this conflict in the context of incentives for responsible entities to control and scrutinise investment managers.

#### **2.5.2 Funds management falls under the jurisdiction of several regulatory bodies**

Financial services are essential to the effective functioning of the economy, and to individuals’ and households’ financial wellbeing. Consequently, the financial sector is regulated to ensure it can continue to perform these roles well. However, regulation and complying with regulation comes at a cost, which is paid by those who purchase financial services.

ASIC is the primary regulator of the securities markets in which fund managers operate. ASIC oversees and administers the *Corporations Act 2001* and the Australian financial services licence regime that govern fund managers and other participants in the funds management industry.

Other regulatory bodies that oversee aspects of the funds management industry include:

- the Australian Prudential Regulation Authority (APRA), which focuses primarily on prudential regulation of institutions including superannuation funds
- the Australian Taxation Office (ATO), which collects Commonwealth tax and regulates SMSFs
- the Australian Securities Exchange (ASX), which makes rules for investment funds that list on the ASX
- the Australian Financial Complaints Authority (AFCA), which considers complaints about managed investments including financial advice, disclosure and inappropriate transactions.<sup>75</sup>

<sup>74</sup> OneInvestmentGroup *Responsible entities and managed investment schemes* (2020)

<<https://www.oneinvestment.com.au/responsible-entities-and-managed-investment-schemes/>>.

<sup>75</sup> Australian Financial Complaints Authority, *Investments and financial advice products and issues* (2018)

<<https://www.afca.org.au/make-a-complaint/investments-and-financial-advice/investments-and-financial-advice-products-and-issues>>.

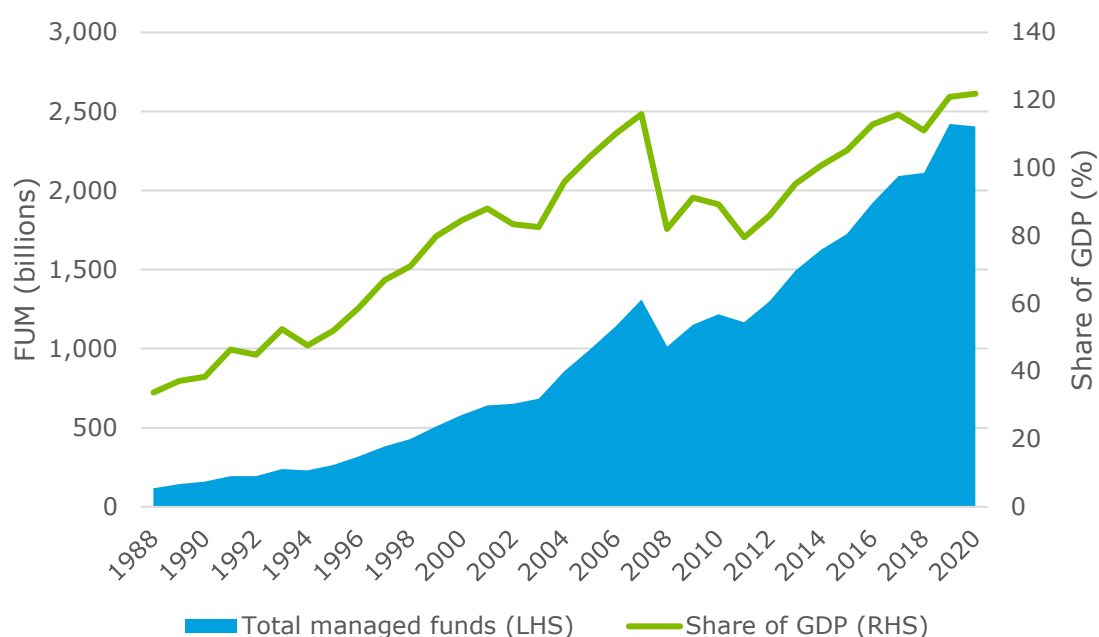
## 2.6 Industry dynamics

In the last 10 years or more, the managed funds industry has undergone considerable change. This change is due in part to rapid growth in demand as well as the changes in the types of products and services demanded by investors. Several significant legislative changes have also affected managed funds, and financial services more generally. These dynamics have and continue to shape the structure of the managed funds industry.

### 2.6.1 Demand for managed funds is growing faster than GDP

Demand for funds management services has been growing steadily. Total FUM has grown significantly over the past 30 years, from 34% of GDP to 122% at the end of 2020 (Chart 2.6). In dollar value of funds under management, this has seen an increase from \$144 billion to almost \$2.5 trillion.

Chart 2.6: Total funds under management from Australian sources



Note: Contents of the Chart are described above in Section 2.6.1.

Source: ABS (2021).<sup>76</sup>

Between March 2011 and March 2021, FUM grew at a compound annualised growth rate (CAGR) of 7.1%, compared to 4% for nominal GDP.<sup>77</sup> Growth in demand was relatively steady; FUM fell in only 6 of 40 quarters during this period. The underlying drivers of this growth are discussed in the sections below.

#### 2.6.1.1 Compulsory superannuation creates a growing pool of savings

Australia's introduction of compulsory superannuation is the single most influential driver of the growth of the funds management industry.

In December 2019, Australia's superannuation system reached \$2.959 trillion of FUM (approximately 150% of GDP) of which most of these funds are managed.<sup>78</sup> Managed

<sup>76</sup> Australian Bureau of Statistics, *Managed Funds*, Australia, Mar 2021, cat. no. 5655 (3 June 2021).

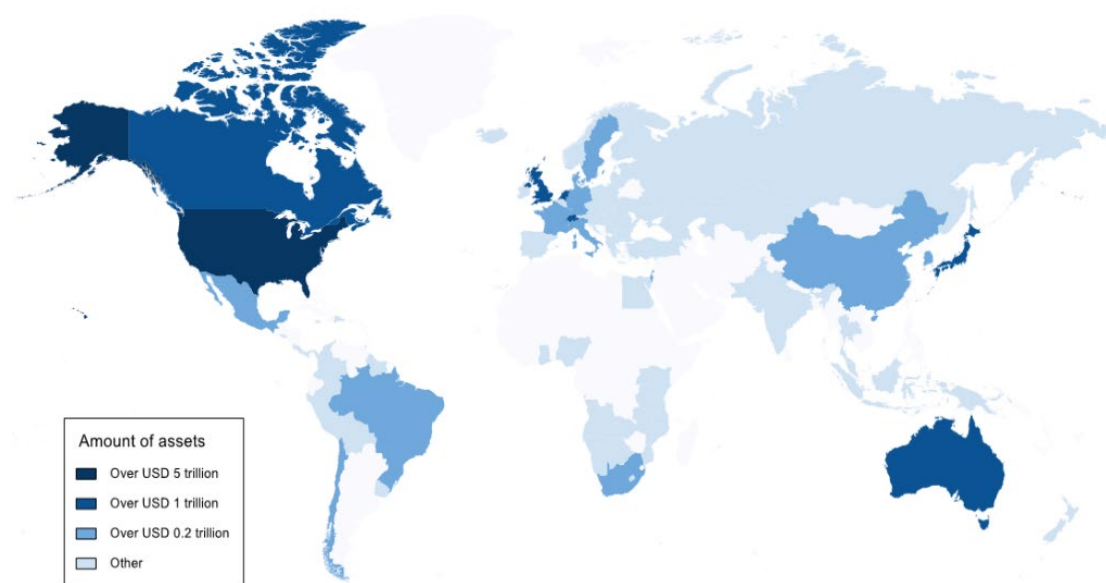
<sup>77</sup> Australian Bureau of Statistics, *Consolidated assets of managed funds institutions*, cat. no. 5655 (3 June 2021); Australian Bureau of Statistics, *Australian National Accounts: National Income, Expenditure and Product*, cat. no. 5206 (2 June 2021). GDP in current prices.

<sup>78</sup> Australian Prudential Regulation Authority, *Quarterly superannuation performance statistics* (March 2020) <<https://www.apra.gov.au/quarterly-superannuation-statistics>>.



funds are well-suited to meet superannuation investors' needs, due to their ability to match the life-cycle stage and risk appetite of the investor as well as providing investors access to different investment strategies and asset types. The number of Australians aged 65 and over is forecast to double in the next 40 years, and retirees will become a higher proportion of the total population.<sup>79</sup> As the population ages, households require more savings to provide income in retirement. Investments in managed funds can be a source of retirement income. Based on current regulatory settings for mandatory contributions, superannuation is projected to grow to \$10 trillion by 2038.<sup>80</sup>

Figure 2.4: Assets in retirement savings plans by country, 2019 or latest available year



The maps show the amount of assets in retirement savings plans in a selection of jurisdictions in 2019, except for: Bolivia (2010), Botswana (2018), Gibraltar (2013), Isle of Man (2017), Lesotho (2012), Liechtenstein (2018), Mauritius (2017), Mozambique (2018), Papua New Guinea (2018), South Africa (2016), Tanzania (2017), Trinidad and Tobago (2012), and Uganda (2016).

Source: OECD Global Pension Statistics (2020)

The Australian superannuation system is the fourth largest pension system in the world after the United States, Canada and the United Kingdom (see Figure 2.4). This size makes Australia an attractive destination for international fund managers despite low fees (see Section 4.3.4) and regulatory barriers to entry (see Section 3.2.3.3). This has ensured a steady stream of international competition in recent years (see Section 3.2.4).

### 2.6.1.2 Investment trends are heavily influenced by the economic cycle

Until the recent global COVID-19 pandemic, Australia had experienced the longest period (28 years) of uninterrupted economic growth among developed economies. In Australia, the median household net worth increased from \$452,100 to \$558,900 over the 10 years to 2018.<sup>81</sup> With interest rates at record lows for most of the past decade, investors have demonstrated a preference for investments (including managed funds) that offer higher returns than bank deposits.

<sup>79</sup> Australian Institute of Health and Welfare *Australia's welfare 2017: in brief* (19 October 2017) <<https://www.aihw.gov.au/reports/australias-welfare/australias-welfare-2017-in-brief/contents/ageing-and-aged-care>>.

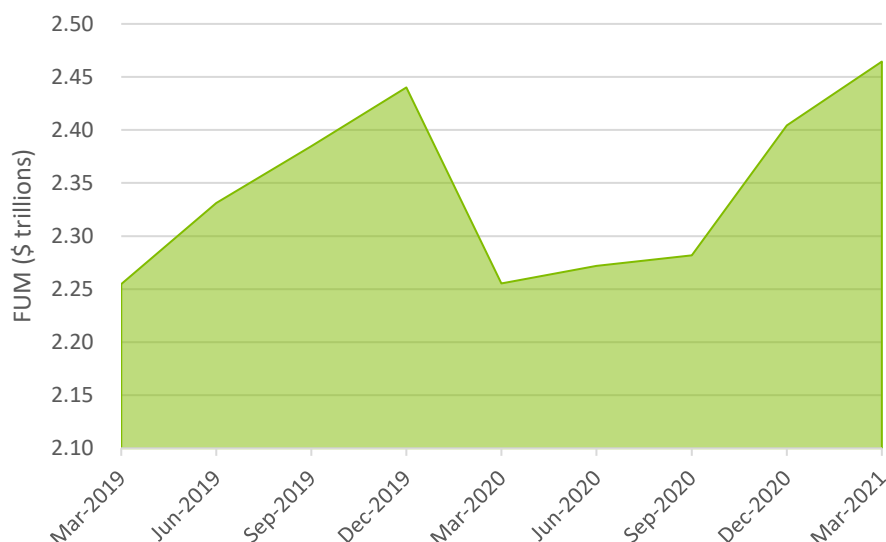
<sup>80</sup> Deloitte, *Dynamics of the Australian Superannuation system* (November 2019), <<https://www2.deloitte.com/au/en/pages/media-releases/articles/dynamics-australian-superannuation-system-next-20-years-deloitte-analysis-271119.html>>

<sup>81</sup> Australian Bureau of Statistics, *Household Income and Wealth, 2017-18*, cat. no. 6523 (12 July 2019).



When the economic cycle turned, or looked to be turning, with the declaration of a global COVID-19 pandemic, funds under management in Australia fell to \$2.25 trillion in March 2020, from \$2.44 trillion in December 2019. This sharp decline was due to a combination of significant asset devaluations as well as large outflows as investors tried to mitigate losses.<sup>82</sup>

Chart 2.7: Impact of COVID-19 on funds under management



Source ABS (2021).<sup>83</sup>

Note: Contents of the chart are described above in Section 2.6.1.2.

The rebound in funds under management was sudden, exceeding previous levels within a matter of months (see Chart 2.7), as many investors looked to capitalise and capture assets at a discounted rate with expectations of a strong recovery.<sup>84</sup> Research from Investment Trends estimates that an additional 435,000 Australians placed their first trade during the pandemic.<sup>85</sup> Fund managers, in particular ETF providers, benefitted from this increase in activity, with Vanguard attracting an additional \$5.7 billion FUM into ETFs in 2020.<sup>86</sup> Box 7.4 in Section 7.3.2 discusses how these trends are impacting on investor outcomes.

### 2.6.1.3 Technology makes managed funds more accessible

Technological advances, particularly around platforms and online trading portals, have made managed funds (and other investment products) more accessible to individual retail investors. Although platforms have been around in some form since the late 1980s, increasing internet usage for financial matters and improvements in design and

<sup>82</sup> KPMG, *Valuations against the COVID-19 pandemic & significant economic uncertainties* (July 2020) <https://assets.kpmg/content/dam/kpmg/sg/pdf/2020/07/valuations-amidst-the-covid-19-pandemic-and-significant-economic-uncertainties.pdf>

<sup>83</sup> Australian Bureau of Statistics, *Managed Funds*, Australia, Dec 2020, cat. no. 5655 (4 March 2021).

<sup>84</sup> David Chau, *Record breaking market frenzy will come to an "abrupt halt", experts warn* (16 March 2021), ABC News, <<https://www.abc.net.au/news/2021-03-16/covid-crash-markets-asx-wall-street-fomo/13250212>> <https://knowledge.wharton.upenn.edu/article/why-is-the-stock-market-so-strong-when-the-economy-is-weak/>

<sup>85</sup> Vickovich, Aleks, *First time traders hit 400,000 during pandemic*, Australian Financial Review (online), 11 March 2021, <<https://www.afr.com/companies/financial-services/first-time-traders-hit-400-000-during-pandemic-20210311-p579qm>>.

<sup>86</sup> Vickovich, Aleks, *Vanguard ETFs hit Australian record amid pandemic*, Australian Financial Review (online), 15 January 2021, <<https://www.afr.com/companies/financial-services/vanguard-etfs-hit-australian-record-amid-pandemic-20210115-p56uf0>>.

capability have driven their recent growth among financial advisers and self-directed investors alike.<sup>87</sup>

As such, technology is increasingly becoming a point of differentiation between managed fund providers, with product offering and usability key sources of competition, not only in the market for retail investors but also financial advisers and the managed accounts sector.<sup>88</sup> Online trading platforms are now the most frequently used trading method for retail investors, with 6 out of 10 Australian investors using a mobile device to trade.<sup>89</sup>

In the last 20 years, increasing use of the internet has allowed a more efficient method for suppliers of financial services to market to investors.<sup>90</sup> As such, investors enjoy greater access to financial information and reduced search costs of finding not only managed funds, but financial advice and other financial services.<sup>91</sup> More recently, digital, or 'robo', advice have also made an impact on the market by making generic, low-cost investment advice more accessible for more investors.<sup>92</sup>

#### 2.6.1.4 Growing focus on sustainability

Environmental, social and (corporate) governance (ESG) has emerged to place more responsibility on business to consider sustainability and societal impact. Investors too are increasingly looking for investments that meet ESG objectives.<sup>93</sup> Demand for responsible investment has experienced strong growth in the last 5 to 10 years and created another way for fund managers to differentiate their products. In July 2019, the Responsible Investment Association Australasia (RIAA) identified 44% (approximately \$980 billion) of Australia's managed assets as 'responsible', up from only 13% in 2013.<sup>94</sup>

#### 2.6.2 Significant regulatory changes are scheduled for later this year

In December 2020, ASIC released *Regulatory Guide 274* (RG 274) that indicated that from October 2021, issuers and distributors of financial products, including managed funds, will be required to comply with design and distribution obligations (DDO). These obligations are intended to improve consumer outcomes by requiring issuers to:

- design financial products that are suitable to the likely objectives, financial situation and needs of the intended consumer
- take 'reasonable steps' to ensure that end consumers are receiving financial products that are suited to their particular characteristics (as above) defined by the issuer
- monitor the outcomes of consumers and review products as needed to ensure that suitable products are reaching the appropriate investors.<sup>95</sup>

<sup>87</sup> Netwealth, *Platforms – the original fintech* (May 2018)

<<https://www.netwealth.com.au/web/resources/insights/platforms-the-original-fintech/>>.

<sup>88</sup> HUB24, *The future of managed portfolios* (2018) <[https://www.hub24.com.au/wp-content/uploads/2018/09/The-Future-of-Managed-Portfolios\\_FINAL.pdf](https://www.hub24.com.au/wp-content/uploads/2018/09/The-Future-of-Managed-Portfolios_FINAL.pdf)>.

<sup>89</sup> Deloitte Access Economics, *ASX Australian Investor Study* (report commissioned by Australian Securities Exchange, 2017) <<https://www2.deloitte.com/au/en/pages/economics/articles/asx-australian-investor-study.html>>.

<sup>90</sup> Seaton Kelton, Andrea & Pennington, Robin R., *Internet financial reporting: the effects of information presentation format and content differences on investor decision making* (2012) 28(4) *Computers in Human Behaviour*.

<sup>91</sup> Freeman, Glenn, *Online advice a close second to financial planning* (July 2019) Morningstar <<https://www.morningstar.com.au/learn/article/online-advice-a-close-second-to-financial-pla/194394>>.

<sup>92</sup> Vickovich, Aleks, *Amid the virus, have robo-advisers found their moment?*, *The Australian Financial Review* (online), 30 April 2020 <<https://www.afr.com/wealth/investing/amid-the-virus-have-robo-advisers-found-their-moment-20200420-p54lh6>>.

<sup>93</sup> Rothwell, Julie, *The Rising demand of ESG ETFs* (May 2019) BNY Mellon <<https://www.bnymellon.com/emea/en/what-we-do/business-insights/the-rising-demand-of-esg-etfs.jsp>>.

<sup>94</sup> Fernyhough, James, *Ethical investments soar to nearly \$1 trillion*, *The Australian Financial Review* (online), 3 July 2019 <<https://www.afr.com/companies/financial-services/ethical-investments-soar-to-nearly-1-trillion-20190702-p5239b>>.

<sup>95</sup> ASIC, *Regulatory guide 274, Product design and distribution obligations* (December 2020) <<https://asic.gov.au/media/5899239/rg274-published-11-december-2020-20201218.pdf>>

These requirements were deemed necessary after the Financial System's Inquiry in 2014 found that consumer protection within financial services was too heavily dependent on appropriate disclosure, financial advice and financial literacy, leading to poor consumer outcomes.<sup>96</sup> DDO therefore shifts some of the responsibility for consumer protection onto the manufacturers and distributors of financial products. RG 274 suggests that some distributors may already have such product governance arrangements in place.

Despite the impending start date of these obligations, and the guidance provided by ASIC in RG 274, consultations with industry revealed there is still a degree of uncertainty surrounding the implementation of DDO, particularly the determination of a target market. Although the obligations do not require issuers and distributors to conduct individual tests of suitability, they must be able to determine a target market for the product based on a range of attributes, and decommission products for which a target market cannot be identified.<sup>97</sup> In addition, issuers will need to work with distributors, including platforms and financial advisers to ensure that the intermediated investors are also receiving appropriate financial products.<sup>98</sup>

Although the full impact of DDO is uncertain, there is some industry speculation that these obligations will increase costs and reduce availability of products.<sup>99</sup> Other participants consulted as part of this report were more optimistic, indicating that the industry would learn to adjust, as it has done for FOFA and other significant reforms. This report does not take a view on the likely impact of DDO on costs or competition, however, does acknowledge that some of the issues and concerns raised in this report may be mitigated by the introduction of DDO later this year. These concerns are discussed throughout this report.

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<sup>96</sup> Ibid.

<sup>97</sup> Ibid.

<sup>98</sup> Teskey, Rosalyn and Kallian, Kavir, *Design and distribution obligations (DDO): Third-party distribution* (April 2021), Deloitte, <<https://www2.deloitte.com/au/en/blog/financial-advisory-financial-services-blog/2021/design-distribution-obligations-third-party-distribution.html>>

<sup>99</sup> Australian Securities & Investments Commission, *Product design and distribution obligations* (Consultation Paper 325, March 2020) <<https://download.asic.gov.au/media/5423121/cp325-published-19-december-2019.pdf>>

# 3 Structure of the industry

## **This chapter finds that:**

The funds management industry has grown significantly as a result of compulsory superannuation. This is expected to continue, with funds under management growing faster than GDP.

The funds management industry in Australia has a long tail, market shares are dynamic, and concentration has declined over the last 20 years. The growing number of firms ensures that consumers can potentially choose from a wide range of fund managers. However, there are large players; the 10 largest fund managers hold more than 50% of funds. There are variations in concentration between different types of funds. The market for listed products is more concentrated than the market for unlisted products.

Fund managers face barriers to entry that increase the time before a fund is cost-competitive. Barriers to entry can allow incumbents to exercise exclusionary conduct. These include regulatory requirements, economies of scale and intermediary requirements. Despite this, new entrants are common.

Retail investors have limited, if any, individual buying power. However, platforms, dealer groups and institutional investors, such as superannuation companies, who represent collections of retail investors, can have significant market power allowing them to exert more influence than individual retail investors. These distribution channels are not highly concentrated, but they can restrict funds from reaching retail investors. The industry is highly dependent on intermediaries in the supply chain.

Fund managers may be vertically integrated with other parts of the investment supply chain. Vertical integration can create conflicts of interest and lead to market power, for example between an investment manager and a responsible entity. Overall, levels of vertical integration are falling.

This chapter looks at how the current market structure and regulations affect concentration in the industry and barriers to entry, exit and expansion.

As noted in Chapter 2, the implications of market structure for competition are inextricably linked to conduct, and vice versa. As an example, vertical integration (structure) can create conflicts of interest (conduct). Likewise, competition on product differentiation (conduct) can lead to changes in concentration (structure).

The following sections describe the structural elements of the funds management industry — in particular, concentration of suppliers and buyers of products, and barriers to entry or expansion that appear to exist in the market. The conduct of firms and investors in response to these structural elements is explored in subsequent chapters of this report.

This chapter includes:

- Section 3.1 – characteristics of demand
- Section 3.2 – characteristics of supply
- Section 3.2 – industry supply chain
- Section 3.4 – changes occurring in supply and distribution.

### 3.1 Characteristics of demand

An assessment of competition depends on the dynamics and characteristics of demand. This section analyses the concentration of buyers (investors) as well as demand dynamics that affect the ways investors engage with fund managers. The implications of these dynamics for competition are explored in detail in further chapters of this report, particularly Chapter 7.

#### 3.1.1 Buyer concentration is relatively high on account of institutional investors

The structure and composition of buyers and sellers in the market can influence the effectiveness of competition. In funds management, a sufficient level of investor concentration can act as a countervailing power, with large investors or investor groups creating rivalry among fund managers who compete to manage their funds.

Countervailing power reduces the potential for incumbent fund managers to exercise market power, however, size and scale do not guarantee countervailing power unless there is a 'credible threat' that investors can bypass the seller.<sup>100</sup> In the funds management market, institutional investors have demonstrated a credible threat using vertical integration, for example:

- in-housing investment management
- importing or sponsoring a rival to the incumbent seller(s)
- superannuation funds collaborating and establishing a dedicated service provider.

In order for countervailing power to operate in the funds management industry, not all buyers need to be sufficiently concentrated. It is often enough that a subset of large buyers be price sensitive for there to be competition in the market. In funds management, large institutional investors potentially provide countervailing power as they have demonstrated their ability to in-house certain investment capabilities.

Superannuation occupies more than 50% (\$1.2 trillion) of the buyer's share of managed funds, with the largest superannuation funds managing as much as \$191 billion in assets as of June 2020.<sup>101</sup> Larger superannuation funds have also displayed a credible threat by choosing to bypass traditional fund managers; for example, AustralianSuper manages up to 50% of its investments in-house.<sup>102</sup> This scale provides the potential for considerable countervailing power and competition between fund managers. Consultations with industry before and after the Interim Report strongly supported the view that competition between managers over the assets held by superannuation funds is highly competitive.

Even if large institutional investors are able to demonstrate countervailing power in the market, market segmentation, particularly between investor types, may mitigate the effect to some extent since not all investors are acquiring the same product. Compared to superannuation funds and other institutional investors, retail investors (including SMSFs) operate as individuals and have relatively limited buyer power. However,

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<sup>100</sup> Australian Competition and Consumer Commission *Merger guidelines* (November 2017) <<https://www.accc.gov.au/system/files/Merger%20guidelines%20-%20Final.PDF>>.

<sup>101</sup> APRA, *Annual fund-level superannuation statistics* (June 2020), <<https://www.apra.gov.au/annual-fund-level-superannuation-statistics>>

<sup>102</sup> AustralianSuper, *How we invest* (2020), <<https://www.australiansuper.com/investments/how-we-invest>>

platforms which see large flows of individual investors' money may be able to exercise countervailing power in their relationships with fund managers (see Section 6.2).

## 3.2 Characteristics of supply

Dynamics of supply and the market power of individual suppliers are an important consideration in assessing competition. This section analyses the concentration of suppliers as well as barriers to entry that may impede the ability to disrupt the market. This section also discusses and analyses merger activity in the industry that can affect both concentration and barriers to entry.

### 3.2.1 Number of fund managers is growing with funds under management

According to ASIC data, there were 450 registered responsible entities in Australia as of June 2021, of which 327 were operating with funds under management.<sup>103</sup> These responsible entities provided 3,712<sup>104</sup> registered managed investment schemes to investors.<sup>105</sup>

Fund managers vary from small, boutique outfits to large multinational organisations to vertically integrated businesses that are part of the wider portfolio of large financial institutions. A complex and evolving product range, the need for investors to diversify and the level of specialised expertise make it possible for a diverse mix of fund managers to exist and differentiate themselves.

#### Box 3.1: Plan For Life

The data used in Chapters 2 and 3 of this report are primarily from *Plan for Life, Actuaries and Researchers* (Plan for Life). The data cover approximately 170 managed funds institutions and are collected on a quarterly basis through survey. Plan for Life is used widely across the Australian managed funds sector. More information on sample collection and data methods can be viewed on the Plan for Life website and documentation.

Some differences in the number of fund managers between ASIC and Plan for Life are expected since ASIC numbers will include any registered scheme with an ARSN, regardless of listing status or scheme type. Plan for Life data exclude several scheme types, including non-retail superannuation, ETFs, LICs or LITs. Nonetheless, Plan for Life does acknowledge that fund managers may be reluctant to participate in the survey until they have reached a sufficient scale or when they believe the research may benefit them. This report cannot rule out the possibility that the Plan for Life data understate the true number of managed fund providers or that the survey methodology leaves open the possibility for some degree of survivor bias.

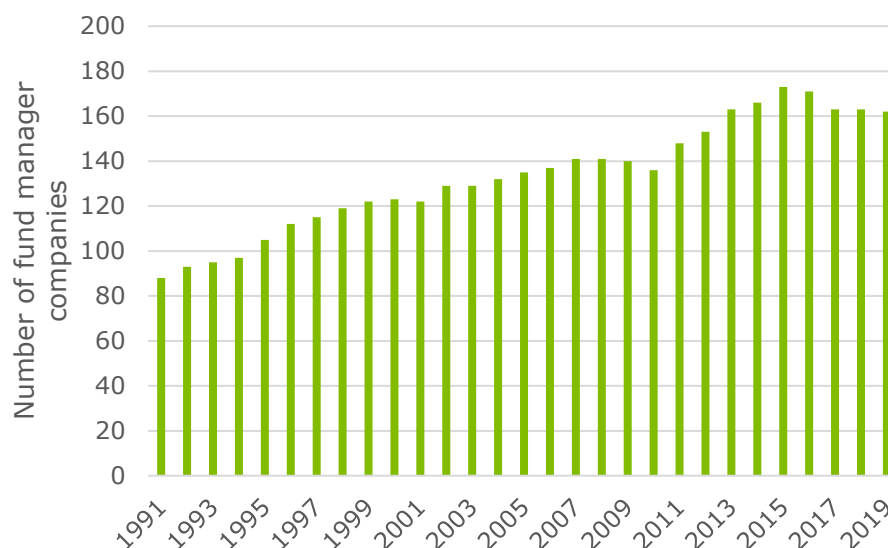
Based on Plan for Life data (see Box 3.2), since 1991, the number of fund managers in Australia has more than doubled, as domestic and offshore managers, such as Vanguard and State Street, seek to capitalise on Australia's growing wealth. Chart 3.1 shows the number of fund managers in Plan for Life data increased from around 80 managers to 160 between 1991 and 2019. However, since 2015, the number of fund managers appears to have declined modestly. A growing number of fund managers may be a positive indicator of competition, in that incumbent managers appear unable to exclude new entrants.

<sup>103</sup> Unpublished ASIC data.

<sup>104</sup> This figure likely includes some funds which are registered but inactive.

<sup>105</sup> Australian Securities and Investments Commission, *Annual Report 2018–19* (October 2019) <<https://asic.gov.au/about-asic/corporate-publications/asic-annual-reports/#ar19>>.

Chart 3.1: Number of fund manager companies (1991–2019)



Note: Plan for Life describes fund managers in terms of 'companies' and 'groups'. Companies is the more disaggregated of the two, since groups refer to the broader financial institution that may include several fund managers. Plan For Life does not include ETFs, LICs or LITs.

Note: Contents of the chart described in the paragraph above in Section 3.2.1.

Source: Deloitte Access Economics (2021) and Plan For Life (2020).

As the number of fund managers has grown, so too has the number of funds available. The number of products available in a market does not, in and of itself, provide evidence on the efficacy of competition. A large number of products may be an indicator of product innovation, a function of the number of competitors, or suggest a wide variety of consumer needs — all positive indicators of competition. However, a proliferation of falsely differentiated products, where products appear to be differentiated despite sharing similar or identical underlying characteristics, may lead to suboptimal consumer outcomes. This possibility, sometimes known as “confusopoly”,<sup>106</sup> is explored further in Section 4.2.1.

### 3.2.2 Supplier concentration is relatively low and market shares are dynamic

To assess seller concentration, the market and the measure of concentration need to be defined. In general, the lower the level of aggregation, the higher the level of concentration; and the more homogeneous the group, the more accurately concentration measures the share of output of a product.<sup>107</sup>

Funds management comprises a lot of functions, as noted above. Some fund managers focus exclusively on funds management, whereas others may provide other financial services such as investment advice, banking and brokerage.<sup>108</sup>

Variables that can be used to calculate market shares and concentration include turnover (sales), output, value added, assets and employment levels.<sup>109</sup> For example, the ACCC

<sup>106</sup> Kalayci, K. *Confusopoly: competition and obfuscation in markets*, (2016) 19(2), *Experimental Economics*.

<sup>107</sup> Britton, L.C., Clark, T.A.R. & Ball, D.F., *Executive search and selection: Imperfect theory or intractable industry?* (1992) 12(2) *The Service Industries Journal*.

<sup>108</sup> This report considers the most appropriate way in which to report on financial groups that may operate under different brands (such as, Westpac/BT, Commonwealth Bank/Colonial First State). Generally, when reporting on the industry as a whole, these groups are reported as one. However, consideration will be given to specific brands when it is relevant to consider more specific markets and consumer segmentation.

<sup>109</sup> For a discussion, see Britton, L.C., Clark, T.A.R. & Ball, D.F., 'Executive search and selection: Imperfect theory or intractable industry?' (1992) 12(2) *The Service Industries Journal*.

Merger Guidelines propose using sales by volume, sales by value, and capacity, in three recent periods.<sup>110</sup>

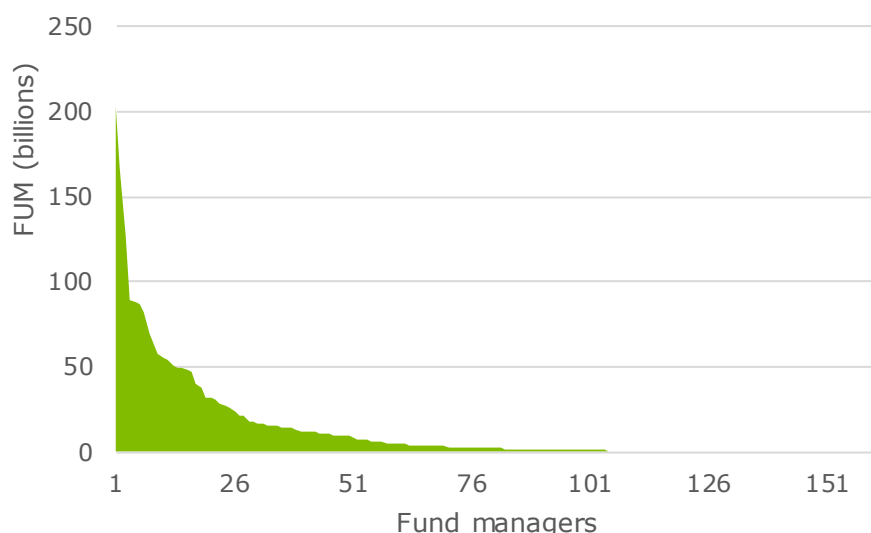
- The industry uses FUM for discussion of market shares, rather than a measure of sales. It is a readily available measure and avoids distortions arising from different fees charged (given heterogeneity of pricing). But it is cumulative (a stock, not a flow) and affected by earnings on funds invested.
- Flows would be closer to the amount of business obtained, to demonstrate the share each manager has of total business in the industry, but can be negative (outflows). Flows (inflows and outflows) are considered further in Section 7.3.1.

This report uses FUM as the measure of concentration.

### 3.2.2.1 Fund manager market shares are skewed but dynamic

Although the Australian funds management industry consists of more than 300 fund managers, it is dominated by a few large companies. In 2019, 10 fund managers represented 50%, or \$1 trillion, of FUM (see Chart 3.2). This level of concentration is similar to that seen in the United Kingdom, where the top 10 managers represent approximately 55%.<sup>111</sup>

Chart 3.2: Fund manager by FUM



Note: Plan for Life data likely excludes some fund managers in the tail of this distribution.

Note: Contents of the chart described in the paragraph above in Section 3.2.2.1.

Source: Deloitte Access Economics (2021) and Plan For Life (2020).

Although Chart 3.2 suggests that the market is heavily concentrated, concentration alone is not necessarily a concern. If a particular fund manager(s) operates more efficiently or holds a particular competitive advantage, concentration can have positive consumer outcomes. What may be a concern is if the concentration or structure of the suppliers remains unchanged over a significant period of time. This could signal anti-competitive conduct, for example, the absence of a credible threat that the incumbents' market position can be challenged through consumer switching.

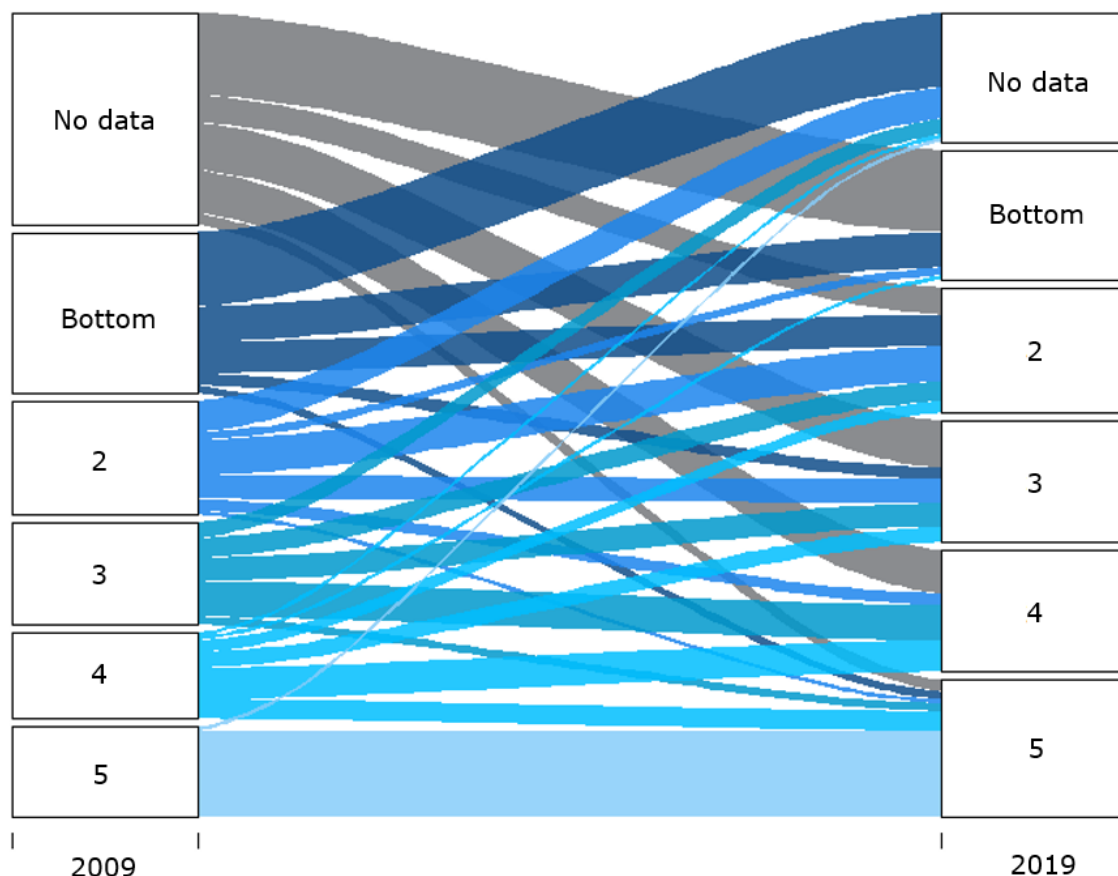
<sup>110</sup> Australian Competition and Consumer Commission 'Merger guidelines' (November 2017) <<https://www.accc.gov.au/system/files/Merger%20guidelines%20-%20Final.PDF>>.

<sup>111</sup> Financial Conduct Authority, *Asset Management Market Study Interim Report* (Market Study 15/2.2, November 2016) <<https://www.fca.org.uk/publication/market-studies/ms15-2-2-interim-report.pdf>>.



This report tests the dynamism of supplier concentration by comparing concentration of funds under management over a 10-year period. Chart 3.3 shows the movement of fund managers across quintiles based on FUM. A dynamic market would show players within each quintile, and even players entering the market over this timeframe, ascending/descending the ranking over a 10-year period.

Chart 3.3: Fund manager quintile comparison



Note: Axes refer to the quintile i.e. 5 represents the top 20%, 'bottom' represent lowest 20%. 'No data' means that the fund manager has either exited or entered the industry over the period or has no data available in a particular year for another reason.

Note: Contents of chart are described in the paragraphs above and below in Section 3.2.2.1.

Source: Deloitte Access Economics (2021) and Strategic Insight (2020).

Chart 3.3 shows that much of the top quintile in 2009 remain in the top quintile in 2019, indicating that they are relatively secure in their positions. Of the top quintile, 96% remain in the top quintile 10 years later. This cohort is dominated by the major banks and financial institutions (such as IOOF, ANZ Wealth and Colonial First State) and relatively long-established fund managers within Australia (such as Platinum and Perpetual). Apart from the top 20%, the supplier concentration appears reasonably dynamic, with new and existing funds able to build on their market share. Only 20% of the bottom quintile remain at the low end, having either exited the industry or moved to a higher quintile. The movements between the third and the second quintile, and from the second to the first quintile, show a clear ability for fund managers to compete upwards. The implications of Chart 3.2 and Chart 3.3 are that much of the dynamism occurs at the tail end of the distribution, that is, among the smaller funds.

In the next section, standard metrics are used to measure concentration of the managed funds industry at both an aggregate level and across various subsections.

### 3.2.2.2 Market for unlisted products is not highly concentrated

The Herfindahl-Hirschman Index (HHI) is a widely recognised measure of market concentration and is used by the ACCC when considering the impact of a merger on competition.<sup>112</sup> It is calculated by summing the squared market shares of each fund manager group, returning a score between 0 (lots of small firms, highly contested) and 10,000 (monopoly).<sup>113</sup> As a general rule, the ACCC considers a HHI of less than 2,000 as an indication that a market is reasonably competitive.<sup>114</sup> However, the ACCC uses this HHI benchmark to assess the impact of mergers on industry concentration rather than the general level of concentration. Other international regulators prefer to use a range from 1,500 to 2,500, instead of a fixed level.<sup>115</sup>

Chart 3.4 shows the HHI calculated at both the fund manager (company) level and the group level over time between 1991 and 2019. A fund manager 'group' refers to the broader financial institution that owns a particular fund manager (if applicable). The reason for this distinction is that some institutions may own or operate more than one fund or wealth management division. Chart 3.4 demonstrates that the concentration of funds under management, at both fund manager and group levels, has been declining over time. As of September 2019, the HHI for fund managers and groups was respectively 327 and 475, indicating levels of market concentration well below the ACCC benchmark. The measures of concentration used in this report do not account for common ownership (see Box 3.2).

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<sup>112</sup> Australian Competition and Consumer Commission, *Merger guidelines* (November 2017)

<<https://www.accc.gov.au/system/files/Merger%20guidelines%20-%20Final.PDF>>.

<sup>113</sup> Rhoades, Stephen A., *The Herfindahl-Hirschman Index* (Federal Research Bank of St Louis, March 1993)

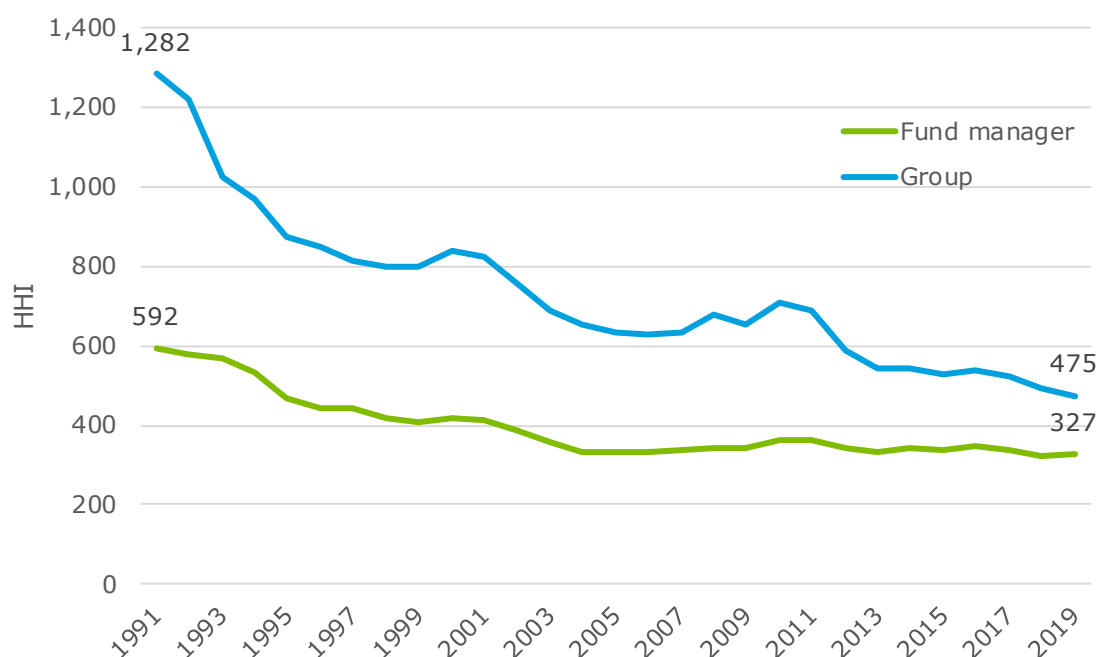
<[https://fraser.stlouisfed.org/files/docs/publications/FRB/pages/1990-1994/33101\\_1990-1994.pdf](https://fraser.stlouisfed.org/files/docs/publications/FRB/pages/1990-1994/33101_1990-1994.pdf)>.

<sup>114</sup> Australian Competition and Consumer Commission, *Merger guidelines* (November 2017)

<<https://www.accc.gov.au/system/files/Merger%20guidelines%20-%20Final.PDF>>.

<sup>115</sup> Department of Justice, *Herfindahl-Hirschman Index* (July 2018) <<https://www.justice.gov/atr/herfindahl-hirschman-index>>.

Chart 3.4: HHI for FUM by fund manager and group



Note: 'Group' refers to the broader financial services entity, if one exists i.e. a 'group' such as National Australia Bank may operate or have ownership in more than one fund manager. Funds under management includes wholesale funds. Plan For Life data does not include ETFs, LICs or LITs.

Note: Contents of the chart are described in the paragraph above in Section 3.2.3.1.

Source: Deloitte Access Economics (2021) and Plan For Life (2020).

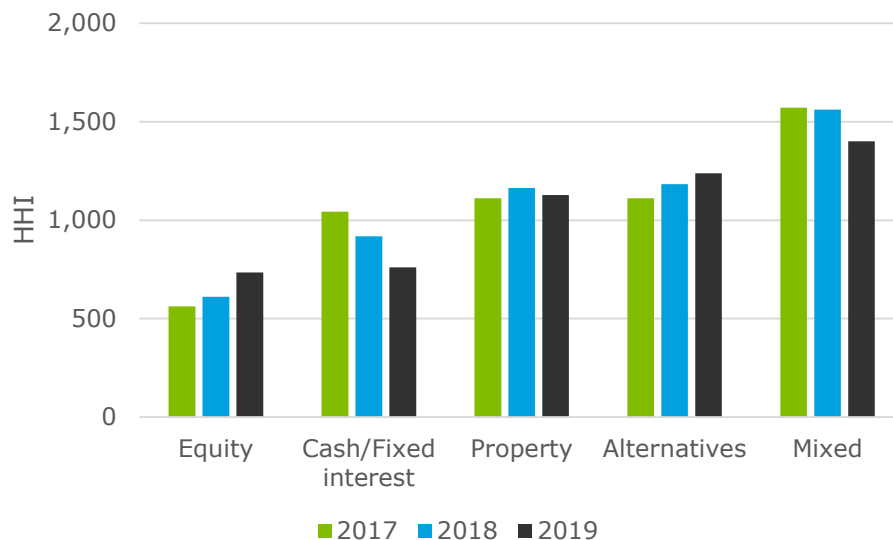
The decline in industry concentration has been a relatively constant trend since 1991. During that time, the market has experienced the following.

- **Increased competition** from global fund managers entering the market — the Australian funds management sector is one of the largest globally and as such represents an opportunity for large global businesses. Over the years, global fund managers have challenged the dominance of Australian fund managers.
- **Regulatory changes and scrutiny** of large, vertically-integrated institutions, adding to the case for some larger Australian financial institutions to spin off their wealth management arms.<sup>116</sup> Some of these demergers are still under negotiation. Regulation has also been a catalyst for consolidation among smaller fund managers facing increased compliance costs.<sup>117</sup>
- **Rise of platforms and fintech** — the rise of digital trading platforms has created a sub-division of 'fintech' managers. These managers may offer lower fees and be preferred by investors seeking more control over assets.<sup>118</sup>
- **Rise in passive investing** — the Australian market, like the global market, is seeing a rise in passive investment and the popularity of listed products such as ETFs.<sup>119</sup> Passive investing requires less specialised investment management skills and is cheaper and easier for fund managers to provide, widening the range of choices for investors. Although ETFs are not included in the data presented above, the increasing popularity of passive products and the effect on the funds management industry has been an ongoing theme in consultation with industry.
- **In-housing of investment capabilities** — as superannuation funds consolidate, increasingly investment capabilities are being brought in-house. This increases the number of rivals to fund managers in the market.
- **Alternative investments** — in recent decades, the significant increase in FUM has provided demand for, and encouraged the provision of, managed funds of alternative asset classes which could not easily be accessed through traditional capital

markets.<sup>120</sup> This has supported more specialist fund managers, while increasing the range of options available to investors.

Some fund managers consider competition for a fund to be within a particular fund type or asset class, rather than the industry in general. Chart 3.5 presents the HHI by broad asset class over a three-year period. Chart 3.5 shows that some asset types are more concentrated than others, although all asset classes remain below the ACCC threshold. In some asset classes (equities and alternatives), concentration has increased whereas concentration of fixed interest and mixed assets markets has declined over the period.

Chart 3.5: HHI by major asset classes (2017–2019)



Note: HHI by asset class calculated by group level FUM for each major asset class available in Plan For Life data. Plan for Life data does not include listed products.

Note: Contents of the chart are described in paragraph above in Section 3.2.2.2.

Source: Deloitte Access Economics (2021) and Plan For Life (2020).

<sup>116</sup> PricewaterhouseCoopers, *Asset & Wealth management market intelligence digest Australia* (2018) <<https://www.pwc.com/sg/en/asset-management/assets/market-research-centre/sample-reports/sample-report-au.pdf>>.

<sup>117</sup> PricewaterhouseCoopers, *Asset & Wealth management 2025: The Asian awakening* (January 2019), <<https://www.pwc.com/au/asset-management/2018-awm-asia-2025-report-31jan19.pdf>>.

<sup>118</sup> Deloitte, *How can Fintech facilitate fund distribution* (June 2016) <[https://www2.deloitte.com/content/dam/Deloitte/lu/Documents/technology/lu\\_how-can-fintech-facilitate-fund-distribution.pdf](https://www2.deloitte.com/content/dam/Deloitte/lu/Documents/technology/lu_how-can-fintech-facilitate-fund-distribution.pdf)>.

<sup>119</sup> Graham Hand, *Three adverse consequences from fund closures* National Australia Bank <[https://www.nabtrade.com.au/investor/insights/latest-news/news/2019/07/three\\_adverse\\_conseq](https://www.nabtrade.com.au/investor/insights/latest-news/news/2019/07/three_adverse_conseq)>.

<sup>120</sup> Austrade, *Australia's managed funds 2017 update* (2017) <[https://www.austrade.gov.au/ArticleDocuments/5720/2017\\_Australias-Managed-Fund-Update.pdf](https://www.austrade.gov.au/ArticleDocuments/5720/2017_Australias-Managed-Fund-Update.pdf)>.

### **Box 3.2: Common ownership**

The Interim Report posed a question to industry as to the possibility and likelihood that common ownership could present a concern for competition in the managed funds industry. Common ownership, or 'horizontal shareholding', in the context of funds management refers to the situation where large institutional investors invest in more than one fund. Common ownership has the potential to create anti-competitive behaviour if significant investors with more than one holding in a given sector, benefit from all companies performing well.

An alternative issue may arise if fund managers use their funds to purchase large shareholdings in other industries. This risk has received some attention in recent years, particularly in the United States, as a result of a small number of large fund managers owning significant shares in other, concentrated industries (including pharmaceuticals or aviation).<sup>121</sup> Research suggested that fund manager holdings have been responsible for a weakening of competition in these industries.

The impact on competition of fund managers owning multiple firms in other industries is outside the scope of this report. However, the Interim Report considered the possibility that common ownership could occur if a small number of institutional investors were large shareholders in listed Australian fund managers.

Since the release of the interim report, Australian research found that common ownership affects 11% of a sample of 443 Australian industries (36% on a revenue basis).<sup>122</sup> Within this sample, the report finds funds management is one of the industries most affected, indicating that accounting for common ownership more than doubles the market concentration.<sup>123</sup> This final report conducted by Deloitte Access Economics has not quantitatively tested for the impact of common ownership on market concentration, however, acknowledges this as an area of growing interest. The House of Representatives Standing Committee on Economics has recently commenced a new inquiry into the implications of capital concentration and common ownership in Australia.

#### **3.2.2.3 Exchange-traded funds are more concentrated than unlisted funds**

The market for listed products is significantly more concentrated than the market for unlisted products. Chart 3.6 shows the HHI calculated using funds under management of listed products, extracted from data provided by the Australian Securities Exchange (ASX). This shows a consistent HHI (approximately 2,500) above the threshold outlined in the ACCC merger guidelines.<sup>124</sup> This is due to a significant concentration of funds in Vanguard and BlackRock ETFs, in particular.

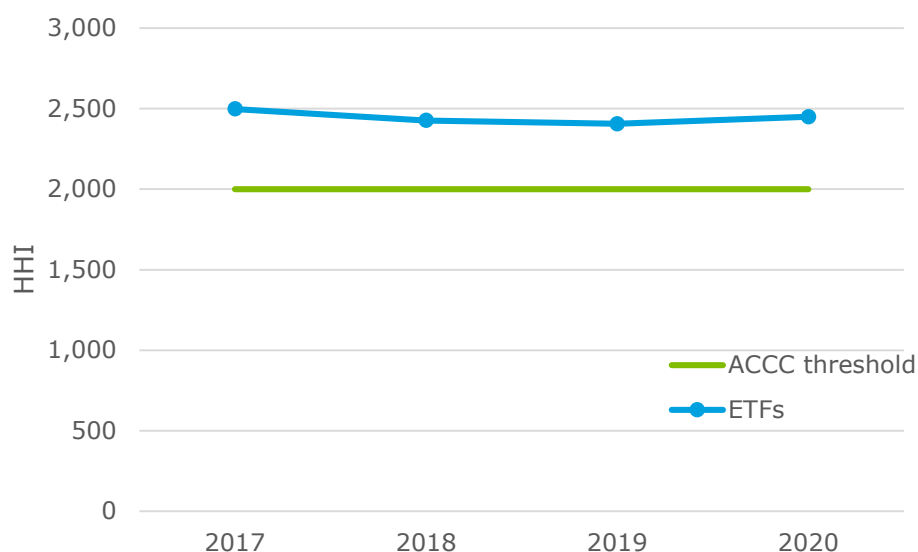
<sup>121</sup> Azar, Jose, Schmalz, Martin C., Tecu, Isabel, *Anticompetitive effects of common ownership* (2018), *Journal of Finance*, 73 (4).

<sup>122</sup> Leigh, A. and Triggs, A., *Common Ownership of Competing firms: Evidence from Australia* (2021), *Economic Record* (forthcoming).

<sup>123</sup> Ibid.

<sup>124</sup> Australian Competition and Consumer Commission, *Merger guidelines* (November 2017) <<https://www.accc.gov.au/system/files/Merger%20guidelines%20-%20Final.PDF>>.

Chart 3.6 Concentration in the market for ETFs



Note: HHI calculated as of March each year.

Note: Contents of the chart are described in paragraph above in Section 3.2.2.3.

Source: Deloitte Access Economics (2021), ASX (2020).<sup>125</sup>

Concentration in and of itself does not necessarily imply that a market is less competitive, since concentrated markets can still face competitive pressure if there are sufficient substitution possibilities<sup>126</sup> or low barriers to entry. As discussed in Section 2.3, a range of investment opportunities operate as substitutes for managed funds, particularly passive funds that are not informed by a particular strategy, experience or sophistication. Concentrated markets can be beneficial for consumers in certain circumstances if economies of scale or scope flow through in the form of lower prices or greater product range.<sup>127</sup> ETFs may benefit from economies of scale in the form of lower transaction costs. The conduct (including pricing) and performance of ETFs are described in Chapter 4 and Chapter 8, respectively.

### 3.2.3 Supply-related barriers to entry exist

In a competitive market, competition not only comes from current market participants but also potential market participants. New entrants to an industry are an important source of competition and innovation, and reduce the potential for incumbents to exercise market power. This section considers the nature and height of barriers to entry in the funds management industry.

<sup>125</sup> Australian Securities Exchange, *ASX Funds Statistics: ASX Investment Products Monthly Update* (March 2020) <<https://www.asx.com.au/products/managed-funds/market-update.htm>>.

<sup>126</sup> Australian Competition and Consumer Commission, *Merger guidelines* (November 2017) <<https://www.accc.gov.au/system/files/Merger%20guidelines%20-%20Final.PDF>>.

<sup>127</sup> Ibid.

The extent to which a barrier to entry is present ('height' of a barrier) is typically assessed against three key features:<sup>128</sup>

- Timeliness of entry — the time it takes for a new entrant to enter the market and offer a competitive alternative product or service. If new entrants require a significantly lengthy period to reach cost-competitiveness, this will reduce the incentive to enter. Without this response, a period of greater than normal profits for incumbent sellers may persist. As a benchmark, the ACCC indicates a suitable time period is one to two years.<sup>129</sup> This timeframe is indicative and not industry specific.
- Likelihood of entry — the likelihood of actual, or threat of potential, entry into the market from new participants. This typically depends on whether new entrants can be profitable and thus encouraged to enter the market.
- Sufficiency of entry — new entrants must be sufficient in scale and offer sufficiently similar products or services to present as a reasonable substitute to the incumbent firms. Relatively small players acting alone, or offering niche or targeted products for which there is limited demand, are unlikely to present a significant competitive threat.

These conditions are relevant to funds management and this report identifies several characteristics of the industry that present as potential barriers to entry. Most of these barriers pertain to the timeliness or sufficiency of entry. In particular, some characteristics of the market may delay — but not prevent — new entrants from reaching the point at which they can effectively compete with incumbents.

Chart 3.7 shows the total number and share of fund managers entering or exiting the Australian market over time, based on Plan for Life data. While this number could understate the true number of exits and entries, the average number of entries each year over the period is six (4.6% of the market). Exits account for four firms (2.7%) on average. To be competitive, the threat of new competition need only be credible, if not realised.<sup>130</sup> As well as existing players expanding, Chart 3.7 shows that new entrants are common in funds management and as such represent some threat to incumbents. As an indication of the credibility of this threat, several larger international players have entered the market and attracted significant market share in a short period of time (see Section 3.2.4).

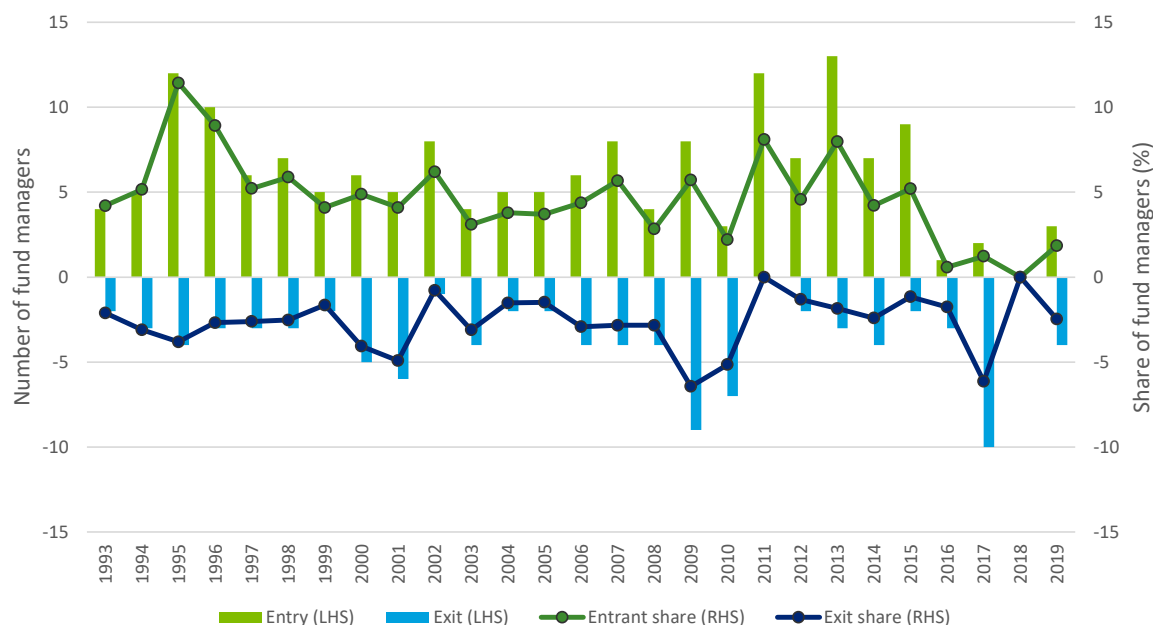
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<sup>128</sup> Australian Competition and Consumer Commission, *Merger guidelines* (November 2017) <<https://www.accc.gov.au/system/files/Merger%20guidelines%20-%20Final.PDF>>.

<sup>129</sup> Australian Competition and Consumer Commission, *Merger guidelines* (November 2017) <<https://www.accc.gov.au/system/files/Merger%20guidelines%20-%20Final.PDF>>.

<sup>130</sup> Ibid.

Chart 3.7: New entrants and exits over time



Note: Plan for Life data captured through survey and may understate the true number of entries and exits each year. Negative axis refer to number and percentage of firms exiting the industry. Strategic Insight data is based on sample of fund managers — true numbers of entry and exit may be larger.

Note: Contents of the chart are described in the paragraph above in Section 3.2.3.

Source: Deloitte Access Economics (2021) and Strategic Insight (2020).

Chart 3.7 appears to show that new entries have declined in the past five years. It is possible that this reflects a number of factors, including maturity of the market or increasing barriers to entry. Market dynamics and profitability (discussed in Section 2.6.1) would suggest that market maturity is an unlikely explanation.

If there are no substantial barriers to entry and expansion and new entrants can provide a reasonable alternative product, attempts by incumbents to capitalise on their market dominance will be unsustainable.<sup>131</sup> Through desktop research and industry consultation, this report has identified several characteristics of the industry that present barriers to entry. These barriers are specific to the industry structure, rather than the nature of the product.

The Interim Report sought insights from industry regarding the decline in numbers of new entrants, particularly over the past five years. Industry participants stated that there are still new entrants entering the Australian market through the emergence of new boutique fund managers and overseas managers. However, regulatory costs are a factor which has discouraged new entrants entering the market or launching new products where regulatory barriers are complex and costly. However, this report considers these costs in context of the benefits and protections provided by these regulatory barriers, which are discussed in several sections throughout this report (for example, see Section 7.2). Consultees indicated that Australia's low fee environment (see Section 4.3.4) affects sustainability, restricting those international entrants to managers with sufficient scale to remain viable with comparatively low fees.

### 3.2.3.1 Brand equity can represent a barrier to entry

Brand equity can act as a barrier to entry for new fund managers because investors are influenced by factors such as reputation and advertising (which are unrelated to the quality or performance of an underlying fund). Similarly, consumer loyalty reduces the

<sup>131</sup> Australian Competition and Consumer Commission, *Merger guidelines* (November 2017) <<https://www.accc.gov.au/system/files/Merger%20guidelines%20-%20Final.PDF>>.



ability of new entrants to compete on a level playing field with incumbents. This is typically present in markets where consumers do not have all the information they need to make decisions.<sup>132</sup> The time that it takes a new fund manager without an established reputation and customer base effectively to compete on these grounds can be lengthy and create a disincentive for potential entrants. In the United Kingdom, the FCA found that it is considerably easier for existing fund managers to launch a new fund than it is for a new fund manager to do so.

### **3.2.3.2 Funds management is characterised by economies of scale and sunk costs that present barriers to entry**

There are significant economies of scale in the manufacture of managed funds (see Box 3.3 below). The costs associated with introducing a subsequent fund tend to be smaller than producing the first fund, and so on. This is due to the significant upfront sunk costs related to setting up a funds management firm, and the relatively smaller variable costs associated with running a fund. Investment management teams and intellectual property, technology, an AFSL, third-party service contracts, brokerage, research house ratings and broad investor networks are all features that need to be acquired before launching the first fund. Consultees agree that sunk costs represented a significant share relative to international markets. Even for a 'vanilla' strategy, legal costs (including disclosure and constitution), registry costs, AFSL and insurance represent significant outlays. Many of these outlays are sunk costs which cannot be recovered when a firm exits as opposed to fixed costs such as leases or capital purchases, which may be at least partly recoverable if a firm exits the industry.

#### **Box 3.3: Economies of scale**

Economies of scale occur where increasing the quantity of a firm's output leads to a decrease in the firm's long-run average total cost of production.<sup>133</sup> Firms with economies of scale experience efficiencies in increasing production. This can be beneficial for consumers and promote competition if the benefits of economies of scale flow through to consumers, for example, through lower prices. However, economies of scale can present a barrier to entry for new firms.<sup>134</sup>

Despite the size of initial sunk costs, this report notes that new entrants need not only be small players. New competition from large and existing companies does occur, for example, through the entry of large international fund managers (see Section 3.2.4) or through vertical integration (see Section 3.4.1). These players represent an important competitive force and are unlikely to be deterred by the presence of economies of scale.

For new, domestic players, the presence of third parties goes some way towards mitigating the fixed costs associated with establishing a fund since many of the onerous technological capabilities such as brokerage, settlements, pricing, fund administration, custody and research can be outsourced. Physical assets required to compete can be limited to a relatively small amount of labour, office space and IT systems, provided that a new entrant can access these services. In consultations, fund managers claimed that third-party services, particularly custodians, may be unwilling to offer services to small funds. This was an issue that was also raised by the FCA in its investigation into asset managers in the United Kingdom.<sup>135</sup> Smaller fund managers are also unlikely to have the

<sup>132</sup> Australian Competition and Consumer Commission, *Merger guidelines* (November 2017) <<https://www.accc.gov.au/system/files/Merger%20guidelines%20-%20Final.PDF>>.

<sup>133</sup> Australian Competition and Consumer Commission, *Merger guidelines* (November 2017) <<https://www.accc.gov.au/system/files/Merger%20guidelines%20-%20Final.PDF>>.

<sup>134</sup> Australian Competition and Consumer Commission, *Merger guidelines* (November 2017) <<https://www.accc.gov.au/system/files/Merger%20guidelines%20-%20Final.PDF>>.

<sup>135</sup> Financial Conduct Authority, *Asset Management Market Study Interim Report* (Market Study 15/2.2, November 2016) <<https://www.fca.org.uk/publication/market-studies/ms15-2-2-interim-report.pdf>>.

same bargaining power as incumbent players to negotiate fees and obtain rebates from third parties (see Section 4.4).

In addition to economies of scale, larger, established firms may experience an advantage in terms of adding additional offerings to product range. Economies of scope refers to the cost advantage obtained by producing numerous, different products within the same firm.<sup>136</sup> For fund managers, although different expertise is often required to operate a successful fund in another asset class, much of the infrastructure and capability has already been created to launch the first fund. For example, a fund manager currently operating an Australian equities fund will be at a significant cost advantage in launching an Australian fixed interest fund relative to a new entrant currently operating neither. Existing fund managers are also able to use existing networks and sources of funds. Of the managers included in the FE Analytics database, the average number of funds per manager was 12.5 in 2019.<sup>137</sup>

### **Box 3.4: FE fundinfo**

The FE fundinfo database (FE fundinfo) contains information on over 15,000 financial instruments including more than 3,000 managed funds. The FE fundinfo provides detailed fund information including fact sheets, product disclosure statements and monthly performance data and ratios.

The FE fundinfo has not been used extensively in Chapter 3 due to some difficulty extracting key variables over time, including funds under management. FE fundinfo is used in later sections of this report for quantitative analysis since it provides historic performance metrics as well as fund features (such as active or passive status) that are not relied on in this Chapter 3.

#### **3.2.3.3 Legal, regulatory requirements are rigorous**

The Australian funds management industry, as well as the broader financial services sector, is regulated by the Australian Securities and Investments Commission (ASIC) and as such, financial service providers, including fund managers are required to hold an AFSL (see Section 2.5).<sup>138</sup> Most fund managers indicated that licensing requirements present barriers to entering the market due to the cost and length of the process. The application process can take up to nine months to complete and requires expensive and specialised advisory services to complete. New entrants may also find it challenging to contract a custodian (and other service providers) until they have an AFSL, yet struggle to meet the requirements of an AFSL without an appointed custodian.

The Interim Report solicited feedback on the AFSL process and received unanimous support for the current rigour of the application process, citing that any simplification would significantly weaken consumer protections and damage confidence in the sector. Without compromising the existing process, consultees noted that significant inconsistencies do exist, and the application could be streamlined to mitigate barriers to entry.

In addition to the application process, consultees indicated that other recent regulatory requirements have increased the height of barriers to entry. Participants suggested that stricter regulation surrounding financial advisers has reduced the overall number of advisers and best-interest obligations have encouraged advisers to select more mainstream products. This channels assets towards incumbent funds and makes it challenging for newer funds to gain listing on approved product lists or to be

<sup>136</sup> Australian Competition & Consumer Commission, *Merger guidelines* (November 2017) <<https://www.accc.gov.au/system/files/Merger%20guidelines%20-%20Final.PDF>>.

<sup>137</sup> FE fundinfo (2020).

<sup>138</sup> Australian Securities and Investments Commission, *AFS licensee obligations* (March 2020) <<https://asic.gov.au/for-finance-professionals/afs-licensees/afs-licensee-obligations/>>.

recommended through the advisor channel to retail clients. Similarly, while fund managers acknowledge the banning of commissions under the *Future of Financial Advice* (FOFA) legislation (see Section 6.3.3) was a good outcome for consumers, it has made it more difficult for new entrants to access retail distribution channels. Commissions incentivised distribution channels to offer products before there is sufficient demand from investors.

### 3.2.4 Despite licensing requirements, offshore competition is present

In most industries, imported goods and services represent a significant source of actual or potential competition for domestic firms. Funds management, however, is partially protected from imported competition by regulation, since Australian retail investors can only access managed funds through a fund manager holding an AFSL. This requires fund managers to hold an AFSL to operate in Australia (subject to some exceptions), as discussed in Section 2.5. A recent Morningstar report found that Australia has some of the most restrictive reporting and taxation requirements among surveyed countries. Although this report focused primarily on investor outcomes (such as the presence of capital gains tax), Morningstar mentions both the PDS and DDO requirements, as well as ASIC's enhanced product intervention powers.<sup>139</sup>

This has limited potential competition from international managers that hold sufficient scale to justify establishing a registered business in Australia (such as Vanguard, BlackRock and State Street). These large international players have proven to be effective competitors in recent years (see Section 3.4.2), representing 20% of total funds under management as at September 2019. Although offshore competition is responsible for a sufficient amount of Australian FUM,<sup>140</sup> it is still likely below potential. Technology and intangible products mean that managed funds are not constrained by the same supply chain limitations that prevent offshore competition becoming a dominant force as seen in other industries.

Recent legislative changes have been made to expose the funds management industry to greater international competition. In February 2019, the Asia Region Funds Passport (ARFP) commenced and, more recently, in April 2020 ASIC introduced a new foreign Australian Financial Services (AFS) licensing regime, which applies to those who provide financial services to wholesale clients. As discussed in Section 3.4.4, both the ARFP and the new foreign AFSL provide exemptions from Australian licensing regulations for funds from certain countries, provided they meet the requirements of their domiciled country.

## 3.3 Industry supply chain

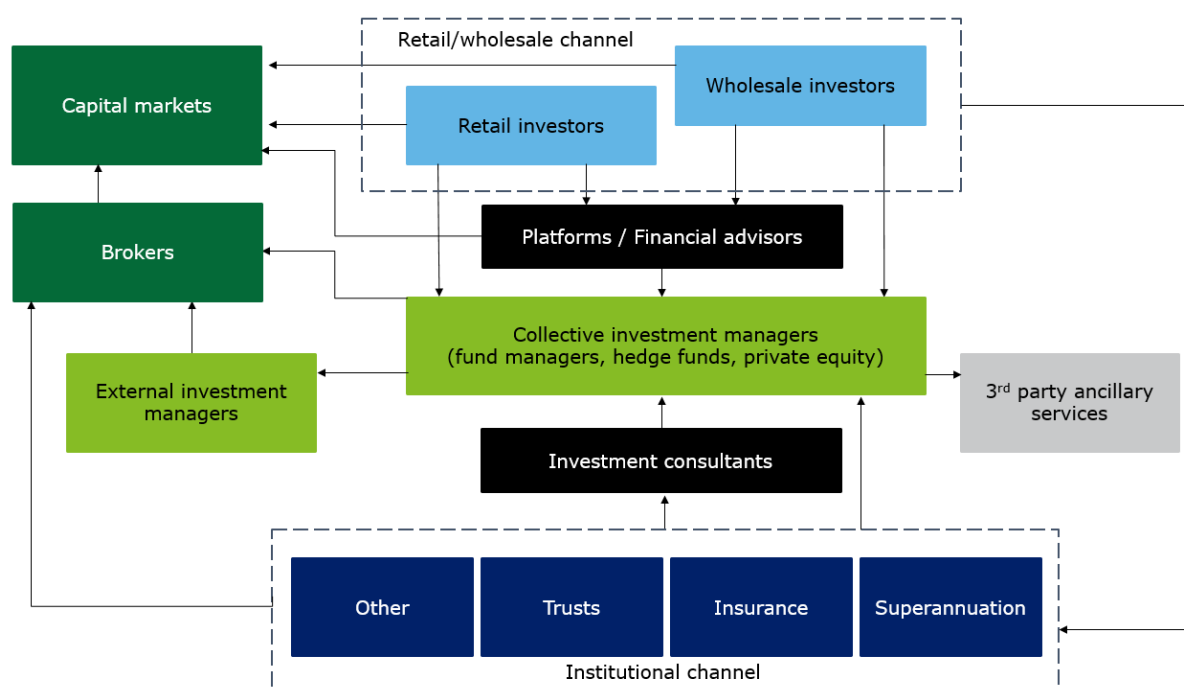
Figure 3.1 describes the supply chain and flow of interaction between participants in managed funds. Investors engage fund managers either directly or indirectly (through an intermediary) who then manage the assets themselves or with the help of an external investment manager. As the figure suggests, the supply chain is complicated by the presence of different investor types, distribution networks and intermediaries that service various core components. This report focuses predominantly on retail investors, who invest in managed funds through two 'channels': the retail channel and the institutional channel.

<sup>139</sup> Morningstar, *Global Investor Experience Study: Regulation and Taxation* (27 April 2020) <<https://www.morningstar.com/lp/global-investor-experience-tax-and-regulation>>.

<sup>140</sup> The ACCC suggests that imports most likely represent an effective competitive constraint if they represent at least 10% of total sales, in each of the previous three years.

Australian Competition & Consumer Commission, *Merger guidelines* (November 2017) <<https://www.accc.gov.au/system/files/Merger%20guidelines%20-%20Final.PDF>>.

Figure 3.1: Collective investment channels – market structure and supply chain



Note: Contents of the figure are described in the paragraph above in Section 3.3.

Source: Deloitte Access Economics (2021).

### 3.3.1 Fund managers rely on distribution channels to reach retail investors

Managed funds are particularly dependent on intermediaries to reach retail investors. In 2018, only 14% of inflows came through direct channels, with the remaining 86% coming through advisers.<sup>141</sup> This section discusses various levels of the distribution channels and the effect they have in promoting or restricting competition.

Managed funds can be distributed through several channels, providing fund managers with another avenue to compete with their rivals for investors. These channels include:

- direct sales
- purchases through SMSFs
- institutional investors, such as superannuation funds
- financial advisers, brokers and personal bankers
- platforms.

However, manufacturers of investment, superannuation and life insurance products mainly use platforms to distribute products to retail investors, and financial advisers use platforms to manage funds (and other assets) on behalf of their clients. Most retail investor flows outside of superannuation go through platforms. In consultations, fund managers stated that up to 80% of their funds are intermediated through platforms (and advisers).

#### 3.3.1.1 Financial advisers support retail investors

Retail advisers, or financial advisers, provide advice to retail clients about a range of financial decisions, including budgeting, superannuation, investing, insurance and taxation.<sup>142</sup> In 2017, the ASX investor study found that 60% of investors were accessing

<sup>141</sup> Strategic Insight, *Managed Funds Market 10 Year Review 2008-2018* (November 2018).

<sup>142</sup> Australian Securities and Investments Commission, *MoneySmart: Choosing a financial adviser* (2020) <<https://moneysmart.gov.au/financial-advice/choosing-a-financial-adviser>>.

financial advice.<sup>143</sup> Investment advice and portfolio management are core areas of advice sought by retail clients, and financial advisers represent the largest distribution channel for fund managers to retail investors outside of their institutional superannuation account.

In November 2019, there were 26,793 financial advisers currently operating under 2,237 AFSLs.<sup>144</sup> Most of these financial advisers operate through a dealer group — a group comprising a number of businesses that operate under a single AFSL.<sup>145</sup> Advisers may work as an officer or employee of a financial institution with an AFSL or as an independent financial advisor (IFA). As at July 2019, only 845 advisers (3%) held their own AFSLs, leaving the remaining 97% operating under a dealer group.<sup>146</sup>

The concentration of financial advisers is calculated using the number of financial advisers registered under a parent entity (licensee), as data on FUM are not available at the advisor level. Based on this, the market for financial advice is not concentrated, with a HHI of only 157, calculated as at March 2020.<sup>147</sup> Chart 3.8 shows the percentage of current financial advisers in the five largest parent entities. The chart shows that the five largest organisations represent 24% of total financial advisers. The largest organisation (AMP) represents only 7% of all financial advisers suggesting that concentration is relatively low compared to other segments of the industry. The report notes however, that since the release of the Interim Report, there are a few instances that may have led to a slight swing in the other direction. For example, in May 2021, IOOF announced the completion of its acquisition of MLC Wealth (MLC) from National Australia Bank Limited.

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<sup>143</sup> Deloitte Access Economics, *ASX Australian Investor Study* (report commissioned by Australian Securities Exchange, 2017) <<https://www2.deloitte.com/au/en/pages/economics/articles/asx-australian-investor-study.html>>.

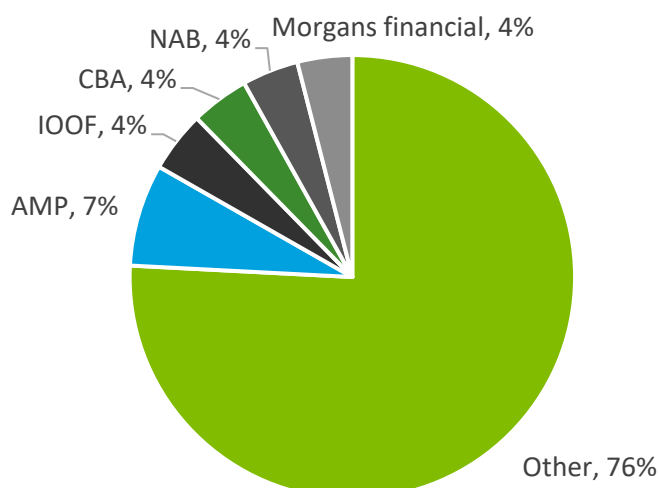
<sup>144</sup> Financial Services Council, *State of the Industry 2019* (2019) <<https://www.fsc.org.au/resources/fsc-state-of-the-industry-2019>>.

<sup>145</sup> Pamela Hanrahan, *Legal framework for the provision of financial advice and sale of financial products to Australian households: Background paper* Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry (April 2018).

<sup>146</sup> Financial Services Council, *State of the Industry 2019* (2019) <<https://www.fsc.org.au/resources/fsc-state-of-the-industry-2019>>.

<sup>147</sup> Australian Securities and Investments Commission, *Financial advisers register* (2020) <<https://asic.gov.au/for-finance-professionals/afs-licensees/financial-advisers-register/>>.

Chart 3.8: Share of registered financial advisers by parent entity – 2020.



Note: Content of the Chart is described in the paragraph above in 3.3.1.

Source: Deloitte Access Economics (2021), ASIC (2020).<sup>148</sup>

### Box 3.5: Investment consultants

Institutional advisers, typically called investment consultants, provide investment advice to wholesale and institutional clients on a range of financial products, including managed funds (see Figure 3.1). In particular, investment consultants advise clients on their overall asset allocation strategy including choice of funds and fund managers, custodians and governance models.<sup>149</sup>

Since they are not typically associated with the retail distribution channel, investment consultants are, for the most part, out of scope for this report. Section 3.4.5.1 briefly discusses how investment consultants are active in the retail channel through their growing influence in managed accounts and Section 7.2.4 mentions the role investment consultants play in wholesale decision making.

#### 3.3.1.2 Financial advisers and self-directed retail investors predominantly access managed funds through platforms

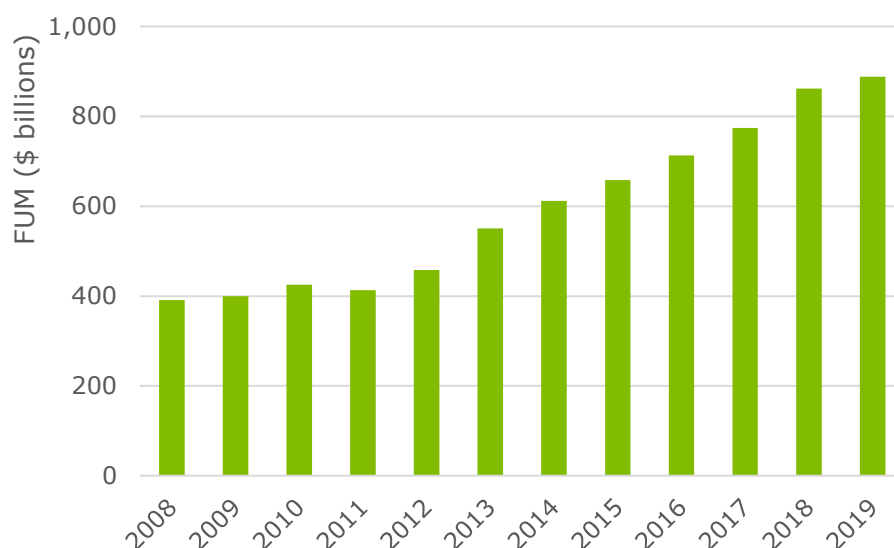
Retail investment platforms are a key component of the managed funds supply chain. Platforms are an online distribution channel for manufacturers of managed investments, superannuation and life insurance products as well as an avenue for investors and financial advisers to buy, sell and manage assets.<sup>150</sup> Since 2011, funds under management through the platform channel have more than doubled from \$390 billion to \$887 billion (See Chart 3.9).

<sup>148</sup> Australian Securities and Investments Commission, *Financial advisers register* (2020) <<https://asic.gov.au/for-finance-professionals/afs-licensees/financial-advisers-register/>>.

<sup>149</sup> Reserve Bank of Australia, *Australian Fund management: Market Structure and Fees* (Bulletin, February 2003) <<https://www.rba.gov.au/publications/bulletin/2003/feb/pdf/bu-0203-3.pdf>>.

<sup>150</sup> Financial Services Council, *State of the Industry 2019* (2019) <<https://www.fsc.org.au/resources/fsc-state-of-the-industry-2019>>.

Chart 3.9: Funds under management, platforms



Note: Includes all product types: Pension, investment, personal super and corporate super. Plan For Life separate platforms into three distinct categories, each defined below:

- Wrap: Masterfunds through which investors can invest in direct shares, and which generally charge one consolidated fee.
- Platform: Masterfunds which have multiple divisions – generally Super, Allocated Pension and Investment divisions.
- Master Trust: products encompass the remaining Masterfund products.

Note: Contents of the chart are described in the paragraph above in Section 3.3.1.2.

Source: Deloitte Access Economics (2021) and Plan For Life (2020).

While investors can access platforms directly, this is rare and financial advisers, on behalf of their clients, are the main customers of retail investment platforms. Financial advisers, in turn, channel the majority of their clients' funds through retail investment platforms. A 2019 survey of 305 financial advice businesses found that 91% of respondents use a super and investment platform, and of these advisers that use platforms, on average, 78% of client funds were held on platforms.<sup>151</sup>

### Box 3.6: Platforms

This report uses the term 'platforms' to refer to a class of products that includes both wraps and mastertrusts. Wraps and mastertrusts both allow investors to access managed funds but differ slightly in scope and ownership structure. For example, wraps provide a greater product range than mastertrusts, allowing investors to access direct investments as well as managed funds.<sup>152</sup> Furthermore, investors using wrap accounts also hold assets in their own name, whereas assets in mastertrusts are held on behalf of the investors.<sup>153</sup> For this report, these differences are largely inconsequential.

<sup>151</sup> Netwealth, *AdviceTech Research Report* (2019) <[https://www.netwealth.com.au/web/media/377106/2019-netwealth-advicetech-research-report\\_web.pdf](https://www.netwealth.com.au/web/media/377106/2019-netwealth-advicetech-research-report_web.pdf)>.

<sup>152</sup> Australian Unity, *What is the difference between a wrap account and a mastertrust?* (March 2019) <[https://www.australianunity.com.au/wealth/~media/publicsite/documents/financial%20advice/factsheets/wealth\\_redundancy\\_planning/what%20is%20the%20difference%20between%20a%20wrap%20account%20and%20a%20master%20trust.ashx?la=en](https://www.australianunity.com.au/wealth/~media/publicsite/documents/financial%20advice/factsheets/wealth_redundancy_planning/what%20is%20the%20difference%20between%20a%20wrap%20account%20and%20a%20master%20trust.ashx?la=en)>.

<sup>153</sup> Ibid.

Platforms offer financial advisers efficiency in administering, managing and reporting investments on behalf of their investors.<sup>154</sup> Platforms create efficiency by consolidating information regarding managed funds in one place, allowing advisers to deal with one portal instead of each fund manager independently. Consolidated fund information also streamlines reporting and valuation of individual customer portfolios. Depending on the platform, financial advisers may be able to trade in bulk across several client portfolios, reducing the time required to manage each individual portfolio.<sup>155</sup>

The benefits for individual investors and advisers are similar in that platforms predominantly assist by providing a single touch-point for an entire portfolio of managed funds, while still allowing individuals to take control of their investments.<sup>156</sup> They also offer information regarding potential investments, such as performance data, and provide tools to assist with portfolio allocation, risk and management.<sup>157</sup>

The growth in retail platforms over the past 10 years is consistent with the growth in managed funds in general, as well as the current low-yield environment, digital innovation and rising self-managed investing.<sup>158</sup> Historically low yields on cash investments have driven investors to other investment types, including managed funds.<sup>159</sup> Equally, the rapid rate of technological change has increased appetites for live information and digital services.

Platforms have a low level of concentration. This report considers platforms at the group level as financial institutions may have more than one platform for their products. Chart 3.10 shows the FUM and the HHI of platforms converging over time, indicating that as the market grows, concentration is declining. Concentration is higher than for fund managers, but the HHI (as of September 2019) is still below the threshold used by the ACCC in assessing mergers (see Chart 3.10).

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<sup>154</sup> Australian Competition and Consumer Commission, *Public competition assessment* (9 September 2010) <<https://www.accc.gov.au/system/files/public-registers/documents/D10%2B3673911.pdf>>.

<sup>155</sup> Netwealth, *Platforms – the original fintech* (May 2018)

<<https://www.netwealth.com.au/web/resources/insights/platforms-the-original-fintech/>>.

<sup>156</sup> IOOF, *Investment Platforms* (January 2020) <[http://www.ioof.com.au/pdf\\_flyers?a=166232](http://www.ioof.com.au/pdf_flyers?a=166232)>.

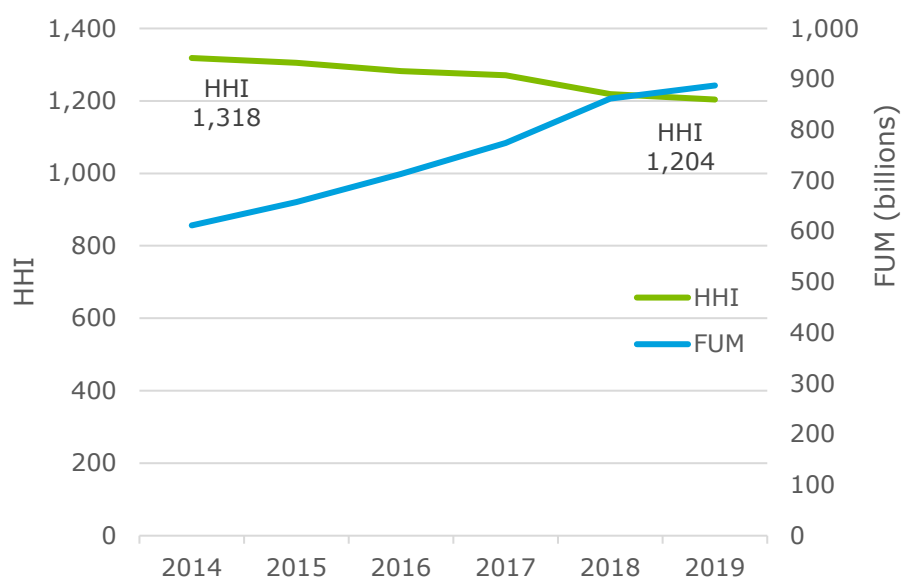
<sup>157</sup> Financial Services Council, *State of the Industry 2019* (2019) <<https://www.fsc.org.au/resources/fsc-state-of-the-industry-2019>>.

<sup>158</sup> Deloitte Access Economics, *ASX Australian Investor Study* (report commissioned by Australian Securities Exchange, 2017) <<https://www2.deloitte.com/au/en/pages/economics/articles/asx-australian-investor-study.html>>.

<sup>159</sup> Price, Fiona & Schwartz, Carl, *Recent developments in asset management*, (Reserve Bank of Australia, 2015), <<https://www.rba.gov.au/publications/bulletin/2015/jun/pdf/bu-0615-8.pdf>>.



Chart 3.10: FUM and HHI – Platforms



Note: This report refers to platforms at the group level. Financial institutions will have many different types of platforms depending on the product.

Note: Contents of the chart are described in the paragraph above in Section 3.3.1.

Source: Deloitte Access Economics (2021) and Plan For Life (2020).

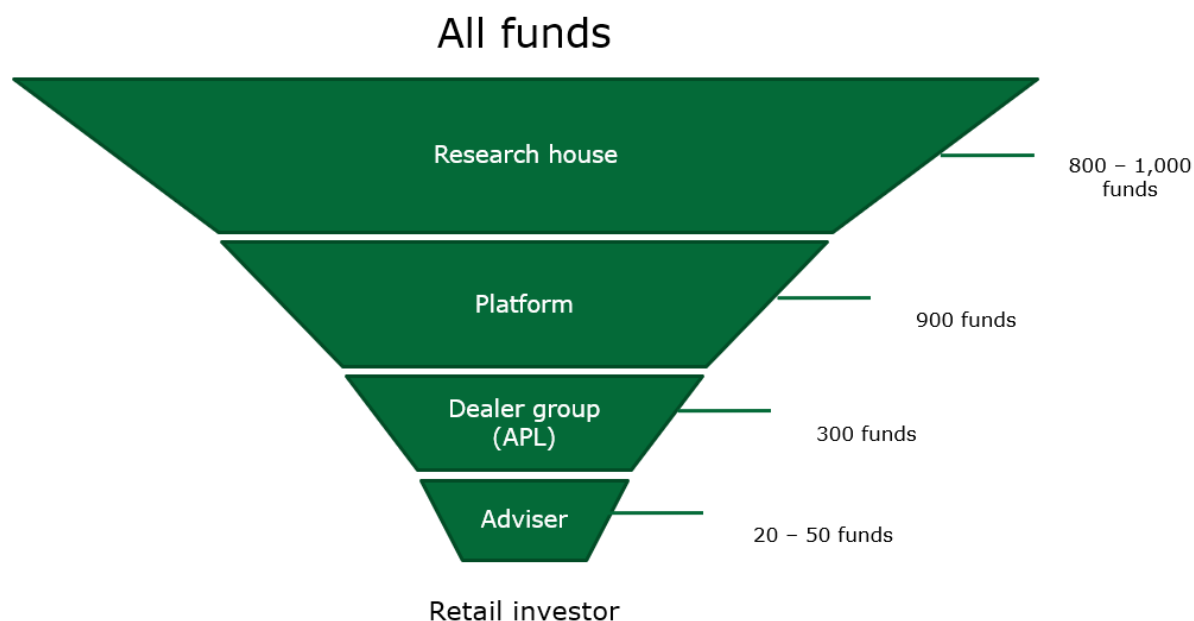
### 3.3.1.3 Retail distribution channels present barriers to market access and barriers to entry

Research houses, platforms and advisory groups perform several levels of due diligence on funds before granting fund managers access to retail investors via their distribution channel. These processes are discussed in detail in Chapter 6. The various levels of the retail distribution channel, as shown in Figure 3.2, can create:

- barriers to market access for new funds
- barriers to entry for new fund managers.

Both of these barriers are discussed in Chapter 6 in relation to the behaviour of distribution channels. However, the impact of distribution channels on barriers to entry is also a structural issue, as it relates to the structure of the supply chain as depicted in Figure 3.2. At the start of the supply chain, research houses rate approximately 800 to 1,000 funds, while at the end of the chain, financial advisers may only consider 20 to 50 funds. Distribution channels can represent structural barriers for new fund managers, as they often require a certain level of FUM, client demand or track record, which can be difficult for a new fund manager to demonstrate.

Figure 3.2: Distribution network and gatekeepers in managed funds



Note: Figures are intended to be demonstrative and are based on approximations. Actual numbers may vary depending on rating agency, platform, dealer groups and advisor.

Note: Contents of the Figure are described in the paragraph above in Section 3.3.1.3.

Source: Deloitte Access Economics consultations with industry (2021).

Responses to the Interim Report regarding distribution channels found that the process of engaging distribution channels can be costly. It can also be challenging to identify and engage with research houses, platforms, and APL gatekeepers. This can lead to fund managers limiting the number of distribution channels by choosing not to target advisers and retail investors. Ultimately there can be implications for competition, by encouraging fund managers to direct their engagement and marketing to wholesale clients rather than retail investors.

From a distributor's perspective, sufficient scale is often a proxy of whether or not to support a product, such as liquidity, track record and cost efficiencies. Furthermore, industry respondents acknowledge that distributors must ensure there is sufficient demand for a product before incurring any costs. Such costs include the undertaking of due diligence which provides insights into whether a product is suitable for inclusion on the Platform or a dealer group's approved product list. Despite the challenging requirements for stakeholders, simplifying this process could lead to an inundation of sub-optimal investment strategies that could cause more harm than good for investors.

### 3.4 Changes occurring in supply and distribution

The following sections consider trends and dynamics in the retail distribution channel.

### 3.4.1 Vertical integration is declining in most areas but remains in others

Vertical integration occurs when a business model combines adjacent activities in the supply chain.<sup>160</sup> This can be a positive force in an industry as it can lead to economies of scale, efficiencies and lower costs for consumers.<sup>161</sup>

However, a vertically integrated business can make competition less effective if its structure allows it to limit supply of inputs, reduces access to distribution or otherwise increases costs for downstream and upstream rivals.<sup>162</sup> The conduct of vertically integrated firms towards their rivals is discussed in Chapter 6.

In the last decade, vertically integrated business models have been investigated in several high-profile reports and reviews, including the *Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry* (2017–2019) and the *Inquiry into Financial Products and Services* (2009). These investigations and subsequent reforms have sought to reduce conflicts of interest arising between advice and investment services being provided by the same entity and have had significant impacts on the structure of the managed funds and advice sectors. One of most significant of these regulatory changes has been the FOFA reforms introduced in 2013, which has had structural implications for broader financial services businesses, particular vertically-integrated groups (see Chapter 6), with the separation of a number of advice and funds management groups.

Notably, there is a conflict of interest between providing advice on products and manufacturing them that needs to be managed. Of particular relevance to this report, previous work by ASIC has focused on:

"... businesses whose operations include at least two of the following functions: (a) investment management; (b) acting as a responsible entity or wholesale trustee; (c) acting as a trustee of a registrable superannuation entity; (d) operating a platform (e.g. investor directed portfolio services (IDPS) or IDPS-like structures); and (e) acting as custodian, which may also include an investment administration (back-office) function."<sup>163</sup>

Fund managers do have formal processes in place to manage conflicts of interest. However, it is not clear how effective these are in practice. Chapters 5 and 6 consider this issue in greater detail.

#### 3.4.1.1 Integration between manufacturers and distributors is declining

Given the dependence on distribution networks, there are clear benefits to a fund manager acquiring and operating a distribution network such as a platform or financial advisory business.

Until recently the Australian platform market was dominated by platform operators located in banks' wealth management arms.<sup>164</sup> In 2018, just over three-quarters of the total platform FUM in Australia was accounted for by the top five master fund

<sup>160</sup> Australian Competition & Consumer Commission, *Merger guidelines* (November 2017) <<https://www.accc.gov.au/system/files/Merger%20guidelines%20-%20Final.PDF>>.

<sup>161</sup> Productivity Commission 'Competition in the Australian Financial System' (Inquiry Report No 89, 29 June 2018) <<https://www.pc.gov.au/inquiries/completed/financial-system/report/financial-system.pdf>>.

<sup>162</sup> Australian Competition & Consumer Commission, *Merger guidelines* (November 2017) <<https://www.accc.gov.au/system/files/Merger%20guidelines%20-%20Final.PDF>>.

<sup>163</sup> Australian Securities & Investments Commission, *Culture, conduct and conflicts of interest in vertically integrated businesses in the funds-management industry* (Report 474, March 2016) <<https://download.asic.gov.au/media/3583028/rep474-published-21-march-2016.pdf>>.

<sup>164</sup> Australian Competition Consumer Commission, *National Australia Bank Ltd – proposed acquisition of AXA Asia Pacific Holdings Limited; AMP Ltd – proposed acquisition of AXA Asia Pacific Holdings Limited* (Public Competition Assessment, 9 September 2010) <<https://www.accc.gov.au/system/files/public-registers/documents/D10%2B3673911.pdf>>; Productivity Commission, *Competition in the Australian Financial System* (Inquiry Report No 89, 29 June 2018) <<https://www.pc.gov.au/inquiries/completed/financial-system/report/financial-system.pdf>>.

administrators, controlled by BT Financial (Westpac), AMP, CBA/Colonial, NAB/MLC Group and Macquarie Group.<sup>165</sup>

While this still remains the case, bank divestment of wealth management arms as well as falling technology costs have led to a growing number of specialist or independent platform providers. These providers have disrupted traditional funds management supply chains by providing sophisticated analysis, personalisation, and new and more flexible options.<sup>166</sup> Netwealth, HUB24, Praemium and Powerwrap started out as specialist platforms.<sup>167</sup>

Despite independent platform operators making up a small share of the market in numbers, in terms of net asset inflows, they were able to gain market share. This is evident in that the top five master fund administrators noted above accounted for 45% of net flows to master fund administrators in 2018, while holding 76% of FUM held on platforms.<sup>168</sup> Specialist platform Netwealth also provides a strong example of the growth of independent providers, holding about 2% of total FUM in the platform market, but representing 19% of net flows.<sup>169</sup> This trend may require additional scrutiny in future to ensure that controls and consumer protections are consistent across platforms.

Financial advice has also faced significant scrutiny in recent years and as a result has undergone a similar divestment process (discussed in Section 3.4.3.1). Despite this, asset consultancies in Australia have remained highly integrated, with Frontier the last asset consultancy business that does not sell affiliated products.<sup>170</sup> This conflict is not discussed further in this report, since asset consultants deal primarily with the institutional channel. The marketing of in-house products on behalf of other distribution networks is discussed further in Chapter 6.

### **3.4.1.2 Vertical integration is still permissible in managed accounts, subject to best interest obligations**

Although manufacturers of financial products have increasingly divested financial advice arms, managed accounts still present an opportunity for vertical integration. During the course of the Hayne Royal Commission, financial advisers were concerned that the recommendations in the Final Report would require the complete separation of product and advice, therefore impacting the ability of financial advisers to offer in-house managed portfolios.<sup>171</sup> In the end, the Final Report stopped short of this recommendation and managed accounts have continued to grow in number and FUM.<sup>172</sup> However, this structure leaves open the possibility that financial advice groups recommend internal managed accounts to clients. This report acknowledges that advisers are still bound by the best interest obligations when it comes to managed accounts and the Royal Commission could not ultimately determine that the benefits of enforced separation would outweigh the costs.

<sup>165</sup> Productivity Commission, *Competition in the Australian Financial System* (Inquiry Report No 89, 29 June 2018) <<https://www.pc.gov.au/inquiries/completed/financial-system/report/financial-system.pdf>>.

<sup>166</sup> Productivity Commission, *Competition in the Australian Financial System* (Inquiry Report No 89, 29 June 2018) <<https://www.pc.gov.au/inquiries/completed/financial-system/report/financial-system.pdf>>.

<sup>167</sup> Boyd, Tony, 'Disrupter attacks platform fees', *The Australian Financial Review* (online), 19 October 2019 <<https://www.afr.com/chanticleer/disrupter-attacks-platform-fees-20191018-p5320f>>.

<sup>168</sup> Productivity Commission, *Competition in the Australian Financial System* (Inquiry Report No 89, 29 June 2018) <<https://www.pc.gov.au/inquiries/completed/financial-system/report/financial-system.pdf>>.

<sup>169</sup> Uribe, Alice, 'Netwealth top-ranked platform, says Investment Trends', *The Australian Financial Review* (online), 4 May 2018 <<https://www.afr.com/companies/financial-services/netwealth-topranked-platform-says-investment-trends-20180304-h0wyl3>>.

<sup>170</sup> IO&C, *Frontier scoops the pool in Peter Lee survey* (April 2018) Investor Strategy <<https://ioandc.com/frontier-scoops-the-pool-in-peter-lee-survey/>>.

<sup>171</sup> Lukasz De Pourbaix, *Managed accounts can't fly under the regulatory radar* (6 February 2019), Lonsec, <<https://www.lonsec.com.au/2019/02/06/managed-accounts-cant-fly-under-the-regulatory-radar>>

<sup>172</sup> IMAP, "results out for IMAP Milliman Managed Account FUM Census as at 30 June 2020" (2020), <<https://www.imap.asn.au/component/content/article/104-perspectives/perspectives-spring-2020/984-mda-census-results-june2020>>

### **3.4.2 Competitors have changed as a result of market forces and regulatory changes**

Even among the top 10 fund managers, the structure and composition of the funds management industry has shifted.

The last 20 years has seen notable entries to, and exits from, the funds management industry in Australia. Table 3.1 suggests that the competition at the top end is dynamic. Notably, three of the first six places in 2019 are global fund managers that were not in the Top 10<sup>173</sup> in 2009.

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<sup>173</sup> Top 10 represents less than half of the top quintile from Chart 3.3 and some managers can exist in the top quintile but not appear in Table 3.1. BlackRock and Vanguard, for example, are in the top quintile in 2009, but not in the Top 10.

Table 3.1: Top 10 fund managers by FUM in Australia – five-year intervals

Rank	1999	2004	2009	2014	2019
1.	BT Financial Group	AMP Financial Services	Colonial First State	Colonial First State	State Street Global Advisors*
2.	ANZ Wealth	Colonial First State <sup>^</sup>	AMP Financial Services	State Street Global Advisors*	Vanguard Investments*
3.	AMP Financial Services	Macquarie Investment Mgt	Macquarie Investment Mgt	AMP Financial Services	Colonial First State
4.	Commonwealth	ANZ Wealth	ANZ Wealth	BlackRock*	BT Financial Group
5.	Colonial First State	BT Financial Group	MLC Investments	MLC Investments	MLC Investments
6.	MLC Investments	MLC Investments	Victorian Funds management	Macquarie Investment Mgt	BlackRock*
7.	AMP Capital Investors	MLC	Perpetual Funds	Victorian Funds management	AMP Financial Services
8.	Pendal Group Limited	Perpetual Funds	BT Financial Group	ANZ Wealth	Macquarie Investment Mgt
9.	Macquarie Investment Mgt	AMP - NMLA	MLC	BT Financial Group	Victorian Funds management
10.	MLC	AMP Capital Investors	AMP Capital Investors	MLC	AMP - NMLA

Note: Some fund managers have multiple fund manager groups (such as MLC) in Plan For Life data.

\* Global fund manager. Dark blue boxes represent fund managers that drop out of the top 10 in the following year. Light grey boxes represent fund managers that entered the top 10 in that year. Does not include ETFs and other listed products.

<sup>^</sup>Commonwealth Bank acquired Colonial First State in 2000 and merged funds management divisions under the Colonial First State name in 2002.<sup>174</sup>

Source: Deloitte Access Economics (2021) and Plan For Life (2020).

### 3.4.3 Mergers and business diversification are common

Firms can diversify through merger, by extending their product line or by extending their market.<sup>175</sup> However, funds management is in transition with the trend moving towards a less integrated model (see Table 3.1). Banks diversified by purchasing wealth management arms in the early part of the century but are now shedding these

<sup>174</sup> The Age, *CBA combines fund managers under Colonial First State name* (1 March 2020), <<https://www.theage.com.au/national/cba-combines-funds-managers-under-colonial-first-state-name-20020301-gdu0e8.html>>

<sup>175</sup> Deloitte, *2020 Investment Management Outlook* (December 2020) <<https://www2.deloitte.com/us/en/insights/industry/financial-services/financial-services-industry-outlooks/investment-management-industry-outlook.html>>.

businesses.<sup>176</sup> In recent years the structure of ownership has undergone a shift, with specialist wealth managers and financial adviser groups purchasing funds management businesses from the banks, in turn diversifying their business portfolios.<sup>177</sup>

### 3.4.3.1 Divestments

Sluggish wealth management performance, coupled with the fallout from the Hayne Royal Commission, has precipitated a trend in the divestment of banks' funds management and financial advice arms, particularly in the retail market.<sup>178</sup> Each of Commonwealth Bank, Westpac, National Australia Bank, and ANZ, have retreated from supplying wealth management and/or advice services.<sup>179</sup>

Table 3.2: Selected divestments

Vendor	Sector	Target	Purchaser
ANZ	Wealth management	OnePath Wealth Management	IOOF
CBA	Wealth management	CommSec Advisory	Morgans Financial Ltd
CBA	Wealth management	CFSGAM	MUFG
CBA	Financial planning	Count Financial	Count Plus
NAB	Wealth management	JANA Investment Advisers	MBO
NAB	Trustee services	National Australia Trustees	IOOF
WBC	Wealth management	Ascalon Capital Managers	CDG
WBC	Wealth management	Hastings Funds management	Northill and Morrison & Co
WBC	Financial planning	BT Financial	Viridian Advisory
Goldman Sachs	Wealth management	Yarra Capital	TA Associates

Source: Deloitte Access Economics (2021).

Not only are fund managers becoming less concentrated, the industry as a whole appears to be becoming less horizontally integrated, shown by the convergence of the manager and group level HHIs (Section 3.2.2.2).

The transition out of vertically integrated services appears to be in line with other advanced countries and ahead of some. For example, the primary channel for

<sup>176</sup> Aleks Vickovich, *Major banks slammed for abandoning wealth*, Australian Financial Review, 8 January 2020, < <https://www.afr.com/companies/financial-services/major-banks-slammed-for-abandoning-wealth-20200106-p53p90>>.

<sup>177</sup> Sally Patten, *Wealth industry landscape set to alter dramatically*, Australian Financial Review, 12 January 2018, <<https://www.afr.com/wealth/superannuation/wealth-industry-landscape-set-to-alter-dramatically-20180109-h0fr80>>.

<sup>178</sup> Productivity Commission, *Competition in the Australian Financial System* (Inquiry Report No 89, 29 June 2018) <<https://www.pc.gov.au/inquiries/completed/financial-system/report/financial-system.pdf>>; Vickovich, Aleks, 'Major banks slammed for abandoning wealth', *The Australian Financial Review* (online), 8 January 2020 <<https://www.afr.com/companies/financial-services/major-banks-slammed-for-abandoning-wealth-20200106-p53p90>>.

<sup>179</sup> Vickovich, Aleks, 'Major banks slammed for abandoning wealth', *The Australian Financial Review* (online), 8 January 2020 <<https://www.afr.com/companies/financial-services/major-banks-slammed-for-abandoning-wealth-20200106-p53p90>>.

distribution in countries such as the UK, the US, and New Zealand is independent advisers, while many European and Asian countries such as China, Germany and Singapore largely rely on banks for distribution, and have high ongoing commissions in the retail market.<sup>180</sup>

### 3.4.4 Regulations have changed to facilitate greater offshore competition

Licensing restrictions may have prevented small to medium international fund managers from entering the domestic market. In the past few years, steps have been taken to reduce these restrictions and allow both greater offshore competition as well as offshore opportunities for Australian fund managers.

Since 2003, ASIC has provided two types of licensing relief to foreign providers of financial services to wholesale clients in Australia:

- Sufficient equivalence relief: provided if the organisation is regulated by an overseas regulator considered by ASIC to be 'sufficiently equivalent'. Such jurisdictions have included the UK, the US, Hong Kong, Singapore, Germany and Luxembourg.<sup>181</sup>
- Limited connection relief: provided to an organisation that only requires a licence to engage with an Australian wholesale client.<sup>182</sup>

In March 2020, ASIC repealed these exemptions in favour of a formalised foreign AFSL, subject to the same 'sufficient equivalence' principle for the provision of financial services to wholesale clients.<sup>183</sup> The number of sufficiently equivalent jurisdictions has also been expanded to include certain financial services providers from Denmark, Sweden, France and Ontario (Canada).<sup>184</sup> However, in 2021, the Federal Treasury announced the possible reinstatement of the previous AFS licensing relief, with ASIC extending the transitional period to accommodate consultation.<sup>185</sup>

The Asia Region Funds Passport officially launched in February 2019. The members of this multi-lateral agreement are Australia, New Zealand, Japan, Republic of Korea and Thailand. The ARFP provides certain licensing exemptions for managed funds from participating nations, allowing greater levels of regional competition within the industry.<sup>186</sup>

These changes to regulation, as well as the growing opportunities in the Australian market (see Section 2.6.1), have seen numerous international fund managers enter the Australian market. Some of these have grown quickly. Three of the largest fund managers in Australia by FUM in 2019 were international managers who were not in the top 10 fund managers in Australia in 2009 (see Table 3.1).

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<sup>180</sup> Morningstar, *Global Investor Experience Study: Fees and Expenses* (17 September 2019) <[https://www.morningstar.com/content/dam/marketing/shared/pdfs/Research/GIE\\_2019\\_v4.5.pdf?utm\\_source=eloqua&utm\\_medium=email&utm\\_campaign=&utm\\_content=18780](https://www.morningstar.com/content/dam/marketing/shared/pdfs/Research/GIE_2019_v4.5.pdf?utm_source=eloqua&utm_medium=email&utm_campaign=&utm_content=18780)>.

<sup>181</sup> NortonRoseFullbright, *ASIC finalizes new rules for foreign financial service providers* (April 2020) <<https://www.nortonrosefulbright.com/en/knowledge/publications/2556291b/asic-finalizes-new-rules-for-foreign-financial-service-providers>>.

<sup>182</sup> Australian Securities & Investments Commission, *19247MR ASIC extends relief for foreign financial services providers* (September 2019) <<https://asic.gov.au/about-asic/news-centre/find-a-media-release/2019-releases/19-247mr-asic-extends-relief-for-foreign-financial-services-providers/>>.

<sup>183</sup> Australian Securities & Investments Commission, *RG176: Foreign financial services providers* (March 2020) <<https://asic.gov.au/regulatory-resources/find-a-document/regulatory-guides/rg-176-foreign-financial-services-providers/>>.

<sup>184</sup> NortonRoseFullbright, *ASIC finalizes new rules for foreign financial service providers* (April 2020) <<https://www.nortonrosefulbright.com/en/knowledge/publications/2556291b/asic-finalizes-new-rules-for-foreign-financial-service-providers>>.

<sup>185</sup> Jim Boynton, Damien Richard and Mark McFarlane, *Australian Government releases licensing relief options for foreign financial services providers* (9 July 2021), King & Wood Mallesons, <<https://www.kwm.com/en/au/knowledge/insights/australian-government-releases-licensing-relief-options-for-foreign-financial-services-providers-20210709>>

<sup>186</sup> Financial Services Council, *Asia Region Funds Passport* (2020) <<https://www.fsc.org.au/policy/investment-management/asian-region-funds-passport>>.



### 3.4.5 Managed accounts are increasingly popular among financial advisers and investors

Managed accounts are gaining significant traction within the advice channel (see Section 2.4.3). In May 2021, State Street released research indicating that 88% of Australian financial advisers agreed that managed accounts had increased transaction speed and 83% indicated that it had supported better outcomes for clients (see Chart 3.11). This report notes that this research relies on the opinions of advisers and does not definitively prove that outcomes are necessarily better for investors.

Chart 3.11: How do you rate the impact of using managed accounts on your business?



Note: Participants responded to the question "Think about the last year, including all the market volatility and business disruption. How do you rate the impact of using managed accounts on your business?", N = 391.

Contents of chart is described above and below in Section 3.4.5.

Source: State Street Global Advisors (2021)<sup>187</sup>

As of 2021, 40% of Australian advisers were using managed accounts, an increase of 22% in the last five years.<sup>188</sup> Furthermore, consultations indicated that a growing share (currently about one quarter) of all new investment on platforms is through managed accounts.

#### 3.4.5.1 Managed accounts are introducing asset consultants to the retail distribution channel

Investment consultants are typically associated with the institutional channel, however, through the rise of managed accounts, increasingly investment consultants are engaged in the retail channel through advising financial advice firms. According to research conducted by State Street, 18% of advisers use an external investment consultant to assist them in constructing managed accounts.<sup>189</sup> Consultations indicated that it is increasingly common for investment consultants to sit on the investment committees of financial advisers' managed accounts to lend greater credibility to the account. This has

<sup>187</sup> State Street Global Advisors, *Investment Trends Managed Accounts Report: 2021 Trends, usage and what's next* (May 2021), <[https://www.ssga.com/au/en\\_gb/institutional/etfs/insights/investment-trends-managed-account-report](https://www.ssga.com/au/en_gb/institutional/etfs/insights/investment-trends-managed-account-report)>

<sup>188</sup> Ibid.

<sup>189</sup> Ibid.

resulted in an increase in the number of small, boutique independent consulting firms in recent years.<sup>190</sup>

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<sup>190</sup> Smith, Matthew, 'Fate of investment consultants in advisers' hands', *Professional Planner* (online), 6 May 2020, <<https://www.professionalplanner.com.au/2020/05/fate-of-investment-consultants-in-advisers-hands/>>

# Part II: Conduct

If players have market power, they can engage in exclusionary conduct. This can have the effect of lessening competition.

Indicators of exclusionary conduct include barriers to switching, bundling, predatory pricing, stickiness/tying and disengagement of retail investors.

## 4 Price and non-price strategies of fund managers

### **This chapter finds that:**

Investors ultimately make investment decisions based on a range of factors (not just absolute returns). Within each investor type (e.g. retail, wholesale), fund managers compete within and across some or all of three main dimensions:

- fund characteristics
- fund manager characteristics
- historical returns, fees and discounts.

Fund characteristics include asset type, listed status, investment style and other forms of product differentiation. Often, fund managers compete across these groups, but sometimes within a specific group. Some examples of product differentiation reflect innovation in the industry, such as managed accounts.

Other non-price factors that fund managers compete over are fund manager characteristics, for example as fund managers seek to differentiate themselves in a low fee environment or demonstrate value while offering higher than average fees. Value on top of fees can be demonstrated through factors such as customer service, brand and the strength of the investment team. Advertising and marketing are also used to differentiate fund managers; however, fund features are presented inconsistently in advertising and there is evidence of misleading marketing.

Many fund managers will compete over fees and discounts, evident in that retail fund management fees are low by world standards. Price dispersion is generally evident across the market and within most product classes, reflecting the high degree of heterogeneity in the industry, with fund managers tailoring products to meet the needs of different investors. As such, while price leading behaviour reflects a degree of market power, it does not appear to be reflective of fund managers engaging in exclusionary conduct.

Discounts are commonly offered by fund managers in the form of rebates, through negotiations with distributors. While discounts can benefit investors, they are dependent on the negotiating power and functionality of distributors and may be not transparent to investors. This suggests that although there is competition between fund managers on fees and discounts, retail investors may not always receive the full benefits of this competition over discounts.

This chapter describes how fund managers compete to deliver value and discusses the features of a fund that make it competitive in its type and class.

It includes the following sections:

- Section 4.1 – nature of the product and competition
- Section 4.2 – non-price competition, including fund characteristics and fund manager characteristics
- Sections 4.3 and 4.4 – price competition
  - Section 4.4 – fund manager fees
  - Section 4.5 – discounts on fund manager fees.

## 4.1 Nature of the product and competition

The ways in which producers of goods and services compete within an industry is influenced by the nature of the product. Managed funds are defined by a number of characteristics, as described in the following sections.

### 4.1.1 Managed funds are heterogeneous and substitutable in some areas

Managed funds are heterogeneous — they differ across a range of dimensions (see Box 4.1). This report defines three distinct dimensions that distinguish managed funds and lead to a multitude of combinations of the options within each dimension. The dimensions, include:

1. **fund characteristics** — for example, asset class, listed status and investment style (active or passive)
2. **fund manager characteristics** —for example, customer service and brand
3. **historical returns, fees and discounts.**

#### Box 4.1: Heterogeneity

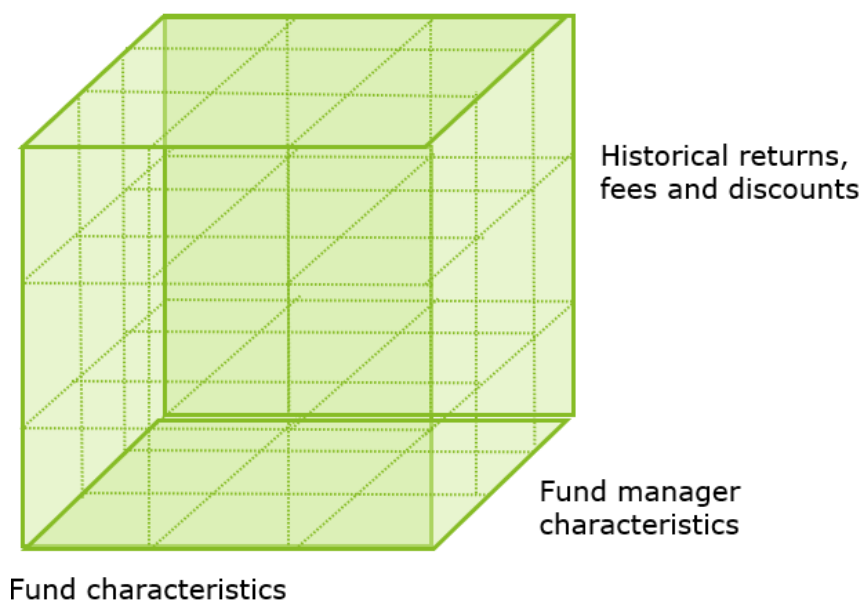
Heterogeneity refers to diversity in characteristics, and product heterogeneity means that products significantly differ in attributes. Heterogeneity can mean that suppliers are tailoring products to meet the needs of different consumers.

Due to heterogeneity, managed funds can be substitutable but are not always direct substitutes for one another. Fund managers considered other funds in other asset classes as competitors, indicating that there is a degree of substitutability between funds. For example, an equities manager will compete to some extent with a fixed income manager in the sense that they provide a substitute to an equity fund. However, funds are not perfect substitutes due to the differentiating characteristics listed above. This will differ across different types of managed funds. For example, passive funds may be considered to be close substitutes, while a greater degree of heterogeneity in active funds might mean that active funds are less substitutable.

Within this framework, each retail investor has the fundamental objective of realising diversification benefits and achieving the highest possible risk-adjusted return after fees (returns and performance are explored in more detail in Chapter 8). However, investors cannot know ex ante which fund will deliver the highest risk-adjusted return. Each investor has a different view of what their investment needs are, and, in turn, how to maximise this risk-adjusted return after fees. As an example, some investors may be most interested in achieving steady returns, others seeking high growth or the lowest fees possible.

To identify which fund is most likely to meet this need, retail investors (often with the assistance of advisers) consider a product within the context of the three differentiating dimensions (see Figure 4.1). Chapter 7 provides further detail on the features important to retail investors in considering a fund.

Figure 4.1: Factors considered by retail investors when making investment decisions



Source: Deloitte Access Economics (2021).

Given that investors' needs and demands are not homogeneous, fund managers compete to deliver a product that best meets customer requirements across these dimensions. As a result, there is no single product with an optimal set of qualities.

#### **4.1.2 Fund managers compete within submarkets based on price and non-price features**

At a macro level, fund managers compete with other investment products provided by the financial services industry, including banking and direct investing. Fund managers differentiate themselves by pooling investor funds to allow individual investors to gain the benefits of diversification.

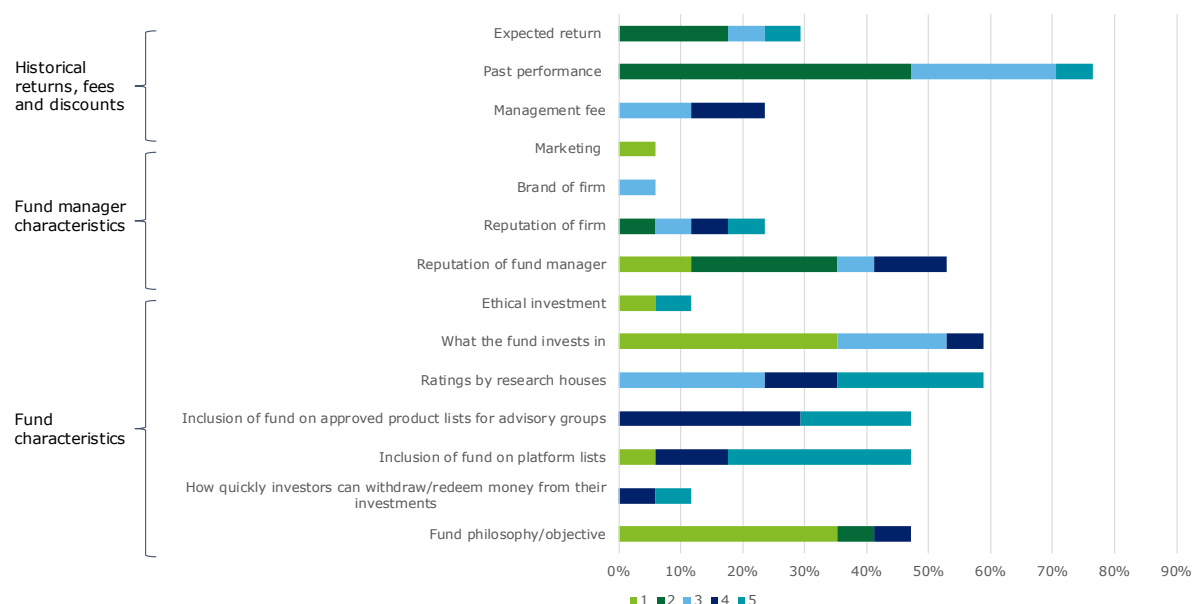
At a micro level, fund managers often compete within submarkets of managed funds, based on accommodation of different investor needs. Within these submarkets, individual funds compete to attract investors (and/or those acting on their behalf) by being the most able to meet these specific investor needs. For example:

- to meet an investor desire for growth, an equity fund manager may only compete within their own product category (i.e. equity growth funds), and aim to differentiate themselves to investors via superior customer service and marketing
- to meet an investor desire for stable returns, a fund manager offering passive funds may compete primarily on product differentiation, by indexing against a particular market index, as their competitors offer similar low prices
- to meet an investor desire for low fees, a fund manager may create a fund with particular characteristics (for example, a fixed-interest passive fund), and not compete over fund manager characteristics.

In many cases, fund managers compete across all three dimensions to reach a target market of investors and meet their investment needs. It is sometimes the case that there is minimal differentiation between funds along one dimension, leading to more focus on competing along other dimensions. For example, Australian equities is a popular asset class (fund characteristic); as such, fund managers in this category are strongly focused on competition over price and non-price factors, or equivalently, historical returns, fees and discounts, and fund manager characteristics.

Chart 4.1 shows how the nine fund managers responding to the survey ranked the top five features of their retail managed fund that make it competitive in its asset class. The chart shows, for each feature, the share of the sample that considered that feature to be most important (rank 1) up to fifth most important (rank 5). Past performance was listed as one of the five most important features for over three-quarters (76%) of the 17 retail managed funds in the survey.

Chart 4.1: Fund features that fund managers consider to be important for competitiveness (% of respondents)



Note: Sample size is 17, reflecting the number of retail managed funds. These funds are held by nine fund managers.

Note: Contents of this chart are found in table form in Appendix F.

Source: Deloitte Access Economics survey (2020).

Other commonly ranked features were fund philosophy/objective and what the fund invests in. Fund managers tended to assign higher importance to fund characteristics and historical returns, fees and discounts than fund manager characteristics. The exception to this was the reputation of the fund manager, which was ranked first or second by over one-third of the sample.

There were similar views regarding which factors make a fund competitive with institutional investors. However, fund managers were more likely to report that institutional investors considered the reputation of the fund manager as important. Specifically, 86% of fund managers who service institutional investors reported this to be in the top five most important factors for competitiveness.

Although the low number of responses from the survey mean that these results may not be representative of the broader industry, the survey responses demonstrate that a range of features contribute to competition between funds and fund managers.

This chapter considers competition based on price and non-price features of a fund. Competition between funds over fund performance is covered in Chapter 8. Chapter 6 explores how the structure of the market, namely intermediaries, distribution channels and gatekeepers, affect the way that fund managers compete.



## 4.2 Non-price competition

The heterogeneity of managed funds ensures that fees are not always the only factor over which fund managers compete. Fund managers often seek to differentiate themselves and compete on the basis of non-price factors. This may be where funds are price leaders and must demonstrate the value of investing in a costly product, or because falling prices and margins in some product classes has made it harder to reduce fees to gain market share.

Some of the key non-price factors (fund and fund manager characteristics) over which funds and fund managers compete include:

- product differentiation
- customer service and digital engagement
- the investment team and process
- brand and reputation
- relationships with distribution channels, including platforms and advisers
- advertising and marketing
- other product offerings.

Consultees noted that advisers are often looking for funds with a competitive advantage, that provide a differential to the market. In this way, although fund fees are important, advisers and investors will consider fees within an assessment of the value of a product to clients.

### 4.2.1 Fund managers compete over a range of fund characteristics

Managed funds are naturally differentiated from each other, as they take a variety of forms and cater to the needs of different investors. As summarised in Section 2.4, managed funds are distinguished by a range of fund characteristics including:

- product structures, for example, listed and unlisted managed investment schemes, ETFs and LICs
- asset class, for example, fixed income, shares and property
- investment style, for example, active and passive.

While funds compete on asset class and investment style based on investor needs, growth in the popularity of certain product structures has particularly contributed to product differentiation as a way for funds to compete.

#### 4.2.1.1 Product differentiation is a popular non-price strategy

Historically, technology has limited the accessibility of managed funds for retail investors. However, advances in technology such as platforms have enabled retail investors to more easily access unlisted managed funds, and also improved the ability of retail investors to access managed funds that are differentiated from 'traditional managed funds'. This report considers 'traditional managed funds' to be unlisted and untraded managed investment schemes that are accessed via distributors, particularly platforms and advisers. Online trading platforms have facilitated increased uptake of traded and listed products, such as exchange-traded funds, which can provide investors with greater convenience, control, and transparency.

The following section discusses the manufacture of traded and listed products as a means of product differentiation relative to traditional managed funds, given the rising popularity of these product structures in the last few decades. Consultees indicated that some fund managers believe that growth in products like ETFs has eroded market share for traditional funds. However, it was also noted that fund managers that can adapt to innovative products and systems do not have to be left behind and can reach new investor markets.

Fund managers can differentiate their offerings through **vehicles traded on an exchange**. Traded vehicles including ETFs and traded managed funds (mFunds) can be

bought and sold on an exchange, while listed products are accepted into the ASX and subject to ASX listing rules. When fund managers compete by offering funds on an exchange, this reflects product differentiation in the form of greater access for investors, as often the underlying fund will be identical whether traded or untraded. Funds traded on an exchange provide an easier distribution process for investors as they can be acquired through a broker or online portal, bypassing traditional channels including platforms.

Consultations indicated that active fund managers that trade their funds on an exchange can experience efficiency gains, due to the more streamlined approval process, but are also able to better appeal to investors looking for a less onerous way to access investments, and investors that only invest via brokers.

**ETFs** represent an increasingly popular form of traded fund that have been rapidly taken up in Australia in recent years by both investors and advisers.<sup>191,192</sup> ETFs can provide investors with easy and quick access to a diversified investment, increased liquidity, low fees (particularly for those that track a passive index), transparency, low pricing risk and tax advantages.<sup>193</sup> Fees are low among ETF products due to strong offshore competition and a preference for passive products; passive ETFs represent 69% of ETF funds (81% asset-weighted).<sup>194</sup> ETFs also provide access to global investment opportunities; international equities were the largest ETF category in terms of FUM as of July 2019.<sup>195</sup>

Product providers are supplying a diverse range of ETF products to respond to market demand. The growth of active ETFs has allowed active managers to distribute their products through a distribution channel that is easier for investors to access, when compared to untraded active funds. 'Strategic beta ETFs' also represent a middle ground between passive and active assets that appeal to investors' search for lower cost products that still allow for control over investment objectives.<sup>196</sup> Increased interest in ethical ETFs with an ESG mandate is another example.<sup>197</sup>

It was noted in consultation that competition does not differ significantly between managed funds and ETFs. Some differences were identified, such as fund managers competing more fiercely over prices in the ETF space, and ETFs (or traded products more broadly) enabling fund managers to compete for the first time in the brokerage sector.

**Listed investment companies** and **listed investment trusts** are the most commonly listed managed funds on the ASX.<sup>198</sup> While in many respects LICs and LITs are investment funds that operate similarly to traditional managed funds or ETFs, they have differentiating structural features that may suit certain types of investors. As traded vehicles, LICs and LITs present an easier form of access for investors, as noted above for other traded products.

As listed vehicles, LICs and LITs are subject to added governance and protection as they are overseen by a board of directors, which may be attractive for investors that desire

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<sup>191</sup> Selby, Ally, 'ETF popularity soars 52%', *Financial Standard* (online), 28 February 2020 <<https://www.financialstandard.com.au/news/etf-popularity-soars-52-155049577>>.

<sup>192</sup> Financial Services Council, *State of the Industry 2019* (2019).

<sup>193</sup> Financial Services Council, *State of the Industry 2019* (2019); Morningstar, *Global Investor Experience Study: Fees and Expenses* (17 September 2019)

<[https://www.morningstar.com/content/dam/marketing/shared/pdfs/Research/GIE\\_2019\\_v4.5.pdf?utm\\_source=eloqua&utm\\_medium=email&utm\\_campaign=&utm\\_content=18780](https://www.morningstar.com/content/dam/marketing/shared/pdfs/Research/GIE_2019_v4.5.pdf?utm_source=eloqua&utm_medium=email&utm_campaign=&utm_content=18780)>.

<sup>194</sup> Financial Services Council, *State of the Industry 2019* (2019) <<https://www.fsc.org.au/resources/fsc-state-of-the-industry-2019>>.

<sup>195</sup> Morningstar, *Morningstar expands global equity ETF coverage*, September 2019, <<https://www.morningstar.com.au/etfs/article/morningstar-expands-global-equity-etf-coverage/195582>>

<sup>196</sup> Selby, Ally, 'ETF popularity soars 52%', *Financial Standard* (online), 28 February 2020 <<https://www.financialstandard.com.au/news/etf-popularity-soars-52-155049577>>.

<sup>197</sup> McArthur, Elizabeth, 'It's Showtime' (2020) 18(10) *Financial Standard* p14.

<sup>198</sup> Australian Securities Exchange, *Listed investment companies and trusts* (2020) <<https://www.asx.com.au/products/managed-funds/lics-lits.htm>>.

extra levels of governance compared to traded and unlisted products. According to consultation, investors in LICs have greater visibility and control over the boards of directors, with the ability to attend AGMs and even negotiate with the listed company over fees during its block raising.

Retail investors are also increasingly looking for greater transparency, flexibility and tax efficiency through **managed accounts** (see Section 2.4.3). While managed accounts can represent a substitute to the traditional managed fund, they can also represent product differentiation in the form of a new distribution channel for fund managers (See Section 3.4.5).

Consultees indicated that fund managers can stay competitive if they continue to engage with financial advisers and other managed account providers. Fund managers can compete to put listed and unlisted funds into managed account portfolios, similar to the process of persuading advisers to sell their funds to investors. The fees paid to managed account providers in this scenario are also akin to shelf-space fees paid to platform providers. Some fund managers have responded by creating new products that are priced lower to suit managed accounts, or by adopting an advice role and helping managed account providers to construct managed accounts with asset allocation advice and research.

Consultees had differing views on the impact of managed accounts on the margins of fund managers. Some indicated that the lower negotiated fees reduce revenue for fund managers, while others noted that despite the lower fees, fund managers can still make a higher margin than that with institutional clients. Fund managers can also benefit from the efficiencies of reaching a broader client base with a more focused subset of advisers, such as reduced spending on sales staff, advertising and promotion.

#### **4.2.1.2 Barriers to product innovation**

While asset management has seen a rise in product differentiation and innovation, there are a number of barriers to innovation that hinder non-price competition. These barriers are similar to the barriers to entry discussed in Section 3.4.

The intangibility of managed funds means that innovation in the industry tends to be driven by price; innovation focuses on products that perform a similar function at a lower fee.<sup>199</sup> This is because it can be difficult to innovate on quality and much harder to demonstrate this consistently through performance.

Regulation also acts as a barrier to innovation by isolating Australia's funds management industry from the rest of the world.<sup>200</sup> Australia's ETF market, while growing, has been unable to keep pace with offshore markets and represented only 0.9% of the global ETF market as at April 2019.<sup>201</sup> This is despite the ability for some internationally domiciled ETFs to be available on the ASX ("cross-listed") if they meet certain requirements.<sup>202</sup> The ASX does not distinguish between locally and internationally domiciled ETFs, however, as of November 2018, only six ETFs were cross-listed after BlackRock's iShares products were officially domiciled in Australia.<sup>203</sup> Similarly, strict reporting and other obligations prevent streamlining of processes and using technology to capitalise on inefficiencies. Many survey respondents indicated that regulatory changes can inhibit the pace of innovation, by diverting resources away from innovative initiatives.

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<sup>199</sup> Hand, Graham, *Is there an Uber or Amazon of wealth management* (March 2015) Firstlinks <<https://www.firstlinks.com.au/uber-amazon-wealth-management>>.

<sup>200</sup> McAlary, Ben, *Fund management innovation in the Australian Market* (August 2019) Financial Services Council <<https://www.fsc.org.au/news/summit-2019-ken-woo>>.

<sup>201</sup> Financial Services Council, *State of the Industry 2019* (2019) <<https://www.fsc.org.au/resources/fsc-state-of-the-industry-2019>>.

<sup>202</sup> ETF Watch, "Which ETFs are cross-listed and what does it mean?" (updated November 2018), <<https://www.etfwatch.com.au/which-etfs-are-cross-listed-and-what-does-it-mean/>>

<sup>203</sup> Ibid.

Distribution networks and gatekeepers also present a barrier to innovation since they effectively control the funds available to retail clients. Consultations with industry suggested that approved product lists (APLs), in particular, are less accommodating of potentially innovative funds if these funds are already sufficiently represented on their APL. For example, dealer groups may overlook an innovative Australian equities fund since the APL contains numerous similar products and agreements with these funds are already in place. This was also found to be the case in the UK funds management industry.<sup>204</sup> While this does not represent a barrier to the manufacture of innovative products per se, dealer groups can prevent innovative funds from reaching investors, which may discourage fund managers from innovating.

Third-party service providers can also restrict innovation. Through the survey conducted for this report, fund managers reported that in a number of third-party markets, such as custody, registry and fund administration, providers have a degree of market power and as such do not have incentives to embrace change and move away from old technologies such as legacy systems. Similarly, innovation in funds management is limited to what third-party systems can accommodate. This report heard anecdotally in consultations that third-party systems, such as pricing, custody and administration, have required costly and timely upgrades to support even relatively simple new products and structures.

#### **4.2.1.3 Product differentiation appears to be genuine**

Section 3.2.1 discussed the possibility for false differentiation in an industry with many products. Particularly in industries with intangible products such as funds management, suppliers may be able to market products as differentiated despite similar underlying characteristics. For example, a fund could be advertising as active while mimicking a passive strategy (Section 8.1.2 considers the extent to which 'partly active' funds are prevalent in Australia and finds limited evidence for partly active funds). False differentiation would lead to negative outcomes for consumers, if they are not choosing the products that best meet their preferences due to difficulties comparing between falsely differentiated products.

Suppliers of most goods and services seek to differentiate their products on a range of factors — brand, price, quality. Investment products can be characterised and differentiated from each other by a range of features, including returns, risk profiles and fees, as well as non-price factors such as service and brand.

Evidence suggests that many of these factors are not reliable predictors of the quality of the underlying fund (if quality were to be measured as risk-adjusted returns net of fees). The analysis in Section 8.2.4.2 shows that past performance is not a reliable predictor of future performance. This means that the product with the highest historical risk-adjusted return after fees will not necessarily be the product with the highest future return. As a result, consumer choice is multi-dimensional. To the extent that consumers value non-price features, products differentiated on this basis may indicate producers reacting to consumer preferences.

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<sup>204</sup> Financial Conduct Authority 'Asset Management Market Study Interim Report' (Market Study 15/2.2, November 2016) <<https://www.fca.org.uk/publication/market-studies/ms15-2-2-interim-report.pdf>>.

This report considers several indicators of genuine differentiation:

- product innovation — evidence in Section 4.2.1.1 above
- high number of firms — evident in this industry as seen in Chart 3.1
- wide variety of investor needs — as discussed in Section 4.1
- lack of supernormal profits – Section 8.1.1 finds that this appears to be the case
- ability to switch and absence of lock-in contracts – despite some barriers, switching appears to be possible, as discussed in Section 7.3
- lack of misleading or deceptive conduct – there is some evidence of misleading advertising as discussed in Section 4.2.2.5.

Considering available evidence on these indicators, it does not appear that false differentiation is widespread.

#### **4.2.2 Fund managers compete over a range of fund manager characteristics**

Investors and advisers often use characteristics of a fund manager to assess the suitability of a particular product to their needs.

##### **4.2.2.1 Customer service and digital engagement can help fund managers compete**

Fund managers sometimes compete over customer service, in particular through digital channels. In line with these changing consumer preferences, fund managers are improving the ability of investors to digitally engage with the sector, such as through mobile and online investment accounts, and social media.<sup>205</sup> Another example is fund managers partnering with digital advice providers to improve customer service.<sup>206</sup> Improving the digital experience of clients also improves data collection and analytics for funds management firms, in turn enabling managers to offer more personalised products to investors and better target marketing campaigns.<sup>207</sup>

##### **4.2.2.2 Fund managers need qualified and large investment teams and a strong investment process**

Qualified personnel can be a critical factor in encouraging financial advisers and investors to invest with particular fund managers. Companies that ensure that their investment teams have appropriate qualifications and experience in the industry increase investor trust in their products. For example, fund managers who have specific expertise in particular sectors, geographies and industries can increase the customer base of a firm, with evidence indicating that specialist investment teams outperform generalist teams.<sup>208</sup>

Fund managers noted in consultation that they compete by highlighting the stability of the business and the investment team, particularly the stability of key people. Firms with well-known industry commentators can be central to the strategies of funds management firms. Consultation and research also indicates that the investment process undertaken by the investment team, coupled with a clear investment philosophy, is important to investors and advisers, and contributes to performance.<sup>209</sup> Over one-third

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<sup>205</sup> Deloitte, *2019 Investment Management Outlook: A mix of opportunity and challenge* (2019) <<https://www2.deloitte.com/content/dam/Deloitte/tw/Documents/financial-services/2019%20Investment%20Mgmt%20Outlook.pdf>>; Accenture, *High Performance Asset Management* (2015) <[https://www.accenture.com/us-en/~media/Accenture/Conversion-Assets/DotCom/Documents/Global/PDF/Industries\\_5/Accenture-CM-AWAMS-High-Performance-Asset-Management.pdf](https://www.accenture.com/us-en/~media/Accenture/Conversion-Assets/DotCom/Documents/Global/PDF/Industries_5/Accenture-CM-AWAMS-High-Performance-Asset-Management.pdf)>.

<sup>206</sup> Productivity Commission 'Competition in the Australian Financial System' (Inquiry Report No 89, 29 June 2018) <<https://www.pc.gov.au/inquiries/completed/financial-system/report/financial-system.pdf>>.

<sup>207</sup> Accenture, *High Performance Asset Management* (2015) <[https://www.accenture.com/us-en/~media/Accenture/Conversion-Assets/DotCom/Documents/Global/PDF/Industries\\_5/Accenture-CM-AWAMS-High-Performance-Asset-Management.pdf](https://www.accenture.com/us-en/~media/Accenture/Conversion-Assets/DotCom/Documents/Global/PDF/Industries_5/Accenture-CM-AWAMS-High-Performance-Asset-Management.pdf)>.

<sup>208</sup> Sood, Kanika, 'The ingredients of a successful fund manager', *Financial Standard* (online), 22 January 2020 <<https://www.financialstandard.com.au/news/the-ingredients-of-a-successful-fund-manager-152792618>>.

<sup>209</sup> Sood, Kanika, 'The ingredients of a successful fund manager', *Financial Standard* (online), 22 January 2020 <<https://www.financialstandard.com.au/news/the-ingredients-of-a-successful-fund-manager-152792618>>.

(35%) of the retail managed funds responding to the survey said that fund philosophy/objective was the most important feature that made their fund competitive in its asset class. Similarly, over one-third (35%) cited what the fund invests in as the largest factor that made their fund competitive in its asset class.

Research shows that big investment teams of 15 people or more outperform smaller teams, however at a diminishing rate, with additional team members creating less value as the size of the investment team increases.<sup>210</sup>

#### **4.2.2.3 Fund managers are often differentiated by brand and reputation**

A recognisable brand and strong reputation can be a key means of differentiation for fund managers, in contributing to the attractiveness of a fund to investors and intermediaries.<sup>211</sup> This is supported by international research, which found that a unique, differentiated brand is more likely to attract investors.<sup>212</sup>

In consultation, many fund managers noted that there is competition over brand and reputation (including loyalty, respect and trustworthiness). Some managers further stated that the importance of brand and reputation is heightened where competing funds have similar product features. Funds management firms therefore have an incentive to build up a strong brand to increase the loyalty of existing clients and attract new investment.<sup>213</sup> Over half (53%) of the retail managed funds responding to the survey listed the reputation of the fund manager as one of the top five features that make a fund competitive in its asset class. Fewer funds cited the reputation and/or brand of the firm as a factor.

A strong brand and reputation are often built on a record of good performance. Investors who trust in a brand are likely to continue investing with that firm during times of poor performance, due to sustained belief and confidence in the firm's ability to achieve high returns in the long-run.<sup>214</sup>

#### **4.2.2.4 Relationships with distribution channels are critical to fund manager strategies**

With the high share of investors accessing retail managed investment products through distribution channels, particularly platforms and financial advisers, funds management firms often use an extensive distribution network to attract and retain clients.

Fund managers that develop strong relationships with platforms and advisers can often better compete with other managers, by growing the distribution networks for their products. This is evident in that overseas fund managers struggle to enter the Australian market without a local partner that can develop relationships with asset consultants and platform providers.<sup>215</sup>

Fund managers in consultation discussed the importance of building relationships with advisers for getting funds to market. A fund manager's business development manager (BDM) typically engages with advisers to articulate the fund's value proposition. Consultations indicated that after ratings information is considered, financial advisers

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<sup>210</sup> Sood, Kanika, 'The ingredients of a successful fund manager', *Financial Standard* (online), 22 January 2020 <<https://www.financialstandard.com.au/news/the-ingredients-of-a-successful-fund-manager-152792618>>.

<sup>211</sup> Walter, Ingo, 'The Global Asset Management Industry: Competitive Structure, Conduct and Performance' (1998) *Department of Finance Working Paper Series 1998*, New York University.

<sup>212</sup> DeSantis Breindel, *Do All Investment Managers Tell the Same Story? How Brand Differentiation Drives Growth* <<http://www.desantisbreindel.com/wp-content/uploads/Asset-Management-Branding.pdf>>.

<sup>213</sup> DeSantis Breindel, *Do All Investment Managers Tell the Same Story? How Brand Differentiation Drives Growth* <<http://www.desantisbreindel.com/wp-content/uploads/Asset-Management-Branding.pdf>>.

<sup>214</sup> Accenture, *High Performance Asset Management* (2015) <[https://www.accenture.com/us-en/~media/Accenture/Conversion-Assets/DotCom/Documents/Global/PDF/Industries\\_5/Accenture-CM-AWAMS-High-Performance-Asset-Management.pdf](https://www.accenture.com/us-en/~media/Accenture/Conversion-Assets/DotCom/Documents/Global/PDF/Industries_5/Accenture-CM-AWAMS-High-Performance-Asset-Management.pdf)>.

<sup>215</sup> Plan For Life, *Managed Fund Market 10 Year Review 2008-2018* (November 2019).

often make decisions about which funds to recommend based on sales pitches made by BDMs.

A strong relationship between BDMs and advisers, with the BDM providing information to advisers, access to seminars and similar, is therefore one of the primary means through which funds compete to reach retail investors. A financial adviser in consultation noted that managers can markedly distinguish themselves by regularly putting out information and data packs to advisers. Relationship building with platforms was communicated in consultation as less significant, but still important for fund managers. While BDMs have some degree of influence, consultees maintained that internal policies and appropriate corporate governance are in place to ensure that BDMs are not the only source of information and that the final decision to offer products is based on merit.

#### **4.2.2.5 Advertising is a common strategy for fund managers but can be misleading and distort investor decision-making**

As in other industries, fund managers use advertising to persuade consumers to invest in their products. Advertising can be targeted at investors, as the final consumer of retail managed investment products, or at financial advisers, as the intermediary that strongly influences the investor and disseminates information to them.<sup>216</sup> Promotions through financial advisers were the most commonly used method of promotion in the survey of fund managers conducted for this report, with 71% of retail managed funds analysed including financial advisers in the top five methods of promotion (see Section 7.2.2).

Fund managers discussed the need to target both groups in consultation, with one noting that they have a dedicated sales team directed at advisers, which advertises through roadshows, information sharing and training (see above on the relationships between BDMs and advisers).

Fund managers advertise their products to investors via a variety of mediums, for example online, in news articles and, when targeting retail investors directly, through distribution channels. It is important for funds management firms to have a strong and clear website, with one fund manager in consultation noting that their marketing is now 100% digital. Fund managers increasingly promote themselves through educational materials sent to investors, such as videos, monthly reports, fact sheets and articles. The ASX was also discussed as a communication or marketing platform for traded funds. In consultation, fund managers also stressed the importance of the PDS to their overall marketing strategy, especially for unlisted products, since it is this document that is given the most scrutiny by advisers and investors when ultimately making the decision of appropriateness.

In response to questions raised by the Interim Report, fund managers indicated that while advertising is important to establishing brand recognition, existing regulation prohibits marketing material from being false and gives ASIC power to pursue instances where customers are misled. ASIC recently identified seven responsible entities in Australia with fund advertising that did not provide adequate, clear or balanced information, leading to the entities undertaking corrective action such as replacing PDSs.<sup>217</sup>

Although funds may exaggerate differences between themselves and other funds, consultees rejected the notion that larger advertising budgets can (legally) create false product differentiation. Participants also indicated that DDO will place additional requirements on fund managers and distributors to ensure appropriate products are

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<sup>216</sup> Gerrans, Paul & St Clair, Sheree, 'Managed Fund Advertising – Progress Report' (2002) *Faculty of Business and Public Management, Edith Cowan University*.

<sup>217</sup> Australian Securities & Investments Commission, *20-137MR Investment funds told to correct advertising and disclosure* (2020) <<https://asic.gov.au/about-asic/news-centre/find-a-media-release/20-137mr-investment-funds-told-to-correct-advertising-and-disclosure/>>.

reaching target markets. Section 7.2.3.1 discusses misleading advertising through the perspective of investors making investment decisions.

Fund managers can also market their products by choosing a fund objective, fund name and benchmark which best represent each fund and appeals to investors. Fund managers and distribution teams typically nominate a fund's objective, asset allocation, performance benchmark and other fund descriptors. ASIC and industry bodies have released guidance and standards on promotion materials. For example, the Financial Security Council's Standards include the Code of Ethics & Code of Conduct (Standard No.1) and Presentation of Past Performance Information & Visual Promotions (Standard No. 10), and a number of ASIC regulatory guides provide best practice for advertising financial products.<sup>218</sup> However, there are no formal regulatory definitions or requirements which govern how fund managers nominate these characteristics.

A fund objective, such as specific return over a certain timeframe, and a fund benchmark to compare measure returns against, can be selectively chosen to market a fund as high-performing. Similarly, the way funds are named and described has created concerns around funds that appear to be competing based on some form of differentiation, despite this 'differentiation' not being reflective of the underlying structure or allocation of the fund. Examples include:

- Illiquid funds marketing themselves as 'defensive', which convinces investors that they will provide adequate liquidity in downturns. Rising buy-sell spreads for fixed income funds during the COVID-19 crisis has exposed the low liquidity portfolios of some fixed income managers that appear to be defensive.<sup>219</sup>
- Funds represented as safe and stable with little risk of capital loss, despite underlying volatility in the fund's assets.<sup>220</sup>

Similar to other products and services, fund managers and responsible entities are governed by legislation regarding misleading advertising. ASIC's Regulatory Guide 234 also provides best practice guidance on advertising financial products.<sup>221</sup>

The fund features that are promoted and communicated as part of fund manager advertising and marketing campaigns are discussed in Chapter 7.

#### **4.2.2.6 Some fund managers compete through mergers or by selling other product offerings**

Fund managers can compete by also selling other financial products. Institutions such as banks and life insurance companies that introduce a funds management arm into their operation are able to benefit from both demand economies of scope, in cross-selling products to customers, and cost economies of scope, in using the same inputs such as professional expertise to sell different products.<sup>222</sup>

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<sup>218</sup> Financial Security Council, 'FSC Standard No 1: Code of Ethics & Code of Conduct' (2018) <<https://www.fsc.org.au/resources-category/standard/337-1s-code-of-ethics-code-of-conduct-pdf/file>>; Financial Security Council, 'Presentation of Past Performance Information & Visual Promotions' (2019) <<https://www.fsc.org.au/resources-category/standard/1778-fsc-standard-10-presentation-of-past-performance-information-and-visual-promotions/file>>; Australian Securities & Investments Commission 'Advertising financial products and services (including credit): Good practice guidance' (Regulatory Guide No 234, November 2012) <<https://download.asic.gov.au/media/5673238/rg234-published-15-november-2012-20200713.pdf>>.

<sup>219</sup> Jamieson, Charlie, 'Buying time to sell – fixed income spreads come under fire' *Livewire* (online), 6 April 2020 <<https://www.livewiremarkets.com/wires/buying-time-to-sell-fixed-income-spreads-come-under-fire>>.

<sup>220</sup> Australian Securities & Investments Commission, *20-137MR Investment funds told to correct advertising and disclosure* (2020) <<https://asic.gov.au/about-asic/news-centre/find-a-media-release/2020-releases/20-137mr-investment-funds-told-to-correct-advertising-and-disclosure/>>.

<sup>221</sup> Australian Securities & Investments Commission, *20-137MR Investment funds told to correct advertising and disclosure* (2020) <<https://asic.gov.au/about-asic/news-centre/find-a-media-release/2020-releases/20-137mr-investment-funds-told-to-correct-advertising-and-disclosure/>>.

<sup>222</sup> Walter, Ingo, 'The Global Asset Management Industry: Competitive Structure, Conduct and Performance' (1998) *Department of Finance Working Paper Series 1998*, New York University.



Mergers and acquisitions reshaped the structure of the funds management industry in Australia in the late 1990s and early 2000s, with each of Australia's big banks, including the Commonwealth Bank and Westpac, acquiring or merging with the major funds management firms. This was intended to enable the merged firms to cross-sell banking products and managed funds. However, evidence indicates that the major banks were not overly successful in cross-selling wealth management products to customers. The Hayne Royal Commission has since seen divestment of funds management and financial advice arms from major banks, including Commonwealth Bank, Westpac, National Australia Bank, and ANZ, particularly in the retail market (see Section 3.4.2 for more detail).<sup>223</sup>

Increasing pressure on fees has also contributed to increased merger and acquisition activity in recent years, with fund managers competing by complementing 'traditional managed funds' with differentiated products and services.<sup>224</sup> Traditional funds management business models rely on annual percentage-based fees, which have been falling due to a range of factors. This has pushed many funds management firms into acquisitions and offerings of new services to clients, such as portfolio modelling and wealth management, as traditional fund managers attempt to gain scale or diversify their product offerings.<sup>225</sup> For example, there has been an increase in acquisitions of ETF businesses by funds management firms attempting to capitalise on this growing segment of the industry.<sup>226</sup>

### 4.3 Price competition — fund manager fees

Fund management fees in Australia — charged by fund managers and not inclusive of platform or advisor fees — are low by global standards (see 4.3.3 for detail). According to consultation, discounting in the form of rebates is also widespread in the industry. Some small fund managers indicated in consultation that they had limited control over prices, appearing to operate as price takers rather than price makers, indicative of a highly competitive market.

The fees charged by Australian retail funds are low by global standards.<sup>227</sup> Analysis of the PDS management fee for nearly 6,000 funds undertaken for this report found that management fees declined from an average of 90 basis points (bps) in 2014 to 87bps in 2020. During consultation, fund managers generally identified fees as an important source of competition, and some indicated that they are price takers rather than price makers. 'Price taking' means that funds accept or offer a price which is consistent with the prevailing market price, and is common in perfectly competitive markets, where individual participants are unable to exercise market power to raise prices, and cannot decrease prices because they are reflective of costs.

Data collected for this report provides some evidence of price taking behaviour, as evidenced by price clustering, which occurs in certain submarkets including passive funds and fixed interest funds. The majority of fund managers also noted that retail

<sup>223</sup> Vickovich, Aleks, 'Major banks slammed for abandoning wealth', *The Australian Financial Review* (online), 8 January 2020 <<https://www.afr.com/companies/financial-services/major-banks-slammed-for-abandoning-wealth-20200106-p53p90>>.

<sup>224</sup> Waite, Suzy, Massa, Annie & Cannon, Christopher, 'Asset Managers With \$74 Trillion on Brink of Historic Shakeout' *Bloomberg* (online), 8 August 2019 <<https://www.bloomberg.com/graphics/2019-asset-management-in-decline/>>.

<sup>225</sup> Allianz, *Our new performance fee model* (2020) <<https://uk.allianzgi.com/en-gb/advisor/funds/new-performance-fee-model>>; Waite, Suzy, Massa, Annie & Cannon, Christopher, 'Asset Managers With \$74 Trillion on Brink of Historic Shakeout' *Bloomberg* (online), 8 August 2019 <<https://www.bloomberg.com/graphics/2019-asset-management-in-decline/>>.

<sup>226</sup> Deloitte, *2019 Investment Management Outlook: A mix of opportunity and challenge* (2019) <<https://www2.deloitte.com/content/dam/Deloitte/tw/Documents/financial-services/2019%20Investment%20Mgmt%20Outlook.pdf>>.

<sup>227</sup> Morningstar, *Global Investor Experience Study: Fees and Expenses* (17 September 2019) <[https://www.morningstar.com/content/dam/marketing/shared/pdfs/Research/GIE\\_2019\\_v4.5.pdf?utm\\_source=eloqua&utm\\_medium=email&utm\\_campaign=&utm\\_content=18780](https://www.morningstar.com/content/dam/marketing/shared/pdfs/Research/GIE_2019_v4.5.pdf?utm_source=eloqua&utm_medium=email&utm_campaign=&utm_content=18780)>.

investors closely scrutinise fees and are placing increasing priority on fees and performance.

Despite this, there are still a range of fund fees offered in the market, with some areas of greater price dispersion. Prices across the industry as a whole are dispersed. This could reflect a degree of product heterogeneity among managed funds, which differ across a range of dimensions, ensuring that one fund may not be a perfect substitute for another. The fact that price dispersion is also evident in submarkets such as the active funds market, where there are many competitors, suggests that fund managers are effectively tailoring products to meet the needs and preferences of different investors, which may in turn impact the cost of managing each fund.

### **Box 4.2: Price dispersion**

Where products are not direct substitutes and there are many suppliers that differentiate products to support differences in consumer preferences, they are able to charge prices that reflect this. In this setting, suppliers are price setters rather than price leaders, able to lower prices to gain market share or increase prices on the basis of product differentiation. This variety of prices within an industry can be referred to as **price dispersion**.

Price dispersion compares to price clustering, where prices are grouped and not widely spread. Price clustering is more closely aligned with the concept of perfect competition, where suppliers offer homogenous products and compete only on price. Under perfect competition, prices converge over time to reach marginal cost.

Price clustering has traditionally been associated with a competitive market, based on economic theory where competition is characterised by convergence to a single price. In contrast, price dispersion has been considered to be reflective of issues with competition, with suppliers exercising market power to hold prices above marginal cost.

However, these relationships assume homogeneous products, and it is increasingly recognised that in theory and practice, price dispersion can actually reflect the outcome of an effectively competitive market.<sup>228</sup> This is because in markets with differentiated products and consumer heterogeneity, suppliers tailor offerings — including products and prices — to the different needs of consumers, such that greater price dispersion aligns with more intense and effective competition.

It is also worth noting that in theory, price clustering can reflect implicit or explicit price agreements between competitors, including cartel conduct. Thus, price clustering is not determinative of the existence of competition.

The existence of price dispersion means that Deloitte Access Economics cannot rule out the possibility that some fund managers may have a degree of market power in setting prices. At the same time, this behaviour could also be explained by product heterogeneity and differences in investor preferences across fund characteristics. It should be noted that there is no evidence of exclusionary conduct being exercised and there is limited evidence of false differentiation (i.e. funds charging higher fees but pursuing passive investment strategies, see Section 4.2.1.3). Given this, it is also not possible to rule out genuine product differentiation as an explanation for price dispersion in submarkets where price dispersion is evident.

<sup>228</sup> Walsh, Patrick Paul & Whelan, Ciara, 'Modelling Price Dispersion as an Outcome of Competition in the Irish Grocery Market' (2003) 47(3) *The Journal of Industrial Economics* 325; Lewis, Matthew, 'Price dispersion and competition with differentiated sellers' (2008) 56(3) *The Journal of Industrial Economics* 654.

This section discusses the types of fees charged by fund managers, how fees are charged, the actual fees charged, and the trend decline in management fees observed in Australia. It is important to note that while this chapter focuses on the fees documented in formal disclosure documents, the final cost of investing in a managed fund for a retail investor will likely differ from documented fees, for the following two reasons:

- Discounting, in the form of rebates, is common practice in the Australian funds management industry. This means the funds management fee is typically offered at a lower rate than documented. This is discussed in Section 4.4 below.
- Investors typically invest via platforms and advisers. The charges paid to these distribution channels will add to the funds management fee and are discussed in Section 6.5.

#### **4.3.1 Fund managers charge a range of fees including management fees**

The fees charged by fund managers can vary considerably due to differences in factors such as product type, investor type and fund size. Responsible entities of retail managed investment products are required by ASIC to disclose the fees and costs they charge to retail consumers through PDSs and periodic statements.<sup>229</sup> ASIC guidelines for PDSs and periodic statements were recently updated in Regulatory Guide No. 97 (RG97), which outlines the types of fees and costs charged by issuers of retail managed investment products in Australia.<sup>230</sup> RG97 must be applied to PDSs issued on or after 30 September 2022 and periodic statements for reporting period commencing on or after 1 July 2021.<sup>231</sup>

Fees and costs charged for managed investment products can be split into:

- ongoing fees and costs, usually charged on an annual basis
- member activity related fees and costs, which are fees and costs charged when money moves in and out of a fund.

The types of fees charged under these categories are shown in Table 4.1 (the actual fees charged are presented in Section 4.3.3 below). The fees and costs presented in Table 4.1 represent a single fee structure charged by an issuer of a retail managed investment product. Often, the fees and costs incurred by an investor will be more complex than this. For example, a multiple fee structure may give an investor the choice of paying a certain type of fee upfront or paying later such as the termination of the investment.<sup>232</sup>

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<sup>229</sup> Wholesale and institutional investors are also able to access retail managed investment products, but do not have to be given a PDS.

<sup>230</sup> Australian Securities & Investments Commission 'Disclosing fees and costs in PDSs and periodic statements' (Regulatory Guide No 97, July 2020) <<https://download.asic.gov.au/media/5700977/rg97-published-24-july-2020.pdf>>.

<sup>231</sup> Australian Securities & Investments Commission, *20-167MR ASIC releases minor updates to RG 97* (24 July 2020) <<https://asic.gov.au/about-asic/news-centre/find-a-media-release/2020-releases/20-167mr-asic-releases-minor-updates-to-rg-97/>>.

<sup>232</sup> Australian Securities & Investments Commission 'Disclosing fees and costs in PDSs and periodic statements' (Regulatory Guide No 97, July 2020) <<https://download.asic.gov.au/media/5700977/rg97-published-24-july-2020.pdf>>.

Table 4.1: Typical fees and costs charged for retail managed investment products with a single fee structure

Fees and costs type	Definition
<b>Ongoing fees and costs</b>	
Management fees and costs	<p>Related to the professional administration of the management investment scheme. This includes:</p> <ul style="list-style-type: none"> <li>• internal management fees incurred in administering the managed investment</li> <li>• operating expenses/fees to third-party ancillary services such as custodians, auditors and asset consultants.</li> </ul> <p>Management fees are expressed as a share of the investment account balance as the Management Expense Ratio (MER).<sup>233</sup></p>
Performance fees	Charged in line with the product's performance, usually if the investment return is greater than a benchmark return such as an index.
Transaction costs	Related to the acquisition or disposal of assets by the managed investment scheme, for example government tax and stamp duty. <sup>234</sup>
<b>Member activity related fees and costs</b>	
Establishment fee	Incurred upon the purchase of the investment option.
Contribution fee	Incurred upon any investor contributions to the investment.
Buy-sell spread	Charged to recover costs incurred in transactions by the scheme when an investor enters or exits the managed investment scheme, requiring the scheme to buy or sell assets. Separately charged from transaction costs, to avoid investors paying for costs incurred by the scheme when another investor enters or exits the scheme.
Withdrawal fee	Incurred when an investor withdraws an amount from their investment.
Exit fee	Incurred when an investor exits an investment option.
Switching fee	Incurred when an investor switches from one product or investment option to another, under the same product provider.

Source: Unless otherwise stated, ASIC (2020).<sup>235</sup>

The fees listed in Table 4.1 represent categories of fees which ASIC requires to be disclosed separately in disclosure statements. However, while all funds have a management fee, not all funds charge the other fees listed. Further, funds may charge other types of fees, or split up fees listed above into other groupings.<sup>236</sup>

<sup>233</sup> Australian Investors Association, *Managed Funds* (2012) <<https://www.investors.asn.au/education/other-investments/managed-funds/>>.

For the 17 retail managed funds analysed in the survey conducted for this report:

- all charged management fees
- 79% charged transaction costs
- 71% charged the buy-sell spread
- 50% charged performance fees
- 7% charged switching fees
- none of the funds charged exit, withdrawal, contribution and establishment fees.

Other types of investment products offered to retail, wholesale and institutional investors are associated with similar fees and costs to those presented in Table 4.1. For example:

- The fees and costs outlined above must be listed in statements issued by operators of notified foreign passport fund products.<sup>237</sup>
- MDA providers must disclose fees and costs in client contracts in the same manner as if they were offering a managed investment product.<sup>238</sup>
- While operators of wholesale managed funds, such as wholesale trustees, typically do not issue PDSs, as they are not required to by ASIC, they charge similar types of fees and costs to those charged for retail managed investment products.<sup>239</sup>

#### 4.3.2 Most fees are charged on an ad valorem basis

Fees may be deducted from an investor's account balance, from the returns on the investment, or from the assets of the managed investment scheme.<sup>240</sup> Management fees and costs, including operating expenses and performance fees, are typically deducted from the fund assets (which include the returns on the investment).

Costs that reduce the return on the product, or the underlying vehicles the product is invested in, can be expressed as the **Indirect Cost Ratio (ICR)**.<sup>241</sup> The ICR is used to compare fees across different managed investment products, as it includes costs outside of management fees. Similar to the MER, the ICR is presented as a share of the fund's total assets.<sup>242</sup> Prior to RG97, the ICR was published as a separate line item in disclosure

<sup>234</sup> Susan Bell Research, *Consumer testing of the fees and costs tools for superannuation and managed investment schemes* (report commissioned by Australian Securities & Investments Commission, 2019) <<https://download.asic.gov.au/media/5381781/rep638-published-29-november-2019.pdf>>.

<sup>235</sup> Australian Securities & Investments Commission 'Disclosing fees and costs in PDSs and periodic statements' (Regulatory Guide No 97, July 2020) <<https://download.asic.gov.au/media/5700977/rg97-published-24-july-2020.pdf>>.

<sup>236</sup> For example, see: Canstar, *Do higher fees charged by managed funds result in higher returns?* (6 March 2018) <<https://www.canstar.com.au/managed-funds/managed-funds-how-do-fees-compare/>>.

<sup>237</sup> Australian Securities & Investments Commission 'Disclosing fees and costs in PDSs and periodic statements' (Regulatory Guide No 97, July 2020) <<https://download.asic.gov.au/media/5700977/rg97-published-24-july-2020.pdf>>.

<sup>238</sup> Australian Securities & Investments Commission 'Disclosing fees and costs in PDSs and periodic statements' (Regulatory Guide No 97, July 2020) <<https://download.asic.gov.au/media/5700977/rg97-published-24-july-2020.pdf>>.

<sup>239</sup> Australian Securities & Investments Commission 'Prospectuses: Effective disclosure for retail investors' (Regulatory Guide No 228) <<https://download.asic.gov.au/media/5230057/rg228-published-12-august-2019.pdf>>.

<sup>240</sup> Australian Securities & Investments Commission 'Disclosing fees and costs in PDSs and periodic statements' (Regulatory Guide No 97, July 2020) <<https://download.asic.gov.au/media/5700977/rg97-published-24-july-2020.pdf>>.

<sup>241</sup> Australian Securities & Investments Commission 'Disclosing fees and costs in PDSs and periodic statements' (Regulatory Guide No 97, July 2020) <<https://download.asic.gov.au/media/5700977/rg97-published-24-july-2020.pdf>>.

<sup>242</sup> The Rask Group, *Management Expense Ratio (MER) & Indirect Cost Ratio (ICR) Explained* (2020) <<https://education.rask.com.au/2020/01/06/management-expense-ratio-mer-indirect-cost-ratio-icr-explained/>>.

documents.<sup>243</sup> Under RG97, indirect costs are included in 'management fees and costs'.<sup>244</sup>

Ongoing fees and costs for managed investment products are also commonly charged on an **ad valorem** basis, as a percentage of funds under management.<sup>245</sup> The ad valorem fee structure incentivises fund managers to grow the size of FUM as long as the marginal cost of increasing inflows is less than the marginal revenue achieved from this increase.<sup>246</sup> Ad valorem fee structures are a common feature in financial services despite concerns that fees do not appropriately align with costs. The appropriateness of fund manager fees and profitability are considered in Section 8.2.1.

**Performance fees** are generally expressed as a percentage of FUM, and as noted in Table 4.1, tend to be charged if fund performance beats a relevant benchmark or where the fund's NAV is greater than the previous NAV high watermark. Performance fees are more common in institutional markets than retail markets, but are permitted for retail managed investment products in Australia.<sup>247</sup> They are usually applied to active funds, and are less common for passive funds.<sup>248</sup> As noted in Section 4.3.1, half of the retail managed funds reported on in the survey conducted for this report charge performance fees.

In Australia, fund managers are allowed to charge asymmetric performance fees to retail investors — that is, fund managers may charge a fee for outperformance, but not provide a discount or similar for underperformance if the fund tracks below the benchmark. This practice is prohibited in some other countries. However, a Morningstar review of funds management in various countries found that performance fees are clearly stated to investors in Australia.<sup>249</sup>

Downward pressure on fund management fees both globally and in Australia has led to **changing fee structures**, particularly for passive and exchange-traded funds. For example, American multinational Fidelity announced two zero-fee index mutual funds in 2018.<sup>250</sup> Another example is the 'fulcrum fee' model, a new fee structure for active funds in the retail market, where investment managers are rewarded for outperformance above a benchmark and otherwise receive a base fee.<sup>251</sup>

No-fee funds have prompted greater use of performance fees in the market for retail and institutional investors. Some institutional investors consider performance fees to be appropriate in a low management fee environment and to establish an appropriate incentive for fund managers, while others argue that performance fees encourage

<sup>243</sup> Financial Services Council & Morningstar, *Australian Managed Funds Industry* (19 July 2016) <<https://www.fsc.org.au/resources-category/publication/791-2016-fscmorningstar-austnmanagedfundsindustryreport/file>>.

<sup>244</sup> Allens, *Disclosure of fees and costs and new RG 97* (13 December 2019) <<https://www.allens.com.au/insights-news/insights/2019/12/disclosure-of-fees-and-costs-and-new-rg-97/#anchor7>>.

<sup>245</sup> Financial Conduct Authority 'Asset Management Market Study Interim Report' (Market Study 15/2.2, November 2016) <<https://www.fca.org.uk/publication/market-studies/ms15-2-2-interim-report.pdf>>.

<sup>246</sup> Financial Conduct Authority 'Asset Management Market Study Interim Report: Annex 6 – Institutional Econometric Analysis' (Market Study 15/2.2: Annex 6, November 2016) <<https://www.fca.org.uk/publication/market-studies/ms15-2-2-annex-6.pdf>>.

<sup>247</sup> Reserve Bank of Australia 'Australian Fund management: Market Structure and Fees' (Bulletin, February 2003) <<https://www.rba.gov.au/publications/bulletin/2003/feb/pdf/bu-0203-3.pdf>>.

<sup>248</sup> IBIS World, *Fund management Services in Australia industry trends (2014-2019)* (2019).

<sup>249</sup> Morningstar, *Global Investor Experience Study: Fees and Expenses* (17 September 2019) <[https://www.morningstar.com/content/dam/marketing/shared/pdfs/Research/GIE\\_2019\\_v4.5.pdf?utm\\_source=eloqua&utm\\_medium=email&utm\\_campaign=&utm\\_content=18780](https://www.morningstar.com/content/dam/marketing/shared/pdfs/Research/GIE_2019_v4.5.pdf?utm_source=eloqua&utm_medium=email&utm_campaign=&utm_content=18780)>.

<sup>250</sup> Deloitte, *2019 Investment Management Outlook: A mix of opportunity and challenge* (2019) <<https://www2.deloitte.com/content/dam/Deloitte/tw/Documents/financial-services/2019%20Investment%20Mgmt%20Outlook.pdf>>.

<sup>251</sup> Deloitte, *2019 Investment Management Outlook: A mix of opportunity and challenge* (2019) <<https://www2.deloitte.com/content/dam/Deloitte/tw/Documents/financial-services/2019%20Investment%20Mgmt%20Outlook.pdf>>.

excessive risk-taking.<sup>252</sup> For example, an asset owner survey in 2018 found that only '37% of institutional investors believe that performance fees are an effective way of aligning an asset managers' interest with [theirs].'<sup>253</sup>

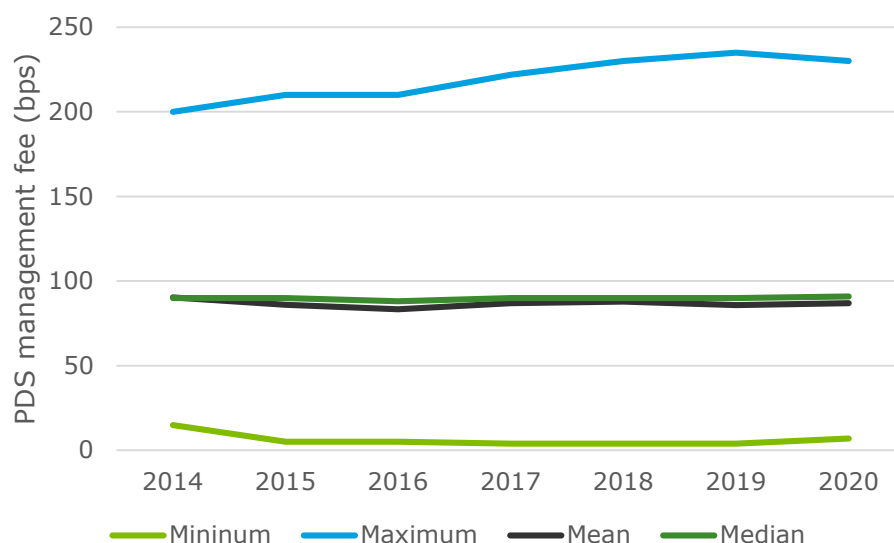
#### 4.3.3 Actual management fees charged are relatively dispersed and have fallen slightly in recent years

Morningstar's most recent Global Investors Experience Study gave Australia a top grade for Fees and Expenses, one of three countries out of 26 that were attributed this rating. This top grade was allocated to Australia due to:

- the relatively low asset-weighted median expense ratio, accounting for all annual fund expenses
- investor-friendly approaches to fees and costs, such as banned commissions (particularly FOFA reforms).<sup>254</sup>

Chart 4.2 presents a summary of management fees extracted from PDS statements over the past seven years. Despite an upwards movement in the maximum fees charged, this appears to show a relatively smooth period of fee growth (mean and median are approximately 90 bps). In contrast, research conducted by Morningstar and industry consultations have indicated a trend decline in management fees. Evidence of falling fees is demonstrated when fees are split by investment style and asset class (Sections 4.3.3.2 and 4.3.3.3), and fees are depicted over a longer time period (Section 4.3.3.3).

Chart 4.2: Management fees, 2014-2020 (N=5,971)



Note: Contents of the Chart are described in the paragraph above in Section 4.3.3.

Increase in the maximum in 2017-2020 due to a boutique Emerging markets (China) fund.

Source: Deloitte Access Economics (2021) and Lonsec (2020).

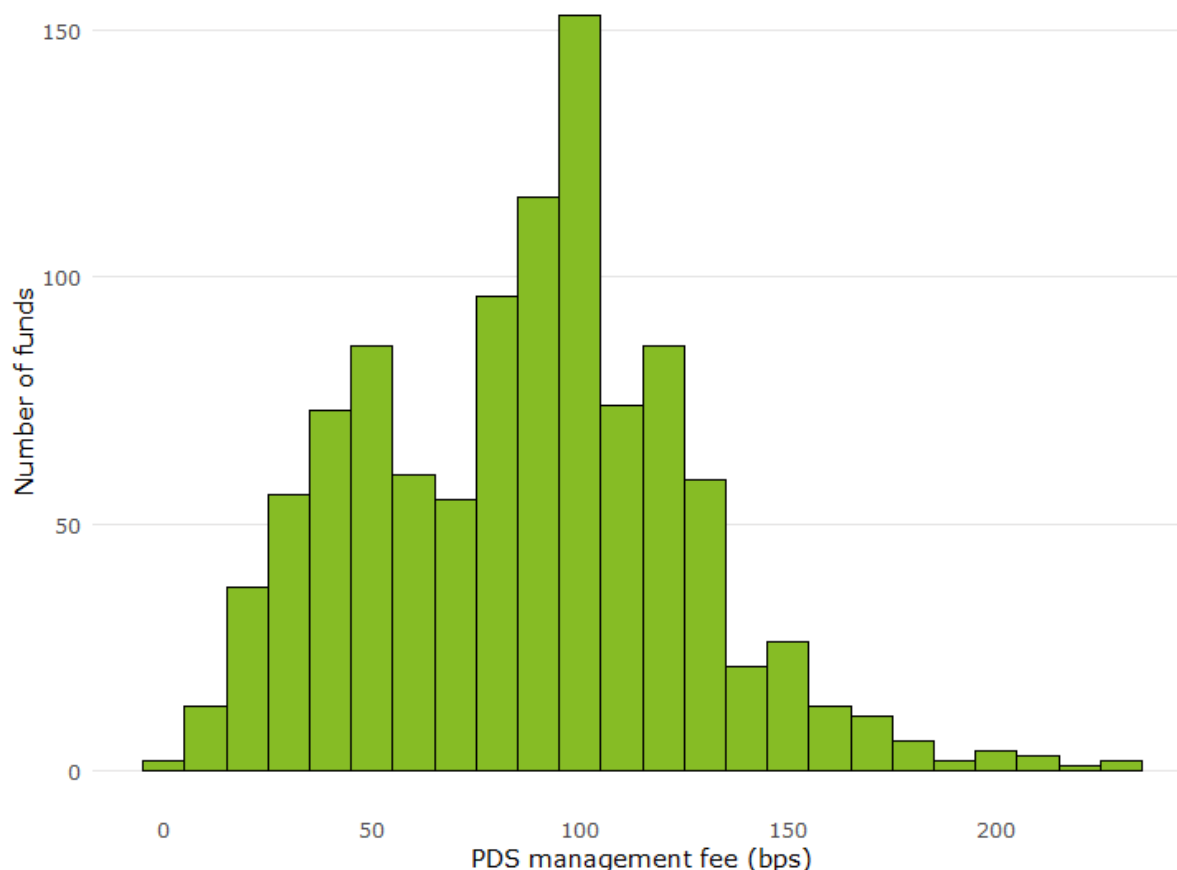
<sup>252</sup> Segal, Julie, 'The Next Big Fee Trend?', *Institutional Investor* (online), 26 November 2018 <<https://www.institutionalinvestor.com/article/b1c0136vg4hb58/The-Next-Big-Fee-Trend>>; DeSantis, Phil, 'Commentary: Performance fees – new hope for active managers', *Pensions & Investments*, 24 October 2019 <<https://www.pionline.com/industry-voices/commentary-performance-fees-new-hope-active-managers>>.

<sup>253</sup> bfinance, *Investment Management Fees: Is Competition Working?* (2019) <<https://www.bfinance.com/insights/investment-management-fees-is-competition-working/#download-form>>.

<sup>254</sup> Morningstar, *Global Investor Experience Study: Fees and Expenses* (17 September 2019) <[https://www.morningstar.com/content/dam/marketing/shared/pdfs/Research/GIE\\_2019\\_v4.5.pdf?utm\\_source=eloqua&utm\\_medium=email&utm\\_campaign=&utm\\_content=18780](https://www.morningstar.com/content/dam/marketing/shared/pdfs/Research/GIE_2019_v4.5.pdf?utm_source=eloqua&utm_medium=email&utm_campaign=&utm_content=18780)>.

Chart 4.3 uses the same data as above to show the distribution of PDS management fees for 2019. The chart demonstrates relatively high price dispersion across the whole sample, with fees as low as 4bps and as high as 235bps.

Chart 4.3: Distribution of management fees, all funds 2019 ( $N=1,055$ )



Note: Contents of the Chart are described in the paragraph above in Section 4.3.3.

Source: Deloitte Access Economics (2021) and Lonsec (2020).

When considering trends and distributions in fees, it is important to note that while fund management fees are an important characteristic of funds and can be used to consider the competitiveness of the industry, ultimately investor outcomes are determined by risk-adjusted returns after fees. This means that investors derive utility from a range of factors that contribute to risk-adjusted returns after fees, and even factors that are not reflected in returns, such as customer service. Further, as discussed at the start of this section, high fees do not necessarily reflect a lack of competition, but can be demonstrative of the heterogeneity in the industry and the fact that funds are not perfect substitutes, reflecting differential costs to manage funds with different characteristics.

#### 4.3.3.1 Fees are higher for retail managed funds compared to wholesale managed funds

Retail managed funds generally charge higher fees than wholesale managed funds.<sup>255</sup>

Chart 4.4 shows the average price for wholesale and retail products over time. The Chart shows retail fees averaging around 90bps while wholesale fees remain consistently

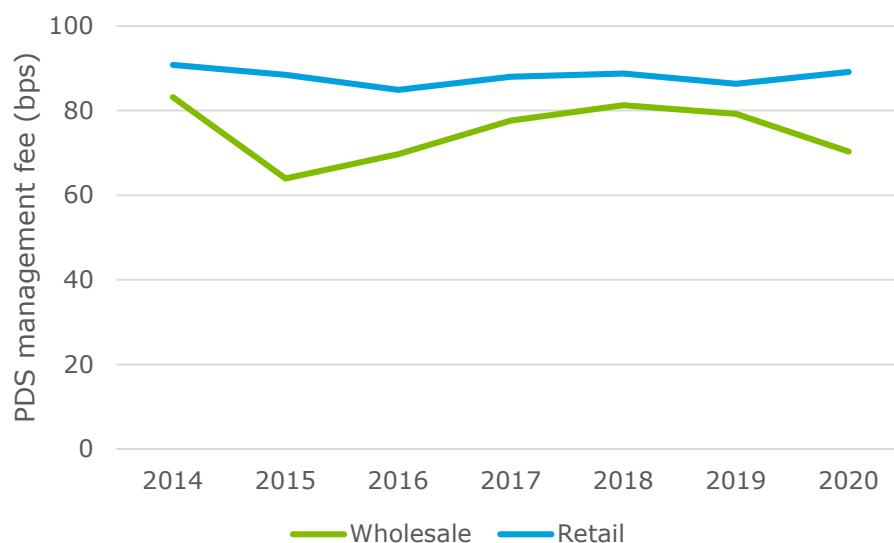
<sup>255</sup> Strategic Financial Solutions, *Wholesale & Retail Managed Funds* (2019)

<<http://www.sfsonline.com.au/income/typesofinvestments/wsaleretailmanagedfunds.asp?>>.



lower. Excluding 2014 due to a low sample of wholesale products, the average difference fee is 10bps.

Chart 4.4: Mean management fees by investor type, 2014-2020 (N=5,970)



Note: Funds are classified as wholesale if the minimum investment amount is greater or equal to \$50,000. This method may incorrectly attribute wholesale status to some retail funds that have minimum investment amounts at a direct level but not on a platform level. Convergence of fees in 2014 due to small sample, particularly wholesale funds.

Note: Contents of the Chart are described in the paragraph above in Section 4.3.3.1.

Source: Deloitte Access Economics (2021) and Lonsec (2020).

#### 4.3.3.2 Active funds charge more and exhibit higher price dispersion than passive funds

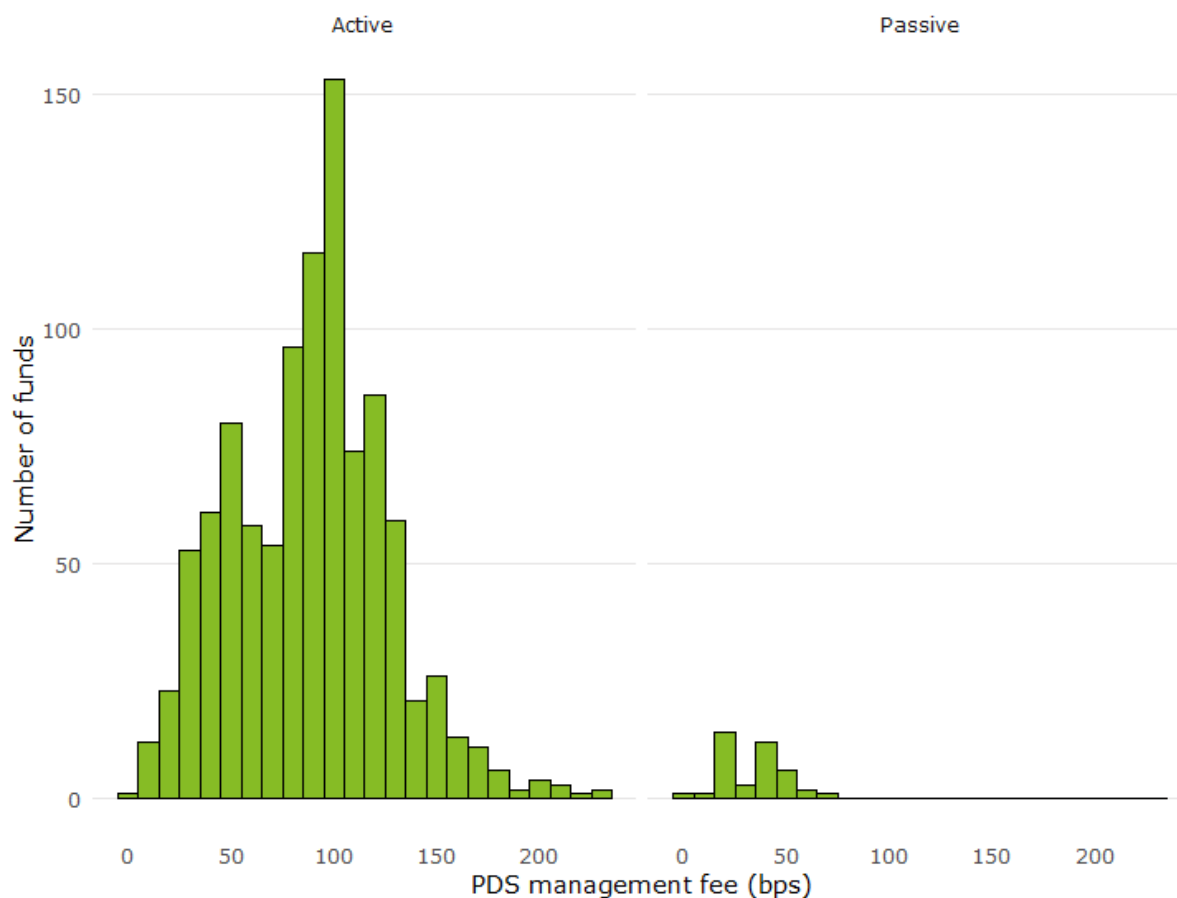
Managers of active funds tend to charge higher fees than managers of passive funds.<sup>256</sup> This is a result of both higher internal administration costs and higher third-party costs such as independent advice, as well as higher transaction costs.<sup>257</sup>

There has been a gradual decline in active management fees between 2015 and 2019, falling from an average of 95bps to 91bps. The distribution of management fees, as depicted in Chart 4.5, reflects significantly greater price dispersion for active funds compared to passive funds. Most passive funds charge management fees below 50bps, while active funds charge fees up to 200bps. The range of fees for active management likely reflects greater fund and fund manager differentiation for this investment style.

<sup>256</sup> Morningstar, *Global Investor Experience Study: Fees and Expenses* (17 September 2019) <[https://www.morningstar.com/content/dam/marketing/shared/pdfs/Research/GIE\\_2019\\_v4.5.pdf?utm\\_source=eloqua&utm\\_medium=email&utm\\_campaign=&utm\\_content=18780](https://www.morningstar.com/content/dam/marketing/shared/pdfs/Research/GIE_2019_v4.5.pdf?utm_source=eloqua&utm_medium=email&utm_campaign=&utm_content=18780)>.

<sup>257</sup> Financial Conduct Authority 'Asset Management Market Study Interim Report' (Market Study 15/2.2, November 2016) <<https://www.fca.org.uk/publication/market-studies/ms15-2-2-interim-report.pdf>>; Reserve Bank of Australia 'Australian Fund management: Market Structure and Fees' (Bulletin, February 2003) <<https://www.rba.gov.au/publications/bulletin/2003/feb/pdf/bu-0203-3.pdf>>.

Chart 4.5: Distribution of management fees by management style, all funds 2019 ( $N=1,055$ )



Note: Contents of the Chart are described in the paragraph above in Section 4.3.3.2.

Source: Deloitte Access Economics (2021) and Lonsec (2020).

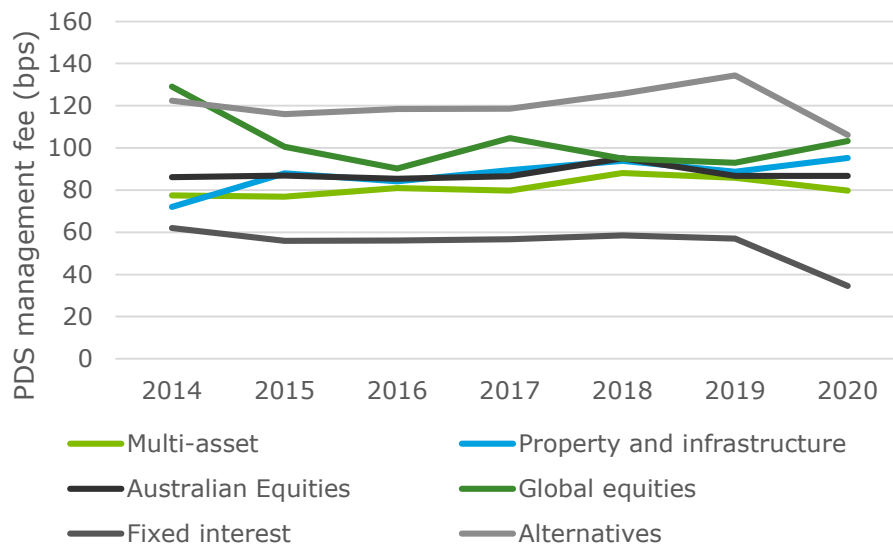
#### 4.3.3.3 Average management fees and fee dispersion differ considerably depending on asset class

The management fee charged by fund managers can vary significantly depending on the underlying assets in the fund.

Chart 4.6 shows the average fees charged on funds over time, grouped by asset class. This report notes that the sample size in 2020 is approximately half of the previous year and could be contributing to the sharp changes between 2019 and 2020. With this in mind, fees across asset classes remain reasonably stable.

The average price for global equities shows the most decline over the period, down to 100bps, which is consistent with the increasing presence of large, offshore managers. Australian equities, while fluctuating in 2018, show stable pricing at approximately 86bps. The fees on property and infrastructure, as well as alternatives, increase over the period while fixed interest floats at approximately 56–57bps (excluding 2020).

Chart 4.6: Mean management fees by asset class, 2014–2020 (N=5,966)



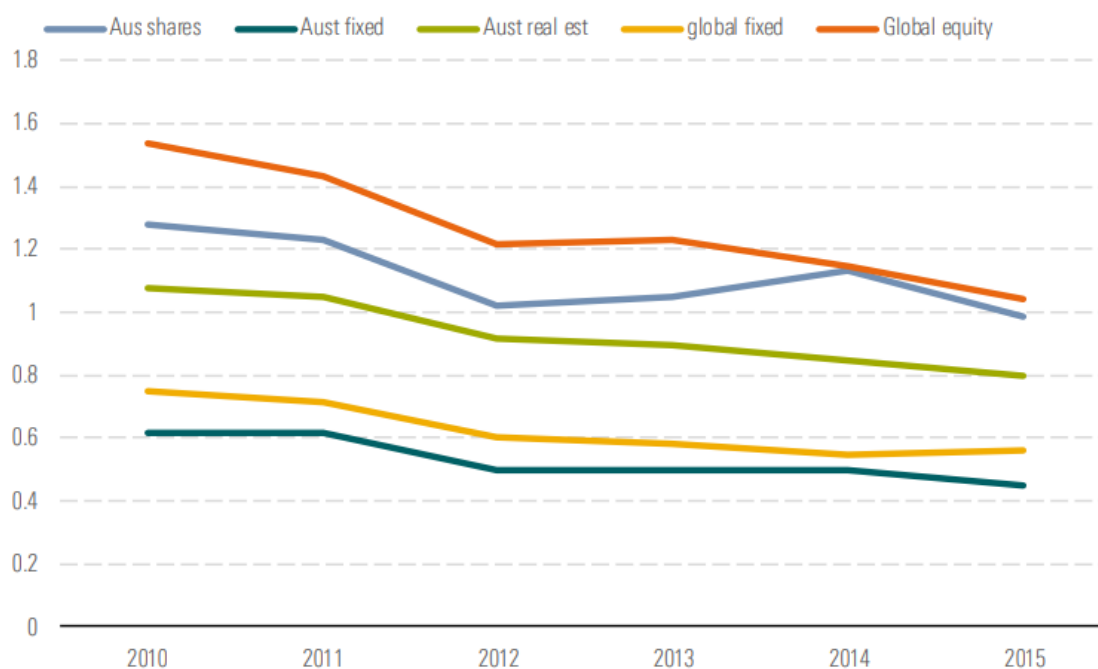
Note: Small sample sizes for fixed interest and alternatives driving sharp decline in 2020.

Note: Contents of this chart are found in table form in Appendix F.

Source: Deloitte Access Economics (2021) and Lonsec (2020).

While Chart 4.6 does not evidence a meaningful decline in management fees in the period 2014 to 2020, Chart 4.7 below demonstrates a trend fall in fees across most asset classes from 2010 to 2015. The data presented in Chart 4.7 includes a slightly different definition of fees, using the ICR which includes all expenses including performance fees, and applies the median rather than the average. However, comparison of the two charts suggests that the decline in fees charged by fund managers mostly occurred prior to 2015. This is most notable for global equities funds, reflecting the price-leading strategies of global managers.

Chart 4.7: Median Australian Investment Trust fees (%) by asset class, 2010–2015 (N=5,966)



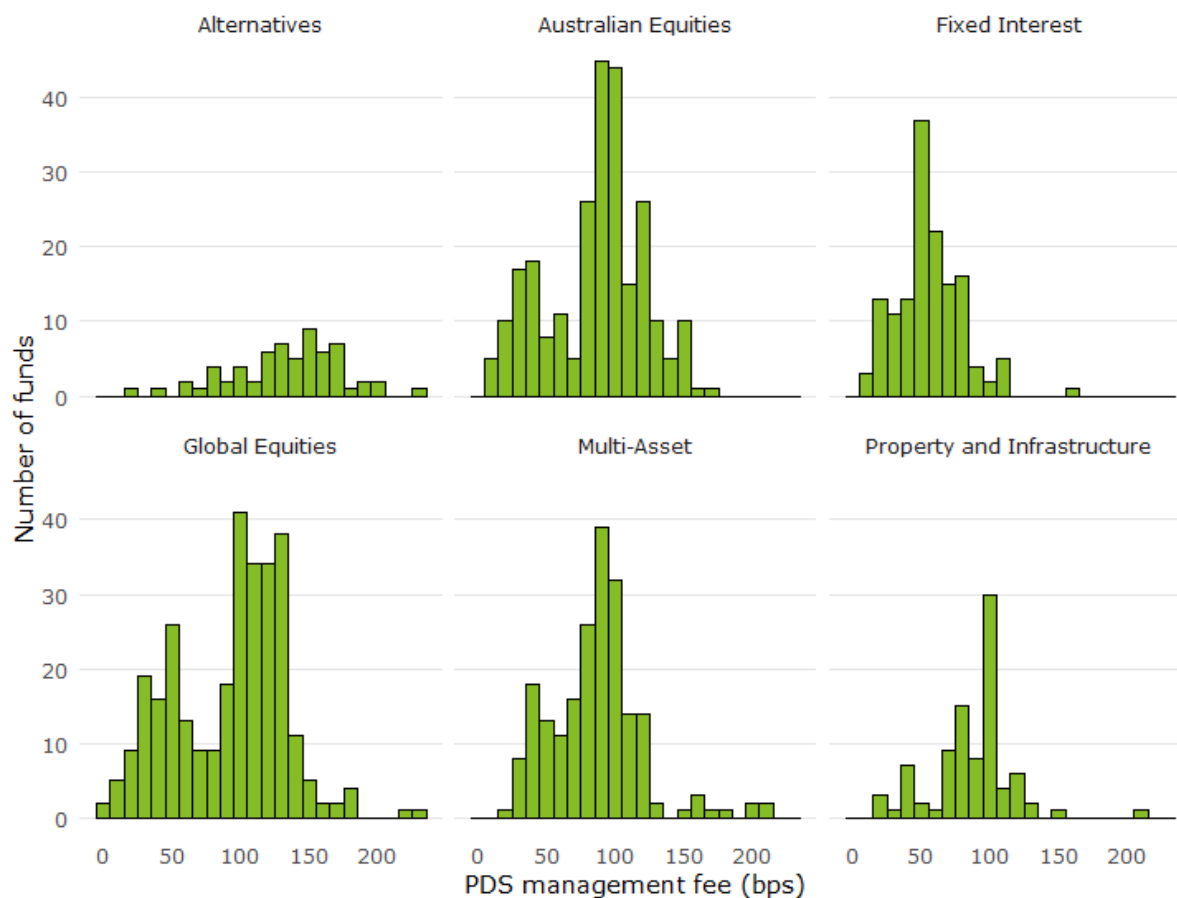
Note: Contents of the Chart are described in the paragraph above in Section 4.3.3.3.

Source: Financial Services Council and Morningstar (2016).<sup>258</sup>

Price dispersion within asset classes, particularly global equities, Australian equities and alternatives, is demonstrated in Chart 4.8. This likely reflects the degree of heterogeneity in these submarkets, which allows fund managers to tailor products to the various needs of investors within these classes. In contrast, price clustering is more evident in fixed interest funds and property and infrastructure funds, potentially indicating a more limited range of characteristics over which funds and fund managers can be differentiated in these asset classes.

<sup>258</sup> Financial Services Council & Morningstar, *Australian Managed Funds Industry* (19 July 2016) <<https://www.fsc.org.au/resources-category/publication/791-2016-fscmorningstar-austnmanagedfundsindustryreport/file>>.

Chart 4.8: Distribution of management fees by asset class, all funds 2019 (N=1,055)



Note: Contents of the Chart are described in the paragraph above in Section 4.3.3.3

Source: Deloitte Access Economics (2021) and Lonsec (2020).

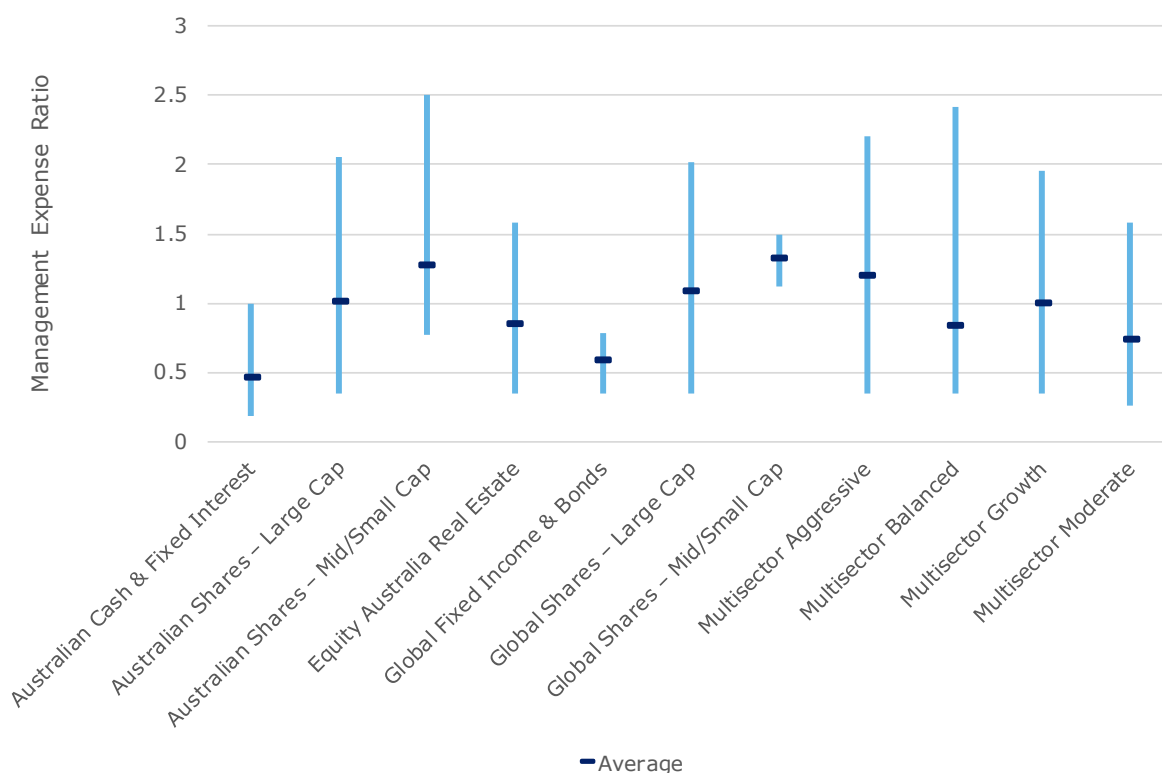
Chart 4.9 depicts the range in management expense ratios (MER)<sup>259</sup> for managed funds rated by Canstar in 2018, for various asset types.<sup>260</sup> Funds with a higher average and/or maximum MER include funds holding global shares, multisector aggressive or balanced funds, and funds holding shares for mid or small cap stocks (those that trade for corporations with a market capitalisation less than \$10 billion).<sup>261</sup> This is likely because these types of funds tend to be less stable and riskier than other types, requiring more active management.

<sup>259</sup> As noted in Table 4.1, the MER is the ratio of management fees to the investment account balance. A higher MER should reflect the higher cost for a fund manager of managing an investment.

<sup>260</sup> Canstar, *Do higher fees charged by managed funds result in higher returns?* (6 March 2018) <<https://www.canstar.com.au/managed-funds/managed-funds-how-do-fees-compare/>>.

<sup>261</sup> CommSec, *What are large, mid and small cap shares?* (2013) <<https://www.commsec.com.au/education/learn/choosing-investments/what-are-large-mid-and-small-cap-shares.html>>.

Chart 4.9: Management expense ratio (MER) range on managed funds by asset type, 2018



Note: The light blue bar represents the range in the size of the MER, based on the minimum and maximum MERs charged by fund managers that are rated by Canstar, while the dark blue line reflects the average MER for these funds.

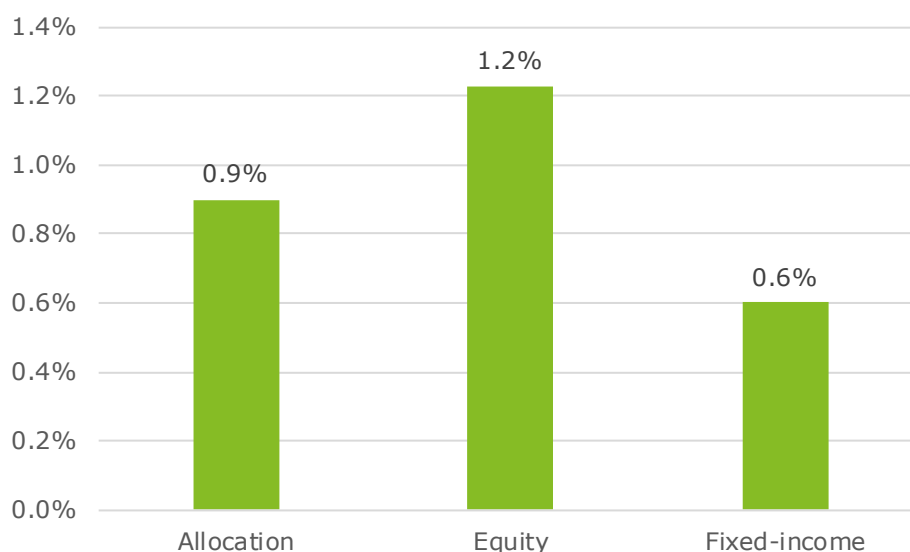
Note: Contents of the Chart are described in the paragraph above in Section 4.3.3.3.

Source: Canstar (2018).

In 2019, Morningstar also published the asset-weighted median expense ratio for three asset classes in Australia, as depicted in Chart 4.10.<sup>262</sup> This chart shows the average asset weighted median expense ratios of equities and fixed interest at 1.2% and 0.6%. This ratio is a representative cost measure that standardises annual fund expenses charged by a fund product. A higher ratio reflects a higher cost to the investor.

<sup>262</sup> Morningstar, *Global Investor Experience Study: Fees and Expenses* (17 September 2019) <[https://www.morningstar.com/content/dam/marketing/shared/pdfs/Research/GIE\\_2019\\_v4.5.pdf?utm\\_source=eloqua&utm\\_medium=email&utm\\_campaign=&utm\\_content=18780](https://www.morningstar.com/content/dam/marketing/shared/pdfs/Research/GIE_2019_v4.5.pdf?utm_source=eloqua&utm_medium=email&utm_campaign=&utm_content=18780)>.

Chart 4.10: Asset-weighted median expense ratio on managed funds by asset type, 2019



Note: Contents of the Chart are described in the paragraph above and below in Section 4.3.3.3.

Source: Morningstar (2019).<sup>263</sup>

The two charts reflect a similar pattern in terms of typical fees charged by funds of different asset classes:

- fixed-income/cash funds charging around 0.5–0.6%
- diversified funds such as allocation and multisector charging just under or at 1%
- equity funds charging the highest fees, above 1%.

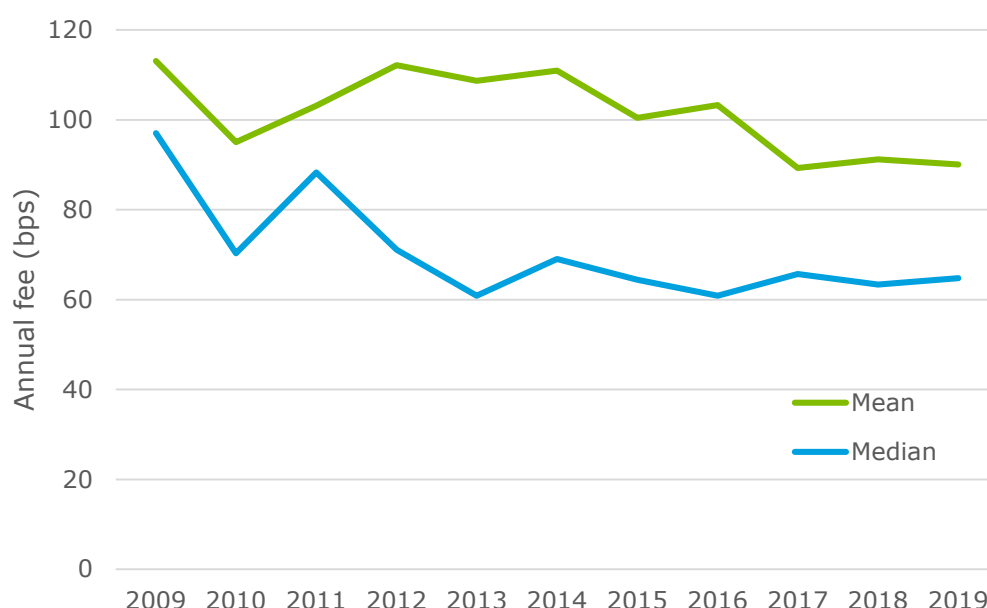
As noted above, differing prices across asset types reflect the costs related to managing funds that hold those assets. Consultation indicated that fees reflect the costs of providing the service, such that a fund manager providing a complex investment process or excellent service will charge higher fees than a fund manager with a simpler process or less dedicated service. This is consistent with the Morningstar and Canstar data showing that equity funds are generally priced higher than fixed-income funds, as they require managers to devote more time to investment management.

<sup>263</sup> Morningstar, *Global Investor Experience Study: Fees and Expenses* (17 September 2019) <[https://www.morningstar.com/content/dam/marketing/shared/pdfs/Research/GIE\\_2019\\_v4.5.pdf?utm\\_source=eloqua&utm\\_medium=email&utm\\_campaign=&utm\\_content=18780](https://www.morningstar.com/content/dam/marketing/shared/pdfs/Research/GIE_2019_v4.5.pdf?utm_source=eloqua&utm_medium=email&utm_campaign=&utm_content=18780)>.

#### 4.3.3.4 Fees show a steadier decline when considering more than management fees

This report also derived fees from total expenses extracted from fund reporting documents submitted to ASIC annually (388 forms). This method captures a broader range of fees charged to the fund than the management fees reported in the PDS, for example performance fees. This method shows a clear and gradual decline in average fees over the period since 2009, perhaps demonstrative of a decline in performance fees over this time. The report notes that the median fee remains reasonably constant from 2015 onwards, due to a minor compression in fees in the higher end of the fee distribution. The decline in the median prior to 2015 is consistent with the trends identified in Chart 4.7, noting that slight differences are likely to arise due to the derivation on fees from financial data used in Chart 4.11.

Chart 4.11: Actual fees charged over time – total expenses by funds under management, 2009–2019



Note: N = 34 fund managers. Sample of randomly selected fund managers from quintiles based on FUM.

Note: Contents of the Chart are described in the paragraph above in Section 4.3.3.4.

Source: Deloitte Access Economics (2021) and ASIC 388 forms.

#### 4.3.4 Fund management fees have fallen

Fees charged by fund managers have been steadily declining over the last few decades, in both the retail, wholesale and institutional investor markets, domestically and overseas.<sup>264,265</sup> While data analysis in previous sections does not demonstrate a significant drop in fees in the last five or so years at an industry-wide level for retail and wholesale managed funds, there is evidence that fees have fallen in the last 10 years across all asset types (Chart 4.7) and have continued to fall to some extent in recent years for active funds. In the survey conducted for this report, 93% of respondents (including fund managers, platforms and other groups) said that fund manager fees had fallen in the last five years.

<sup>264</sup> Reserve Bank of Australia 'Australian Fund management: Market Structure and Fees' (Bulletin, February 2003) <<https://www.rba.gov.au/publications/bulletin/2003/feb/pdf/bu-0203-3.pdf>>.

<sup>265</sup> Morningstar, *Global Investor Experience Study: Fees and Expenses* (17 September 2019) <[https://www.morningstar.com/content/dam/marketing/shared/pdfs/Research/GIE\\_2019\\_v4.5.pdf?utm\\_source=eloqua&utm\\_medium=email&utm\\_campaign=&utm\\_content=18780](https://www.morningstar.com/content/dam/marketing/shared/pdfs/Research/GIE_2019_v4.5.pdf?utm_source=eloqua&utm_medium=email&utm_campaign=&utm_content=18780)>.



**Institutional fees** have also fallen in recent years, in particular segments of the industry. A 2019 report on global investment management fees notes that falling fees are evident in areas such as emerging market equity (6% decline since 2016), emerging market debt (10% decline since 2016), and absolute return fixed income or unconstrained bonds (15% decline since 2016).<sup>266</sup>

This trend has been driven by a range of factors.

#### **4.3.4.1 Investor pressure has led some fund managers to reduce fees**

In Australia and globally, investors have greater awareness of fund costs and have placed pressure on fund managers to reduce fees and/or reconsider their fee structure. One reason for this is the rising number of sales channels causing investors to focus on minimising total investment costs, and therefore shifting preferences towards lower-cost funds.<sup>267</sup> In Australia, investors and advisers have become more focused on fees with greater coverage of the topic in the media. Consultees indicated that media attention on industry super fund fees has put pressure on managed fund fees more generally, and that the Hayne Royal Commission has also increased financial awareness among investors and increased attention on fees.

Australian investors are also demanding that fees should be more closely aligned to performance and reduced when funds are performing poorly. There is a perceived misalignment between investor and fund manager interests, where investors consider fund managers to be failing to demonstrate value while earning high incomes.<sup>268</sup> As a result, institutional investors are demanding discounts from fund managers, while fund managers are increasingly accountable to retail investors who can observe the full spread of fees in fund documentation. Exceptions to this are fund managers who serve specific consumer groups such as SMSFs, or those that are continuing to perform well.<sup>269</sup>

#### **4.3.4.2 Regulation on fee transparency and commissions have contributed to lower fees**

Regulation has had a dampening effect on the price of retail managed investment products. Globally, reforms by regulators and governments to improve fee transparency and promote fairness for consumers, such as policies regarding conflicted remuneration in the UK and Netherlands, have had the overall effect of lower fund fees.<sup>270</sup>

In Australia, conflicted remuneration regulation, particularly the FOFA reforms and more recent ban on grandfathered commissions, prevent financial advisers from charging commissions to fund managers. This reduces the incentive for advisers to recommend expensive actively managed funds, placing more downward pressure on fees and further facilitating the trend toward passive funds.<sup>271</sup> The repeal of grandfathered commissions is also expected to lower fees for retail consumers, as fees will no longer need to cover

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<sup>266</sup> bfinance, *Investment Management Fees: Is Competition Working?* (2019)

<<https://www.bfinance.com/insights/investment-management-fees-is-competition-working/#download-form>>.

<sup>267</sup> Morningstar, *Global Investor Experience Study: Fees and Expenses* (17 September 2019)

<[https://www.morningstar.com/content/dam/marketing/shared/pdfs/Research/GIE\\_2019\\_v4.5.pdf?utm\\_source=eloqua&utm\\_medium=email&utm\\_campaign=&utm\\_content=18780](https://www.morningstar.com/content/dam/marketing/shared/pdfs/Research/GIE_2019_v4.5.pdf?utm_source=eloqua&utm_medium=email&utm_campaign=&utm_content=18780)>.

<sup>268</sup> Frost, James, 'Fund managers to appease investors by cutting fees', *Australian Financial Review* (online), 21 January 2019 <<https://www.afr.com/companies/financial-services/fund-managers-to-appease-investors-by-cutting-fees-20190121-h1ab4u>>.

<sup>269</sup> Frost, James, 'Fund managers to appease investors by cutting fees', *Australian Financial Review* (online), 21 January 2019 <<https://www.afr.com/companies/financial-services/fund-managers-to-appease-investors-by-cutting-fees-20190121-h1ab4u>>.

<sup>270</sup> Morningstar, *Global Investor Experience Study: Fees and Expenses* (17 September 2019)

<[https://www.morningstar.com/content/dam/marketing/shared/pdfs/Research/GIE\\_2019\\_v4.5.pdf?utm\\_source=eloqua&utm\\_medium=email&utm\\_campaign=&utm\\_content=18780](https://www.morningstar.com/content/dam/marketing/shared/pdfs/Research/GIE_2019_v4.5.pdf?utm_source=eloqua&utm_medium=email&utm_campaign=&utm_content=18780)>.

<sup>271</sup> Morningstar, *Global Investor Experience Study: Fees and Expenses* (17 September 2019)

<[https://www.morningstar.com/content/dam/marketing/shared/pdfs/Research/GIE\\_2019\\_v4.5.pdf?utm\\_source=eloqua&utm\\_medium=email&utm\\_campaign=&utm\\_content=18780](https://www.morningstar.com/content/dam/marketing/shared/pdfs/Research/GIE_2019_v4.5.pdf?utm_source=eloqua&utm_medium=email&utm_campaign=&utm_content=18780)>.

the cost of paying commissions to advisers.<sup>272</sup> Regulation has also reduced the commissions and rebates paid to platforms, further leading to lower fund management fees.

#### **4.3.4.3 The rise of passive funds has reduced fees across the industry**

Another reason for this trend is the rising preference for **passive and exchange-traded funds** compared to active funds. Industry participants no longer expect active fund managers to outperform passive funds, despite the higher fees charged for the former.<sup>273</sup> As a result, investors have turned to passive funds which offer low fees and reliable returns. The growing take-up of passive ETFs is a key example of this. The mass outflows from active funds and increased competition for assets has also contributed to a lowering of fees in the active space as funds management firms try to retain, and attract new, clients.<sup>274</sup>

#### **4.3.4.4 Price competition and economies of scale have placed pressure on fees**

Analysis of the Australian funds management industry indicates that lower fees have also resulted from increased price competition and economies of scale, with fund managers strongly competing on price in markets with high FUM to improve market share (economies of scale is defined in Section 3.2.3.2). As noted above, price competition is particularly evident in passive fund markets, with the introduction of the 'no-fees-charged' models as an example of intensifying fee competition across the industry.<sup>275</sup>

Economies of scale can arise in markets with high fixed costs and low variable costs. Where a player has a larger market share, the fixed cost can be recovered from more customers, thereby enabling that player to charge lower overall fees. Consultations provided mixed views on the impact of economies of scale on fees in funds management. While some fund managers indicated that economies of scale provide fund managers the capability to lower fees; others suggested that economies of scale has not been a significant contributor to declining fees in Australia.

Chart 4.12 shows that the range of fees charged by larger retail managed funds is smaller than for smaller funds. While larger funds are not necessarily low fee funds, all instances of fees above 170bps occur for funds with less than \$2.5 billion in assets and funds charging over 200bps tend to be relatively small. The relationship between FUM and profitability is tested in Section 8.2.6.

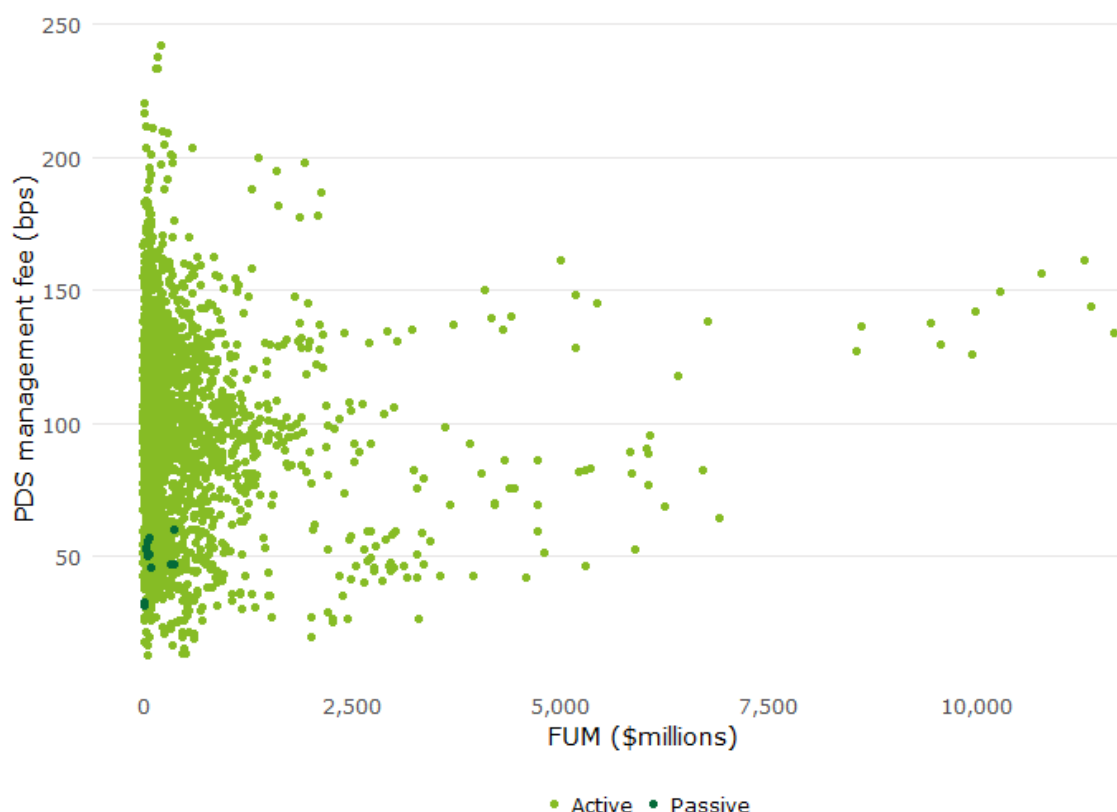
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<sup>272</sup> Frydenberg, The Hon Josh, *Media release: Taking action on the Banking, Superannuation And Financial Services Royal Commission – Recommendation 2.4: Grandfathered Commissions* (15 October 2019) <<https://joshfrydenberg.com.au/wp-content/uploads/2019/10/Treasurer-Joint-Media-Release-Grandfathered-Commissions.pdf>>.

<sup>273</sup> Plan For Life, *Managed Fund Market 10 Year Review 2008-2018* (November 2019).

<sup>274</sup> Waite, Suzy, Massa, Annie & Cannon, Christopher, 'Asset Managers With \$74 Trillion on Brink of Historic Shakeout' *Bloomberg* (online), 8 August 2019 <<https://www.bloomberg.com/graphics/2019-asset-management-in-decline/>>.

<sup>275</sup> Morningstar, *Global Investor Experience Study: Fees and Expenses* (17 September 2019) <[https://www.morningstar.com/content/dam/marketing/shared/pdfs/Research/GIE\\_2019\\_v4.5.pdf?utm\\_source=eloqua&utm\\_medium=email&utm\\_campaign=&utm\\_content=18780](https://www.morningstar.com/content/dam/marketing/shared/pdfs/Research/GIE_2019_v4.5.pdf?utm_source=eloqua&utm_medium=email&utm_campaign=&utm_content=18780)>.

Chart 4.12: Management fees by FUM for retail managed funds, 2014–2020 ( $N=2,626$ )

Note: The contents of Chart 4.12 are described above in Section 4.3.4.4.

Source: Deloitte Access Economics (2021) and Lonsec (2020).

#### 4.3.4.5 Retail investors may be enjoying lower prices through superannuation

Australia's highly competitive and large superannuation system was identified in consultation as another reason for the decline in fund management fees, both for institutional and retail clients. Superannuation funds control significant FUM, giving them bargaining power to drive down fees in negotiations with fund managers. According to consultation, this has also lowered fees in the retail space, although not to the same extent, due to the lower bargaining power of retail investors. Nonetheless, the primary way that Australians access managed funds is through superannuation. Thus, if superannuation funds are able to negotiate lower fees and pass these through to investors, this represents a positive outcome for retail investors in Australia. This is discussed further in Section 4.4.

### 4.4 Price competition — discounts on fund management fees

Discounting fund management fees is common practice in the funds management industry in Australia. Discounts generally take the form of rebates on the published fee. This is due to the structure of traditional managed funds, characterised by unit trusts and constitutions where a fee cannot be changed for a fund without making a new share class. This means that the standard published rates in public disclosure documents such as PDSs are often higher than the fees that are paid by investors. To varying extents, platform providers and dealer groups negotiate, and pass on to investors, fund management fees. Institutional investors also have significant bargaining power to negotiate lower fund management fees with fund managers, which are disclosed through agreements rather than rebates, and tend to get passed on to unitholders.

Discounting implies that investors have more market power in purchasing funds. It can also serve as a form of price competition. However, in examining the impacts of discounting on the market, consideration must also be given to:

- whether and to what extent discounts are passed on to investors
- the extent to which discounts can be considered a form of price discrimination
- the transparency of discounts
- whether discounting suggests that original prices were not reflective of underlying costs.

This section discusses the distributors that negotiate discounts with fund managers, the range of discounts commonly offered by managers, the extent to which discounts are passed on to investors, whether discounting reflects competitive behaviour, other ways that intermediaries can provide lower fund management fees to investors, and barriers to fund managers offering discounts.

#### **4.4.1 Fund managers negotiate rebates with platform providers and advisory groups**

For retail investors, fund managers will generally offer discounts on the fund management fee through negotiations undertaken by distributors, including platform providers and advisory groups (dealer groups or independent financial advisers). At the institutional level, investors negotiate the management fee directly with fund managers to achieve discounts.

Both platform providers and advisory groups have the ability to secure lower fees for retail investors. By aggregating FUM, platform providers and advisory groups have increased bargaining power relative to individual retail investors. Platform providers in particular have the scale to negotiate discounts with fund managers, and advisory groups also have an incentive to negotiate discounts to demonstrate value to their clients. Where advisory groups lead negotiations on behalf of investors, the platform is typically involved in negotiations as the entity that passes discounts through to investors where relevant.<sup>276</sup>

Consultees noted that, although discounting through rebates has become commonplace, fund managers are becoming less able to discount headline fees, given that headline fees have declined over the last 10 to 15 years.

Institutional investors secure discounts through extensive negotiation processes. It is important to consider how institutions negotiate fees, as the final beneficiary of these negotiations is mostly retail investors, largely through their superannuation accounts. The fund manager has much less bargaining power when negotiating fees with institutional investors compared to intermediaries acting on behalf of retail investors, due to the scale of FUM managed by institutions such as superannuation funds. As a result, there is more scope for negotiation. Consultees suggested that fund managers are often price-takers in the institutional market. In the survey conducted for this report, all seven fund managers who provide managed funds to institutional investors indicated that institutions can negotiate on the total fees paid.

Platform providers, advisory groups and research houses can all negotiate lower fund management fees when running managed accounts, including segregated accounts and MDAs. This is discussed in Section 4.4.2.

#### **4.4.2 How often are discounts offered and how large are discounts**

The survey conducted for this report asked respondents which groups receive discounts on management fees. Noting low responses, the survey indicated that half of institutional investors (53%) received discounts on standard published rates in the year

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<sup>276</sup> 2020 DIRECTINVEST, *How much do wrap accounts cost?* (2019)  
<https://www.2020directinvest.com.au/investor-education/wrap-account-costs.aspx>.

ending 30 June 2019. Consistent with the discussion in Section 4.4.1, funds responding to the survey were more likely to report providing discounts to platforms (41%) than dealer groups (18%) or independent financial advisers (29%).

Direct retail investors typically do not receive discounts, since it is not economical for a fund manager to offer discounts to individuals with small mandates. Retail investors pay advisory and platform fees to benefit from the scale that these platforms generate through representing numerous individuals.

Respondents were also asked to indicate the lower and upper bound of discounts on management fees that were provided to platform operators and dealer groups. On average, funds that provide discounts to platforms discounted the management fee by 5 to 13bps, while discounts to dealer groups ranged from 8 to 50bps on average. However, these numbers should be considered with caution, as seven funds provided discounts to platforms and only three funds provided discounts to dealer groups.

#### **4.4.3 Discounts are generally passed on in part, if not in full, to investors**

Consultations indicated that rebates negotiated by distributors are generally passed on to retail investors. As such, most retail investors receive a rebate when investing in a traditional managed fund.

**Advisory groups** are able to retain discounts on the funds management fee. The fact that discounts are offered as rebates makes it possible for dealer groups to retain discounts offered by fund managers. Consultation suggests that some advisory groups will pass discounts through to investors, but there are cases where discounts are negotiated but retained.

**Platform providers** — As of this year (2021), there can be no circumstances under which rebates negotiated by platforms are not fully passed on to investors. Prior to the FOFA reforms in 2013, platforms could and would negotiate large discounts as rebates, as part of fund managers paying for access to the platform, and would retain them or share them with the advisory group. However, the FOFA reforms banned conflicted remuneration, which included any asset-based fees including this form of rebate. Platforms could not retain rebates for any new contractual arrangement after this, ensuring that all rebates were passed on to investors in full.

The exception to this has been grandfathered commissions. As noted under ASIC Regulatory Guide 245 and S1529 of the *Corporations Act 2001*, the ban on volume-based fees does not apply to arrangements made before FOFA. This has allowed platform operators to retain considerable rebates for pre-FOFA contracts. However, the *Treasury Laws Amendment (Ending Grandfathered Conflicted Remuneration) Regulations 2019* repeals the grandfathering of conflicted remuneration from January 2021 onwards, ensuring that platform providers are required to rebate investors for the full amount of any discounts negotiated with fund managers.

Discounts to fund management fees that are negotiated in contracts for **institutional investors** seem to be passed on to unitholders. For example, the superannuation market has seen sharp declines in fund fees across retail and industry funds, which may be reflective of institutions passing through lower fund management fees.<sup>277</sup> Consultees indicated that trustees negotiate lower fees to gain market share given the competitiveness of the superannuation industry, suggesting that rebates are being passed through to members.

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<sup>277</sup> Mather, Joanna, 'Super fee gap shrinking as retail funds catch up', *The Australian Financial Review* (online), 8 October 2019 <<https://www.afr.com/companies/financial-services/super-fees-drop-but-are-still-too-high-20191008-p52ylw>>.

#### **4.4.4 Discounting generally reflects competitive behaviour but creates transparency issues**

While discounting is common in the industry, it is not necessary for fund managers to be competitive. This is evident in that some firms on the forefront of the industry are able to attract and retain a large consumer base without discounting, relying on unique fund and fund manager characteristics. However, many fund managers do not have sufficient bargaining power in negotiations with platforms and advisory groups, while relying on these distributors to access retail investors. Discounting therefore often reflects fund managers competing to be listed on the product lists of platform and advisory groups.

A potential issue with discounting is that the headline fee may be artificially inflated in the expectation that discounting will occur. With discounting so common and fund managers appearing to give discounts to many distributors, this could be the case. Nonetheless although there may be some cases where fund managers charge a high headline fee and then provide large discounts, overall the evidence suggests that on average fees are not likely to be severely inflated as average fees are very low by global standards.

As discussed above, there is a widespread practice of discounting, which benefits investors who can enjoy lower prices. However, this is dependent on the visibility of rebates. Fund management fees are typically transparently communicated to investors through disclosure documents such as PDSs, and rebates will be clearly credited back to the investor where they occur. Some of the funds responding to the survey said their PDSs disclose rebates to investors, while most responding funds indicated that they disclose discounts to retail investors through rebate side-letters.

However, discounting limits the ability of investors to make informed decisions on price when comparing funds, as usually they can only compare headline rates (for example, where discounts are only disclosed through rebate side-letters). Further, it was demonstrated in consultation that rebates may only be offered to distributors when they specifically ask for a discount on behalf of investors. This creates a clear transparency issue in that fund managers may be willing to compete on price, but due to the intermediation of the market, this need not lead to lower fees for investors. These issues may be mitigated by advisers who have a better understanding of how discounting affects fees and could assist investors with making decisions, and also have an incentive to demonstrate value to clients by making any rebates well known.

Discounting in the funds management industry appears to be a combination of second-degree and third-degree price discrimination (see Box 4.3 below). Fund managers charge different fees for different quantities using volume discounts, dependent on the negotiating power of distribution channels. This form of discrimination can represent competitive behaviour if it reflects the tailoring of fees and products to investor preferences. However, as discounting occurs between fund managers and intermediaries acting on investors' behalf, which is not transparently communicated to investors, it does not appear that discounting is reflecting investor preferences. Discounting may benefit some investors but make others comparatively worse off.

### Box 4.3: Price discrimination

Price discrimination refers to suppliers charging different prices for the same or similar product or service, where there are no differences in the cost associated with producing each unit. Price discrimination need not connote anti-competitive conduct and may increase consumer choice and accessibility, where pricing is set according to consumer willingness to pay.<sup>278</sup> There are three main types of price discrimination:

- **First-degree:** each quantity of a good or service is associated with a different price
- **Second-degree:** different quantities of a good or service are associated with different prices, for example discounts for bulk purchases
- **Third-degree:** different consumer groups pay different prices for the same product.

#### 4.4.5 There are other ways that distributors can provide lower fees

Platform operators, and advisory groups to a lesser extent, can also rebrand and sell managed funds in a practice known as **white-labelling**. Under this arrangement, the platform provider (or other entity) is the responsible entity for the fund and negotiates the management fee with the fund manager who originally offered the fund. The fund manager gains efficiency benefits as the white-labelled fund is managed by a third-party with greater exposure to investors, and the manager can focus on offering specialised funds and services.<sup>279</sup> White-labelled funds tend to be offered at lower fund management fees than the original fund, with the platform provider negotiating based on volume. Investors may nonetheless still be required to pay a fee to the platform.

Typically, investors who purchase white-labelled products pay less than if they bought the original. However, white-labelling can reduce transparency and comparability for retail investors, as it is difficult to distinguish between identical underlying products that are packaged or sold in different ways. White-labelling also creates a barrier to switching between platforms, as repackaged products are only available on one platform, thereby triggering a tax event if an investor who usually uses another platform wants to exit the re-badged fund.

**Managed accounts**, including SMAs and MDAs, are increasingly used by advisory groups, platform operators and research houses to effectively run a form of a managed 'fund of funds', through which a 'management fee' can be earned. Fund managers will often offer discounts to these entities to put their funds in managed accounts, through a volume-based arrangement which includes a discount. Submissions indicated that these discounts must be passed through to investors in the case of MDAs but might not be passed through in the case of SMAs. This is allowable since the responsible entity of an SMA is not involved in advice and, as such, the law can be interpreted to allow the responsible entity to retain any discounts. Industry contacts suggested that some SMA providers will have internal policies to forbid this practice but noted that it is possible under existing legislation.

It is also worth noting that although fund managers may provide a discount on management fees to managed accounts, investors need to consider the total cost of fees associated with a managed account.

<sup>278</sup> Harper, Ian et al. 'Competition Policy Review' (The Australian Government Competition Policy Review, 2015) <[https://parliament.nt.gov.au/\\_\\_data/assets/pdf\\_file/0006/436119/Appendix-Bii.-Competition-Policy-Review~Professor-Ian-Harper,-Peter-Anderson,-Su-McCluskey,-Michael-OBryan,-March-2015.PDF](https://parliament.nt.gov.au/__data/assets/pdf_file/0006/436119/Appendix-Bii.-Competition-Policy-Review~Professor-Ian-Harper,-Peter-Anderson,-Su-McCluskey,-Michael-OBryan,-March-2015.PDF)>.

<sup>279</sup> Deloitte, *Focus on your strengths, white label the rest* (Performance magazine issue 29, 2019) <<https://www2.deloitte.com/content/dam/Deloitte/lu/Documents/financial-services/Banking/lu-focus-on-your-strengths-white-label-the-rest.pdf>>.

#### 4.4.6 Platforms and the rebate structure can create barriers to discounting

There is some evidence that some platforms do not have the functionality to pass through discounts negotiated by advisory groups for certain types of investors. It was noted in consultation that most 'newer' platforms, such as Netwealth and HUBb24, that have emerged since the big banks' divestment of wealth management arms, allow for rebates to be passed through to investors. However, consultees also indicated that, due to technology limitations, some platforms are unable to identify which investors should be offered rebates.

If advisers do not switch platforms in this instance, fund managers who are willing to compete on price are prevented from offering lower fees to investors who use those platforms. The principal-agent relationship between platforms and investors, and advisers and investors (discussed further in Box 4.4 and Chapter 7), is therefore creating two problems for investors:

- they may not receive a possible discount on the fund management fee due to the platforms' inability to return rebates to investors and advisers' unwillingness to switch platforms
- even if they do receive a discount or a discount was not offered, they may not be aware of the potential for advisers to accept and reject rebates, creating transparency issues.

#### **Box 4.4: Principal-agent relationship**

A principal-agent relationship refers to an 'agent' acting on behalf of a 'principal' to perform a task for the principal. These relationships are common in all parts of society, for example, a real estate agent selling a house on behalf of a homeowner.<sup>280</sup>

Principal-agent relationships can create issues for competition and consumer outcomes if there is information asymmetry between the two parties, with the principal not having information on the actions of the agent, or misaligned incentives, where the agent does not act in the best interests of the principal, as they have an incentive to act in their own interests.<sup>281</sup>

As noted above, fund managers also cannot reduce the management fee on a fund from its headline fee<sup>282</sup>, which has led to the common use of rebates applied after the investor pays the full original fee. An alternative to offering rebates is creating new share classes that offer different fees on essentially the same underlying fund, which is time-consuming for managers and confusing for investors. This structural issue could be impeding fund managers from offering investors lower fees. It also hampers discount transparency, with discounts managed through rebates to distributors rather than clearly visible to investors as a discount on the headline management fee.

<sup>280</sup> The CFA Institute Research Foundation, *The Principal-Agent Problem in Finance* (2014) <<https://www.cfainstitute.org/-/media/documents/book/rf-lit-review/2014/rflr-v9-n1-1-pdf.ashx>>.

<sup>281</sup> The CFA Institute Research Foundation, *The Principal-Agent Problem in Finance* (2014) <<https://www.cfainstitute.org/-/media/documents/book/rf-lit-review/2014/rflr-v9-n1-1-pdf.ashx>>.

<sup>282</sup> Some fees, including the entry, exit or periodic management fee, can be waived.



# 5 Third-party services

## **This chapter finds that:**

Managed funds are bundled products, as investors purchase the services of the investment manager as well as third-party services such as the responsible entity, custodian and unit registry. Bundling does not appear to reflect exclusionary conduct, as fund managers tend to bundle investment management with third-party services.

Third-party service providers are selected based on cost, quality and brand. It is important to consider the willingness and ability of fund managers to control the costs of third-party services as survey analysis suggests that third-party services can represent 37% of the annual fund management charge paid by investors.

Fund managers are incentivised to control and scrutinise the costs and quality of third-party providers as:

- these costs are included in the management fee, which is very competitive
- investors may consider the brand and quality of third-parties to signal the quality of fund managers.

However, third-party costs are not explicitly disclosed separately under RG97. This differs from other jurisdictions, for example in Europe where recent regulation requires fund managers to include third-party costs in disclosure to investors.

It is also difficult for fund managers to control the costs and quality of external service providers, as some third-parties have greater bargaining power than fund managers. This can be due to the limited number of providers in markets such as custody and data services.

Fund managers use tendering and contractual arrangements to review external investment managers and ancillary and administrative service providers. However, typically only global and large fund managers are able to negotiate the costs of third-party services.

Unlike other countries, such as the UK and the US, the appointment of third-party providers is not governed by an independent board. There are also potential conflicts related to the dual role of the responsible entity, even though the dual role was an intentional change to improve fund manager accountability to investors. The requirement for independent board members in other countries has been driven by concerns over conflicts of interest and that boards were not acting in the best interests of their investors or providing 'value for money'.

A number of functions are required to bring a fund to market and, as such, fund managers have a range of responsibilities. These include:

- investment management: day-to-day management of the fund
- responsible entity or wholesale trustee: overall management of the fund
- ancillary and administrative services: supportive functions, including custody, administration and transaction services.

For a number of reasons, ancillary and administrative services are typically outsourced to third-party providers meaning investors are not only purchasing the services of the investment manager, but also the third-party services associated with running the fund. In this sense, investors are purchasing a bundled product (see Box 5.1 on bundling).

### **Box 5.1: Bundling**

Bundling is the practice of offering two products exclusively as a package or 'bundle' or offering a lower price for two products if purchased as a package. Bundling can improve consumer outcomes and promote competition if consumers are offered more compelling products. However, firms with sufficient market power can also use bundling to extend market power into other markets.<sup>283</sup>

Bundling is not necessarily a problem in an industry as it generally reduces costs for investors; third-party providers may be more efficient in delivering ancillary services due to scale. However, conduct in markets with bundled products can present an issue if investors are not receiving value for money due to the fund manager's choice of third-party services, or there is a conflict in the acquisition of third-party services. These issues are discussed in Sections 5.3 and 5.4. Section 5.3.2 also considers the extent to which the choice of third-party services is used to judge the quality of a fund.

This chapter includes the following sections:

- Section 5.1 — why third-party services are typically outsourced
- Section 5.2 — how third-party service providers are selected
- Section 5.3 — whether fund managers are incentivised to control and scrutinise third-party services, including external investment managers and ancillary and administrative services
- Section 5.4 — whether fund managers are able to control and scrutinise third-party services.

Managed funds can also be seen as bundled products as most retail investors will also purchase the services of intermediaries including platforms and advisers when investing in a fund. The impact of intermediaries on competition between fund managers is discussed in Chapter 6, and Section 6.5 looks at the impact of this bundle of services on the total cost of investing in managed funds.

## **5.1 Outsourcing certain functions is common and represents a significant amount of a fund's overall costs**

Fund managers commonly outsource certain ancillary services to third-parties. Ancillary services refer to the range of supporting functions that go into ensuring that a fund is meeting its regulatory and compliance obligations, administrative functions and managing the operations of the fund. In many instances, the responsible entity will outsource these functions to third parties. The reasons for doing so typically include:

- Specialisation: outsourcing back and middle office roles allows for the fund manager to focus resources towards operations unique to the fund, such as client and asset management.
- Scale: particularly for new or small funds, reducing the level of fixed costs allows the fund manager to be scalable and responsive to size.
- Economies of scale: some ancillary tasks are onerous and labour intensive and outsourcing to third parties where teams, technology and processes are already in place creates economies of scale.
- Independence: outsourcing services such as custody, audit and fund accounting to a third-party give investors greater confidence that the reporting is accurate and reflective.<sup>284</sup>

<sup>283</sup> Australian Competition and Consumer Commission 'Guidelines on misuse of market power' (August 2018) <<https://www.accc.gov.au/system/files/Updated%20Guidelines%20on%20Misuse%20of%20Market%20Power.pdf>>.

<sup>284</sup> OneInvestmentGroup *Fund administration* (2020) <<https://www.oneinvestment.com.au/services/fund-administration/>>.

Although the contract for service is between the responsible entity and the service provider, the individual investor is often the beneficiary of the service, and will be affected by the cost and quality of outsourced services. Examples of **ancillary or administrative services** are summarised in Table 5.1. Some of the ancillary services are typically bundled together and are negotiated and acquired through a competitive tender process.<sup>285</sup> Typically, fund administration and accounting, custody, compliance and transaction services are operated by the same entity, whereas more specialised services including research, systems and risk, legal and audit may have individual contracts. Evidence from consultations and survey responses indicated that the services in Table 5.1 are typically outsourced, with the exception of portfolio management and systems.

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<sup>285</sup> Financial Conduct Authority 'Asset Management Market Study Interim Report' (Market Study 15/2.2, November 2016) <<https://www.fca.org.uk/publication/market-studies/ms15-2-2-interim-report.pdf>>.

Table 5.1: Examples of ancillary or administrative services

Service	Description	Reasons for outsourcing
Custody	Custody refers to the safekeeping of assets. <sup>286</sup> Other functions performed by custodians include reconciliations, corporate actions and trade and transaction settlement. <sup>287</sup>	Custodians have net tangible asset (NTA) requirements and if a fund does not meet these they must use an external custodian. <sup>288</sup> Custody is also an onerous activity and few institutions have capability.
Fund administration	Fund administration involves managing the share registry and ownership records of investors. <sup>289</sup>	Custody and fund administration are typically packaged together. Custodians benefit from economies of scale.
(Fund) Accounting	Calculation of the fund's net asset value and unit pricing for managed funds and unit trusts. <sup>290</sup>	Fund accounting is typically packaged with custody and fund administration. Independence is also valued in fund accounting.
Transaction services	Transaction services involves the transfer and settlement of assets within funds.	Transaction services are typically packaged with custody.
Risk management	Risk management tools provide alerts to managers around fund mandates as well as market risk.	Risk platforms are complicated and dynamic systems that are costly to maintain. Outsourcing to respected tools reduces risk.
Information services/research	Research is purchased by fund managers to identify investment opportunities. <sup>291</sup>	Research is a highly specialised skill and managed internally across multiple asset classes and risk appetite is onerous.
Portfolio management and systems	Portfolio management involves selection and monitoring of investments for funds.	Depending on the size of the fund manager, certain (particularly specialised) investment capabilities may be sought externally.
Auditor (fund)	Auditors interrogate and verify the fund records and procedures. <sup>292</sup>	An independent auditor is standard practice and provides investors with greater confidence in the fund's operations.
Legal services	Funds require legal advice across a number of items such as regulation, tax, fund structure, commercial advice and asset ownership.	Funds may have a small internal legal team for day-to-day items and seek external advice on major items such as capital raising. <sup>293</sup>
Compliance	Compliance services ensures funds conform to laws, regulations, internal policies and procedures, mandates, and ethical standards. <sup>294</sup>	Funds and investors see value in having an independent compliance officer.

Sources: see footnotes in table.

### 5.1.1 The types of services outsourced and the share of costs represented by outsourced functions

In funds management, the benefits of outsourcing ancillary services typically stem from the reduction in fixed costs and overheads, as well as the efficiencies gained from outsourcing onerous tasks to entities that specialise in the delivery of these core functions. In other instances, certain services are outsourced due to legal requirements. For example, registered managed investment schemes are required to appoint an external auditor and custodian.<sup>295</sup>

The proportion of functions that are outsourced and the types of functions that are outsourced varies. Some of the most commonly outsourced third-party services identified by fund managers in consultation and in the survey conducted for this report are supportive services including custody, fund administration, transaction services, and accounting. Chart 5.1 demonstrates the share of retail managed funds responding to the survey that outsource certain services to third-parties. All of the responding funds outsource custody and most outsource fund administration (70%) and fund accounting (70%).

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<sup>286</sup> Deloitte, *The evolution of a core financial service: Custodian and depository banks* (2019) <<https://www2.deloitte.com/content/dam/Deloitte/lu/Documents/financial-services/lu-the-evolution-of-a-core-financial-service.pdf>>.

<sup>287</sup> Australian Securities & Investments Commission 'Custodial and depository services in Australia' (Report No 291, July 2012) <<https://download.asic.gov.au/media/1343948/rep291-published-5-July-2012.pdf>>.

<sup>288</sup> One Investment Group, 'Why appoint a custodian?' (2020), <<https://www.oneinvestment.com.au/why-appoint-a-custodian/>>

<sup>289</sup> Financial Conduct Authority 'Asset Management Market Study Interim Report' (Market Study 15/2.2, November 2016) <<https://www.fca.org.uk/publication/market-studies/ms15-2-2-interim-report.pdf>>.

<sup>290</sup> Financial Conduct Authority 'Asset Management Market Study Interim Report' (Market Study 15/2.2, November 2016) <<https://www.fca.org.uk/publication/market-studies/ms15-2-2-interim-report.pdf>>.

<sup>291</sup> Financial Conduct Authority 'Asset Management Market Study Interim Report' (Market Study 15/2.2, November 2016) <<https://www.fca.org.uk/publication/market-studies/ms15-2-2-interim-report.pdf>>.

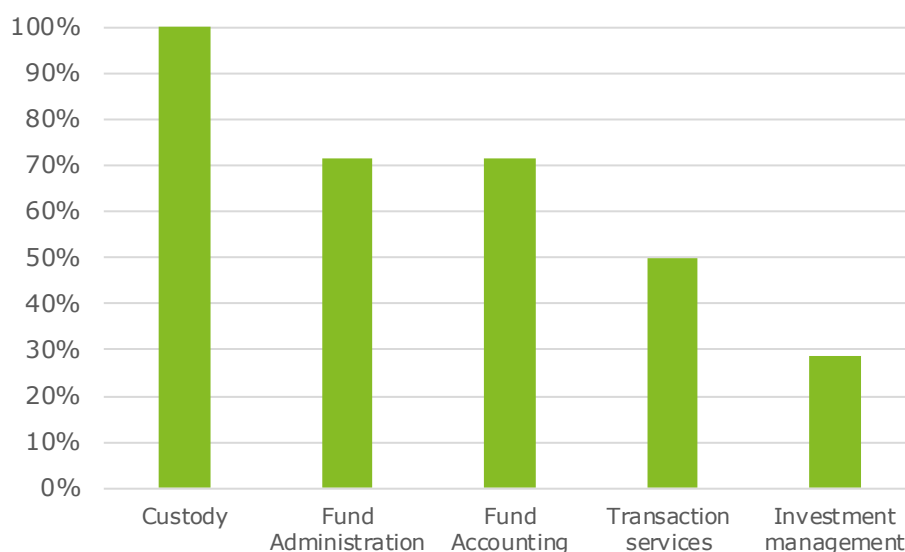
<sup>292</sup> Joubert, Jacques, *Fund Auditor* QuantPortal <<http://www.quantportal.com/fund-auditors/>>.

<sup>293</sup> Ashurst, *Investment funds* (March 2020) <<https://www.ashurst.com/en/expertise/practices/investment-funds/>>.

<sup>294</sup> Australian Securities Exchange, *Investment product summary* (February 2020) <[https://www.asx.com.au/documents/products/ASX\\_Investment\\_Products\\_February\\_2020.pdf](https://www.asx.com.au/documents/products/ASX_Investment_Products_February_2020.pdf)>.

<sup>295</sup> OneInvestmentGroup *Responsible entities and managed investment schemes* (2020) <<https://www.oneinvestment.com.au/responsible-entities-and-managed-investment-schemes/>>; Australia Securities & Investments Commission, *Requirements when running a managed investment scheme* (2020) <<https://asic.gov.au/for-finance-professionals/fund-operators/running-a-fund/requirements-when-running-a-managed-investment-scheme/>>.

Chart 5.1: Share of funds that outsource certain services to third parties



Note: Sample size is 17, reflecting the number of retail managed funds. These funds are held by nine fund managers.

Note: Contents of the Chart are described in the paragraph above at the beginning of Chapter 5.

Source: Deloitte Access Economics survey (2020).

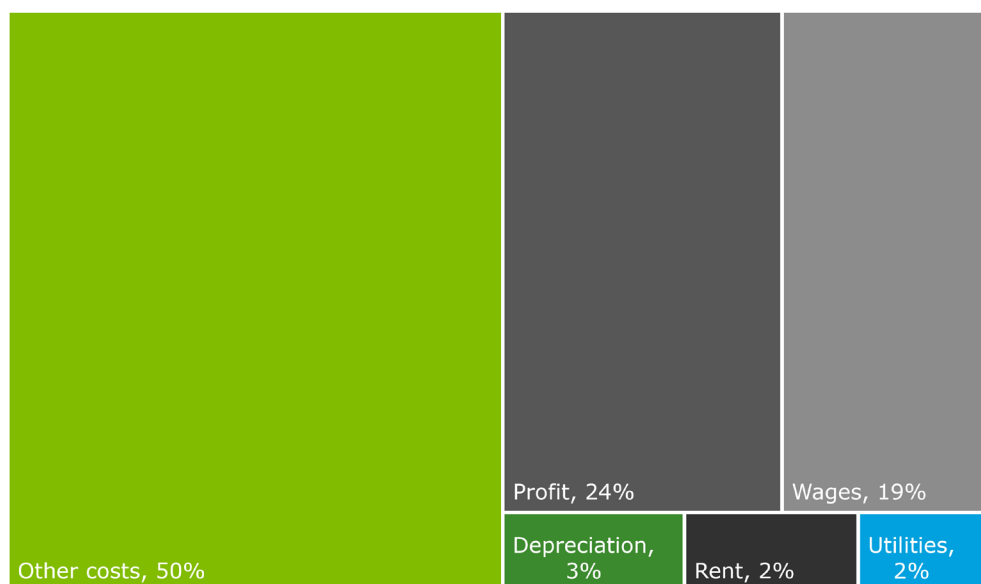
Generally larger fund managers are less likely to outsource to third parties, as they have the expertise and capacity to perform functions in-house. For example, large fund managers are less likely to outsource the responsible entity role than newer and smaller managers that do not yet have the expertise or have not yet built industry relationships.

The selection of third-party providers, and arrangements between third-parties and fund managers, can affect the competitiveness of funds and outcomes for investors as they influence the costs and quality of funds. For example, based on the nine funds that provided data on this question in the survey, third-party services on average represented 37% of the annual funds management fee paid by investors.

As a result, responsible entities and fund managers have a range of processes in place to control and scrutinise the costs and performance of third-party services to ensure that they are getting value for money for investors. This includes the governance process that a responsible entity will use to select and review the investment manager, where the responsible entity role or the investment manager role is outsourced (noting low survey responses, Chart 5.1 demonstrates that around one-third of funds outsource investment management).

Chart 5.2 indicates that third-party services can represent a significant part (50%) of the cost structure of fund managers (other costs include third-party services such as custody and unit pricing).

Chart 5.2: Cost structure of managed funds companies (2019)



Note: 'Other costs' include all third-party services including custody, unit pricing, platform fees, fund accounting and other professional services.

Note: Contents of the Chart are described in the paragraph above at the beginning of Chapter 5.

Source: IbisWorld (2019).<sup>296</sup>

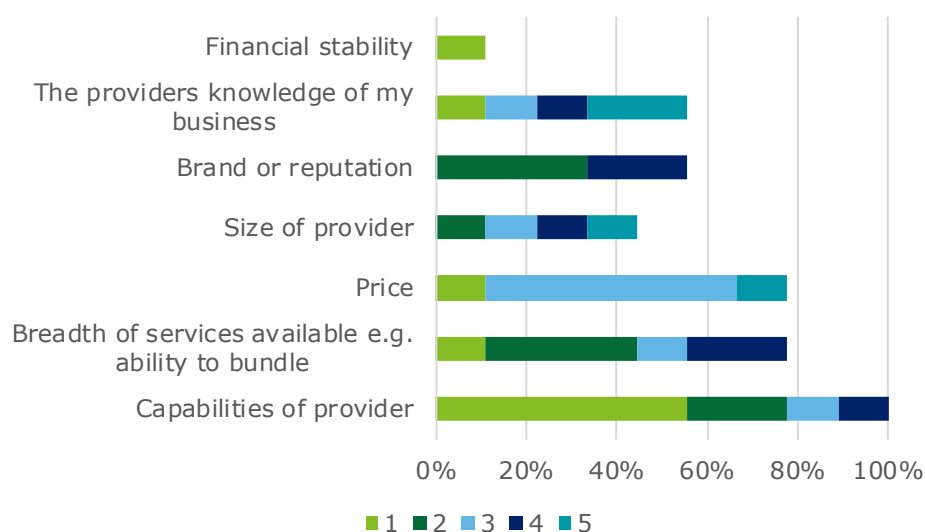
While this chapter focuses on third-party services and the supply chain, it is important to note two other significant drivers of costs: staff and regulatory compliance. Funds management is labour intensive because investors are paying fund managers for their specialist skills. While technology is increasingly taking over more data-intensive and repetitious tasks, and 'robo' advice is becoming more accepted, labour and labour costs are central to funds management. The complex regulatory regime in Australia was also identified in consultation as an increasingly significant cost burden, with external service providers such as auditors, accountants and lawyers needed to ensure that regulatory requirements are met. Fund managers who responded to the survey indicated that regulatory compliance represented 8% of total costs on average. This is significant when compared to the costs of third parties (see Section 5.2).

## 5.2 Third-party service providers are largely selected based on quality and cost

Fund managers select third-party providers based on factors such as cost, quality and brand. The survey conducted for this report asked fund managers to rank the factors (from one to five) that are most important in selecting one third-party provider of ancillary and administration services over another. Chart 5.3 demonstrates that 56% of respondents considered the capabilities of a provider to be the most important factor when choosing a provider, and all respondents considered capabilities to be in the top five most important factors. Other important factors include breadth of services available and price.

<sup>296</sup> IBIS World, *Fund management Services in Australia industry trends (2014-2019)* (2019).

Chart 5.3 Most important factors in selecting third-party service providers (% of respondents)



Note: Sample size is 9, reflecting the number of fund managers.

Note: Contents of this chart are found in table form in Appendix F.

Source: Deloitte Access Economics survey (2020).

Consultation identified custody, transaction services and fund administration to be the largest third-party costs associated with running a fund. Noting low responses, fund managers responding to the survey reported that these services represent 2 to 4% of total costs, with fund administration appearing to be a relatively high cost compared to other third-party ancillary and administrative services.

### 5.3 Fund managers are incentivised to control and scrutinise third-party services

Outsourced costs can be recovered at the fund level or at the corporate level. When recovered at the fund level, investors directly pay for these costs, and the fees can be included either within or on top of the management fee. When recovered at the corporate level, the firm pays for the third-party charges itself. Regardless of how costs are charged, fund managers should monitor and evaluate third-party providers.<sup>297</sup> However, the way in which costs are charged will affect the incentives that fund managers have to scrutinise third parties.

Similar to any other cost, fund managers have an incentive to control and scrutinise the costs and quality of third-party services if they are recovered at the corporate level. Ideally, fund managers should also have an incentive to control and scrutinise the costs and quality of third-party services that are recovered at the fund level if:

- third-party costs are disclosed to investors in some way
- investors respond to the quality of services purchased on behalf of the fund.

Consultation indicated that fund managers have traditionally recovered third-party fees at the fund level, on top of the management fee. However, ASIC's 2019 disclosure guide on fees and costs (RG97) indicates that fees to third parties<sup>298</sup> should be included within the 'management fees and costs' amount in disclosure documents (see Table 4.1). Consistent with this, multiple fund managers noted during consultations that they include third-party fees including custody, fund administration and audit within the

<sup>297</sup> In some cases third-party services could be provided by related company service providers. It is important that there is also an incentive to control and scrutinise these costs to ensure investors receive value for money.

<sup>298</sup> Including custodians, auditors and asset consultants.



management fee. One manager indicated that this reduces the complexity of compliance with RG97, and another noted that under this structure, third-party services are paid through the corporate account then charged to the fund through the management fee. Others pay some third-party fees through the fund, and some at the corporate level.

Fund managers face strong competition over management fees (see Sections 4.3 and 4.4), management fees are directly visible to the user, and in most instances, third-party fees are recovered through management fees. As such, fund managers have an incentive to reduce the amount they pay for third-party services to remain price competitive.

However, there is a tension between the simplicity of providing investors a single fee — ‘management fees and costs’ — that assists with transparency and comparability, and a lack of disclosed detail on the costs of external sources. As third-party service costs are not individually disclosed to investors, this may reduce the incentive for fund managers to control third-party costs that are ultimately borne by the investor. The Markets in Financial Instruments Directive (MiFID II) in the European Union has significantly increased fee disclosure requirements for fund managers, requiring all costs and charges that are related to external parties, such as custodians, to be separately disclosed to investors.<sup>299</sup>

In response to this particular issue raised in the Interim Report, fund managers suggested that the incentive structure is appropriately aligned such that fund managers negotiate the lowest fees for third-party providers. Rather than allowing managers to conceal costs, participants indicated that bundling of fees into a single metric ensures that fund managers scrutinise and negotiate hard for every cost. Any failure to do so will reflect poorly on them and directly impact their price competitiveness.

Fund managers also consider the quality of third-party services. According to consultees, the quality and brand of third-party services are important in providing a signal to investors and gatekeepers of the fund manager’s credentials. Further, third-party services are part of the bundle of services that an investor purchases when investing in managed funds. Poor quality third-party services are therefore likely to be reflected in the services of the fund manager, for example in inaccurate reporting and unmet deadlines, such that investors and their advisers would respond to the quality of third parties through the quality of fund manager services.

Although this indicates that there is an incentive for fund managers to scrutinise the quality and performance of outsourced services, one submission to the Interim Report noted that the ‘unduly high attention’ paid to fees within the industry can cause responsible entities to opt for low cost providers over quality providers. According to the submission, this results in a poor standard quality of third-party service that reduces the end investor’s experience.

The following sections discuss the processes employed by fund managers to control and scrutinise external investment managers, and ancillary and administrative services.

### **5.3.1 Processes to control and scrutinise external investment managers**

An external investment manager may be acquired to support a fund manager in the investment decisions related to a fund. Fund managers have in place processes to control and scrutinise the costs and quality associated with an external investment manager. Similarly, a responsible entity or trustee of a managed fund that appoints a funds management firm to undertake the day-to-day operation of the fund will employ a process to review the fund manager. These processes are likely to include formal due

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<sup>299</sup> Morningstar, *Global Investor Experience Study: Regulation and Taxation* (27 April 2020) <<https://www.morningstar.com/lp/global-investor-experience-tax-and-regulation>>.

diligence processes, reference checks and face to face meetings, according to consultation.

Otherwise, as noted in Section 2.5.1, the responsible entity role and fund manager role can be performed by the same entity or affiliated entities. The 'single responsible entity' is not common in other countries.<sup>300</sup> This can create conflicts as the responsible entity is balancing the interests of the firm and the interests of investors. This conflict reduces incentives for the responsible entity to control and scrutinise the investment manager and may reduce value for money for investors. For example, the responsible entity may not terminate an investment that is performing poorly to continue to receive management fees, despite this not being in the best interest of investors.<sup>301</sup> By putting the interests of the firm above the interests of investors, evidence of this conflict would represent an indicator of misuse of market power.

A responsible entity has fiduciary duties to its members. As part of the *Corporations Act 2001*, an AFS licensee must have in place processes to manage conflicts of interest and must be able to demonstrate as a responsible entity, that it gives priority to the interests of its members over its own interests in the event of a conflict.<sup>302</sup> Nonetheless, there have been examples of this conflict emerging and potentially leading to significant losses for investors through fund failures, with responsible entities making decisions in the role of investment manager that may have been avoided if they acted only as the trustee.<sup>303</sup>

Where there is a conflict, this should be resolved in an environment where consumers are actively engaging with the market and switching out of poor performing funds. The ability for retail investors to search for products and effectively transact in the industry is discussed in Chapter 7.

### **5.3.1.1 The 'dual role' system came about due to failings in the previous structure.**

The dual role of responsible entity is unique to the Australian funds management system and as such the Interim Report sought feedback on the extent to which a conflict exists between these roles. Industry participants acknowledged that a conflict is possible within the structure, however, contested any suggestion that fund managers were acting improperly as a result. Justification for this objection predominantly rested on competitive pressure as well as internal practices, corporate governance and industry standards that fund managers have widely implemented to prevent any conflict occurring.

Fund managers also indicated that, although conflict is possible under the dual role, the current system came about due to specific failings in the previous model. Prior to 1998, the prescribed investments system, or 'dual party' system, meant that accountability for a fund was shared by the trustee and the fund manager. Issues with the dual-party structure became evident through the collapse of several high property funds including Estate Mortgage in 1989 and Aust-Wide in 1992.<sup>304</sup> In both these cases, lengthy disputes over liability followed the collapse of the fund. To clarify the accountability structure in

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<sup>300</sup> Bianchi, Robert, 'Principal and agent problems in Australian responsible entities' (2010) *Deakin Business Review* p23.

<sup>301</sup> Bianchi, Robert, 'Principal and agent problems in Australian responsible entities' (2010) *Deakin Business Review* p23.

<sup>302</sup> Australian Securities & Investments Commission 'Culture, conduct and conflicts of interest in vertically integrated businesses in the funds-management industry' (Report 474, March 2016) <<https://download.asic.gov.au/media/3583028/rep474-published-21-march-2016.pdf>>.

<sup>303</sup> Dr Robert Bianchi summarises examples of fund failures that may have been caused by the conflicted roles of responsible entities in Bianchi, Robert, 'Principal and agent problems in Australian responsible entities' (2010) *Deakin Business Review* p23.

<sup>304</sup> Bernard T Mees, Monica S Wehner and Pamela F Hanrahan, *Fifty years of managed funds in Australia*, Investment and Financial Services Association, 2005, <[https://law.unimelb.edu.au/\\_\\_data/assets/pdf\\_file/0008/1709909/91-50\\_Years\\_of\\_Managed\\_Funds1.pdf](https://law.unimelb.edu.au/__data/assets/pdf_file/0008/1709909/91-50_Years_of_Managed_Funds1.pdf)>

the future, the *Managed Investments Act 1998* introduced a 'responsible entity' that would be solely responsible for a scheme including any liability for losses incurred.<sup>305</sup>

While the failings of a previous structure are not sufficient to defend the possible limitations or conflicts that arise in the dual role system, this report does acknowledge that the introduction of the dual role was an intentional effort to improve outcomes for investors.

### **5.3.1.2 Other jurisdictions implement independent boards of directors to resolve similar conflicts**

The placement of independent directors on the fund governance body is common in other countries. These countries mandated the placement of independent directors on fund governance bodies to manage conflicts and incentivise the bodies to provide value for money for investors (see Box 5.2 below).

#### **Box 5.2: Overseas evidence of independent directors on boards of funds management companies**

The *Investment Company Act 1940* in the United States specifies that investment companies must have a specified percentage of independent directors. Independent directors are defined as those that do not have, or have not had, a business relationship with related parties or own any stock of any related parties, and the Act requires independent directors to monitor potential conflicts of interest and consider the interests of fund shareholders.<sup>306</sup>

In the UK, following the FCA's Asset Management Market Study, the FCA introduced the requirement for independent directors to make up at least 25% of an Authorised Fund Manager's board, with a minimum of two independent directors.<sup>307</sup> The FCA implemented this policy change as external directors or board members, independent of the fund manager, are considered more likely than internal directors to scrutinise the costs and quality of services to ensure that they are delivering value for money for investors.<sup>308</sup>

In Australia, while in practice the appointment of independent directors is common, there is no obligation for the Board of a responsible entity to have any external directors.<sup>309</sup> Instead, under the *Corporations Act 2001*, responsible entities are required to establish a compliance committee for registered managed investment schemes where less than half of the directors of the responsible entity are considered 'external directors'. This compliance committee must be composed of a majority of external members.<sup>310</sup>

<sup>305</sup> Ewan MacDonald and Joanna Hemingway, *Report on the review of Managed Investments Act 1998* (2002), Findlaw.com.au,

<<https://www.findlaw.com.au/articles/777/review-of-the-managed-investments-act-1998.aspx>>

<sup>306</sup> Investment Company Institute, *Frequently Asked Questions About Mutual Fund Directors* (2020)

<[https://www.ici.org/pubs/faqs/ci.faq\\_fund\\_gov\\_idc.print](https://www.ici.org/pubs/faqs/ci.faq_fund_gov_idc.print)>.

<sup>307</sup> Financial Conduct Authority 'Asset Management Market Study remedies and changes to the handbook – Feedback and final rules to CP17/18' (Policy Statement 18/8, April 2018)

<<https://www.fca.org.uk/publication/policy/ps18-08.pdf>>.

<sup>308</sup> Financial Conduct Authority 'Asset Management Market Study Final Report' (Market Study 15/2.3, June 2017) <<https://www.fca.org.uk/publication/market-studies/ms15-2-3.pdf>>.

<sup>309</sup> Morningstar, *Global Investor Experience Study: Regulation and Taxation* (27 April 2020)

<<https://www.morningstar.com/lp/global-investor-experience-tax-and-regulation>>.

<sup>310</sup> Australian Securities & Investments Commission 'Fund management: Compliance and oversight' (Regulatory Guide No 132, July 2018) <<https://download.asic.gov.au/media/4832064/rg132-published-31-july-2018.pdf>>.

Compliance committees assess whether a responsible entity is compliant with *Corporations Act 2001*, financial services laws and the conditions of its AFSL. However, while compliance committees may consider conflicts of interest created by the integrated role of responsible entities, they do not assess value for money for investors.

There are mixed views on the importance of independent board members. Morningstar's Global Investor Experience Study on regulation and taxation considers the requirement for funds or funds companies to be governed by a board with independent directors to be best practice.<sup>311</sup> However, the Productivity Commission's review of competition in superannuation indicated that the value add of independent directors is strongly contested. This is because even independent directors can be 'affiliated', and evidence is not clear on the impact of independence on performance.<sup>312</sup>

### 5.3.2 Processes to control and scrutinise ancillary and administrative services

Most fund managers use a competitive tendering process to procure the services of third-party ancillary and administrative providers, in particular for high cost services such as custody. Fund managers indicated in consultation that they run periodic tender processes to review existing providers and determine if they should switch provider. Some funds management firms have dedicated teams that manage relationships with ancillary service providers, and one firm noted that responsible entities or boards of directors are engaged in decisions regarding external service providers, given that they reflect a major operating cost.

Fund managers typically use contractual arrangements such as service level agreements to manage and control the quality of third-party ancillary and administrative service providers. Contracts are used to regulate the quality of services, with detail in contracts on risk management and timeframes. Service level agreements and governance structures are audited regularly, including site visits, and fund managers will request GS007 audit reports from administrators and other service providers. Fund managers also noted that they monitor providers closely by tracking deliverables and reviewing regular KPIs.

The tendering process can allow funds management firms to test whether third-party **costs** are competitive. Consultees had differing views on competitive tension along the value chain. Many managers identified that the smaller number of competitors in some markets for third-party ancillary and administrative services allows service providers to charge high prices. However, others indicated that there is generally competitive tension along the value chain.

Further, there may be scope to negotiate third-party charges. It was noted in consultation that being a global fund manager or a large fund manager makes negotiating easier, as the manager is able to negotiate at a global scale or use scale to consolidate and negotiate.

It is common for third-party services to be bundled, as noted in Section 5.1.<sup>313</sup> Bundling can assist fund managers with controlling the costs of ancillary services through discounts. Fund managers in consultations discussed the use of bundling of third-party services, particularly for functions such as transaction services and accounting.

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<sup>311</sup> Morningstar, *Global Investor Experience Study: Regulation and Taxation* (27 April 2020) <<https://www.morningstar.com/lp/global-investor-experience-tax-and-regulation>>.

<sup>312</sup> Productivity Commission 'Superannuation: Assessing Efficiency and Competitiveness' (Inquiry Report No 91, 21 December 2018) <<https://www.pc.gov.au/inquiries/completed/superannuation/assessment/report/superannuation-assessment.pdf>>.

<sup>313</sup> This form of bundling, where multiple third-party services are purchased together as a package, is distinct from the bundling of investment management with third-party services, which is typically provided to investors by a managed fund.

Respondents to the survey conducted for this report said that bundling principally allows for convenience and reduced administration, and sometimes lower fees.

Fund managers in Australia can use commission sharing arrangements (CSAs) to bundle brokerage and research services.<sup>314</sup> CSAs allow fund managers to pay a flat percentage rate to brokers to trade and receive research.<sup>315</sup> This practice was banned in the European Union, as noted in Section 5.3.<sup>316</sup>

**Conflicts of interest** may reduce fund manager incentives to control and scrutinise third-party services. Where fund managers act in a conflicted manner — acting in their own best interests rather than the best interests of investors — can be also an indicator of market power. A conflict of interest may emerge if a responsible entity outsources services to related third parties to maximise revenue or receive other monetary or non-monetary advantages, which may not be in the best interests of investors if a more suitable provider, for example in terms of price, was not selected.<sup>317</sup> A responsible entity must have adequate processes in place to manage any conflicts of interest in the appointing of third-party services that are related to the entity.

As mentioned above, responses and consultations following the Interim Report rejected the notion that conflicts of interest occur in the procurement of third-party services. This is due in part to the strong incentive to reduce the bundled management fee of a fund, as well as a low number of instances in which third-party services (outside of the responsible entity) are vertically integrated. As part of the desktop research and consultations, this report found minimal evidence of vertical integration between fund managers and other third-party services, such as legal, audit, custody and funds administration. Although there are exceptions, consultations suggest that these services are outsourced to independent parties.

Section 2.5.1 introduced the integrated role of trustee and investment manager in the structure of responsible entities in Australia. The section highlighted the potential conflicts of interest created by this structure, with broader implications for other conflicts such as in the appointment of third-party service providers and value for money for investors.

## 5.4 Fund managers are not always able to control and scrutinise third-party services

Despite the incentives fund managers have to review the services delivered by third parties, the ability for fund managers to control and scrutinise the costs and quality of third-party ancillary and administrative services is often limited. The complex fee structures imposed by third-party service providers, for example with varying fees charged for settling different types of securities, make it difficult for fund managers to compare options and scrutinise third-party service providers.

Fund managers are also practically limited in their ability to switch between providers. This is due to the urgency of service need, the lack of competitors in some third-party markets, and the technological and technical features of providers that can make switching costly. To the extent that fund managers cannot credibly switch or threaten to

<sup>314</sup> Financial Security Council, 'FSC Guidance Note No 10: Brokerage Arrangements' (2006) <<https://www.fsc.org.au/web-page-resources/fsc-guidance-notes/1527-10gn-brokerage-arrangements>>.

<sup>315</sup> Moullakis, Joyce, 'Unbundling of broker fees a hot topic', *The Australian Financial Review* (online), 30 August 2010 <<https://www.afr.com/markets/equity-markets/unbundling-of-broker-fees-a-hot-topic-20100827-iv0rq>>.

<sup>316</sup> PricewaterhouseCoopers, *How will MiFID II impact Australian firms?* (2017) <<https://www.pwc.com.au/publications/pdf/mifid-ii-document.pdf>>.

<sup>317</sup> Australian Securities & Investments Commission 'Culture, conduct and conflicts of interest in vertically integrated businesses in the funds-management industry' (Report 474, March 2016) <<https://download.asic.gov.au/media/3583028/rep474-published-21-march-2016.pdf>>.

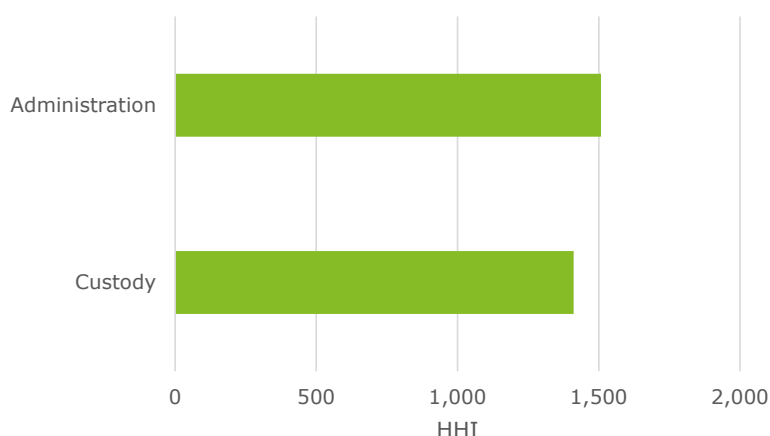
switch, this impedes their ability to control the costs and quality of outsourced services, as they cannot place pressure on current providers and negotiate effectively.

Fund managers noted in consultation that switching does not occur frequently, despite regular tendering process. Many ancillary and administrative services that support fund managers are very technology heavy. Switching, therefore, requires the transfer of data and processes to the new party, and is time consuming, costly and onerous.

The ability to switch third-party provider is also limited by the small number of participants offering these services. Nearly two-thirds (64%) of respondents to the survey indicated that there is more room for competition in third-party administration and ancillary service providers. This was significantly higher than responses for other parts of the supply chain, including platforms and dealer groups.

Data and market concentration statistics for the full range of third-party services are not publicly available, however, fund managers highlighted custody and fund administration as areas that are significantly concentrated. According to the industry body (Australian Custodial Services Association), the industry is made up of 11 organisations, with J.P. Morgan holding almost a quarter of the market in both custody and administration in 2019. This results in a relatively high HHI, despite just remaining below the ACCC threshold (discussed in Section 3.2.2.2) of industry concentration (see Chart 5.4).<sup>318</sup>

Chart 5.4: Concentration of custodial and administration services



Note: Figures for custody and administration incorporate all sources of funds including superannuation sector.

Note: Contents of the Chart are described in the paragraph above in Section 5.4.

Source: ACSA (2019).<sup>319</sup>

Many acknowledged that a reason for the low number of ancillary and administrative providers is the complexity of the industry and required functions, and the resulting need for specific expertise. This means that there are only a few providers that can perform these functions effectively.

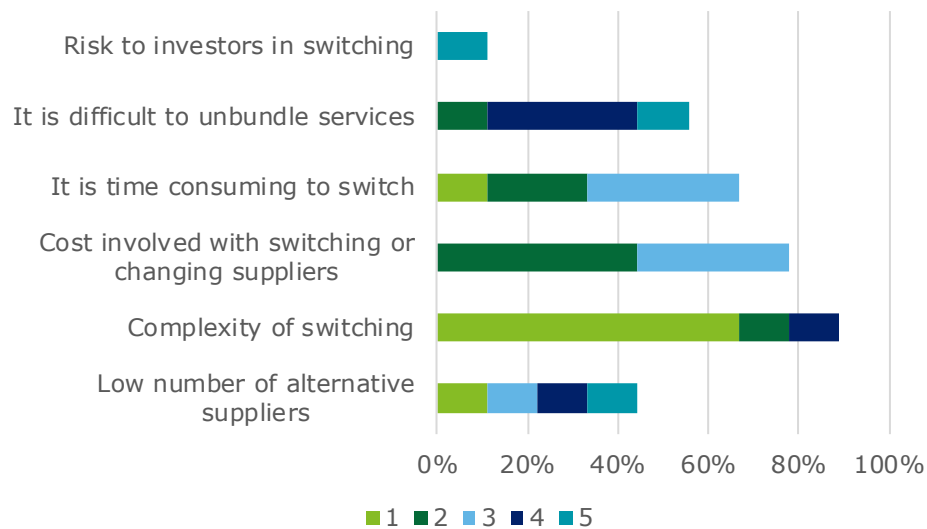
The survey of fund managers conducted for this report asked respondents to rank (from one up to five) the barriers to changing suppliers of third-party ancillary and administrative services. Chart 5.5 demonstrates that the complexity of switching is a key barrier to switching providers, with nearly all respondents reporting it as a top five

<sup>318</sup> This is in contrast to the Productivity Commission report in 2018 that used unpublished APRA data for the superannuation sector that indicated concentration in both custody and administration surpassed a HHI of 2,000.

<sup>319</sup> Australian Custodial Services Association, *Australian Investor Assets Under Custody* (December 2019) <<https://acsa.site-ym.com/page/AUSCustody>>; Australian Custodial Services Association, *Assets Under Administration* (December 2019) <<https://acsa.site-ym.com/page/AssetsUnderAdmin>>.

barrier and more than 60% reporting it as the top barrier. Fund managers also cited the cost and time involved as barriers to switching suppliers. This presents a potential conflict of interest since the cost of switching is borne by the responsible entity, while the benefits accrue to the fund's unit holders.

Chart 5.5 Barriers to changing suppliers of third-party services (% of respondents)



Note: Sample size is 9, reflecting the number of fund managers.

Note: Contents of this chart are found in table form in Appendix F.

Source: Deloitte Access Economics survey (2020).

## 6 Distribution and gateways

### **This chapter finds that:**

The funds management industry is heavily intermediated, which fundamentally affects the way that fund managers compete for investor funds.

Investment platforms, dealer groups and financial advisers, and research houses all play an important role in the distribution of funds to investors, and assist in providing due diligence on the funds available to investors. However, these intermediaries can create barriers to market access, barriers to entry and conflicts of interest. These structures may allow incumbent fund managers to exercise market power.

The extensive approval process for a fund to be listed on a platform can make it difficult for funds to reach investors, and the higher bargaining power of platforms in negotiations with fund managers can also limit funds' access to market. However, this does not seem to be a result of misuse of market power, and declining vertical integration is reducing the potential for conflicts of interest.

Similar to platforms, dealer groups' APL process can be lengthy and reduce market access for funds, while advisers' recommendations can be dependent on relationships which makes it harder for new entrants to reach investors. While there are fewer vertically integrated financial advice and investment product businesses, the growth of managed accounts has created some concern over conflicts of interest.

The process to receive a research house rating can establish barriers to market access for funds, and if it requires a long track record and sufficient client demand, can also present a barrier for new entrants without an existing track record or brand. Conflicts of interest may emerge where fund managers pay for ratings.

The final fee paid by retail investors is the cumulative sum of the costs of purchasing a 'bundle' of products and services, include funds management, platform use, and advice.

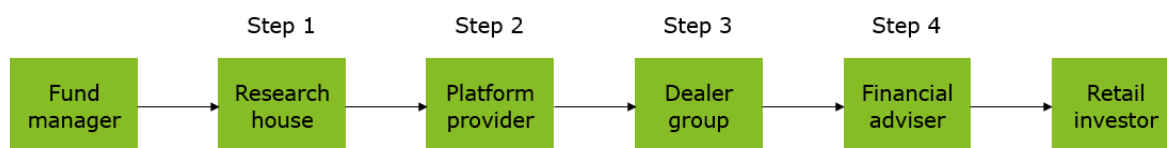
Fund managers do not have much control over the downstream charges that they pay to intermediaries, such as shelf-space fees paid to platforms, as there are a limited number of players in these markets, and fund managers rely on distribution to access investors.

Intermediaries, including platforms, exchanges, dealer groups, financial advisers and research houses, are heavily involved in most retail investors' fund purchases. They provide access to, and advice on, the market. A heavily intermediated funds management industry results in the end consumer and fund manager being separated by a range of distribution channels and gatekeepers. Intermediation affects the way fund managers behave and compete. To reach retail investors, funds must compete in intermediary markets.

The industry has responded to this by finding new distribution channels and ways of accessing investors, for example through listed funds and managed accounts, as discussed in Section 4.2.1.1. While an increasing number of funds use these distribution channels, the majority of investors still access funds via the process depicted in Figure 6.1 below, where fund managers must engage with research houses, then platforms, dealer groups and advisers to reach investors.



Figure 6.1 Steps along the supply chain for a fund manager to reach retail investors (unlisted funds)



Source: Deloitte Access Economics.<sup>320</sup>

Although the distribution process outlined in Figure 6.2 is not the only way in which retail investors can access funds, this chapter largely focuses on this process, as discussed in Box 6.1.

### Box 6.1: Distribution channels as discussed in this chapter

Managed funds can be distributed through many channels. This section of the review considers the competitive implications of distribution and gateways for funds which are distributed via financial advisers, dealer groups, platforms and research houses. It does not examine the competitive implications of other intermediaries and distribution channels, including listed funds such as ETFs and LITs.

Competition in intermediary markets has an impact on investor outcomes, contributing to the cost of the final investment product and the choice of funds available to investors. However, competition in intermediary markets is not in the scope of this report. Instead, the behaviour of intermediaries is considered to the extent that it has implications for the way that fund managers compete and access investors.

This chapter discusses the impact of distribution channels and gateways on competition between fund managers, and concludes the analyses of how charges and costs differ along the value chain, and of the extent to which fund managers are willing and able to control costs and quality along the value chain. The chapter includes:

- Section 6.1 – downstream value chain
- Section 6.2 – investment platforms
- Section 6.3 – dealer groups and financial advisers
- Section 6.4 – research houses
- Section 6.5 – managing fees along the value chain.

## 6.1 Downstream value chain

Fund managers typically have their funds reviewed and approved by intermediaries to reach retail investors. This includes platform providers and advisory groups as distribution channels, and research houses as gatekeepers.

The process for a fund manager taking a fund through the intermediated market to reach retail investors typically includes the following steps:

- obtain a research report and rating from a **research house/s**
- gain approval to sit on a **platform/s**
- sell the fund's value proposition to a **dealer group/s** to be listed on its approved product list or similar
- persuade **financial advisers** to recommend the fund to their clients.

<sup>320</sup> For independent financial advisory groups, steps 3 and 4 will be combined.

The approximate number of funds that typically make it through each step is depicted in Figure 3.2 in Section 3.3.1.3. The process at each step is discussed in the following sections in turn. In general, these steps must be undertaken sequentially. Advisers generally recommend products based on the dealer group's APL, dealer groups will not consider a fund for the APL unless it sits on an appropriate platform, and platforms will not list funds unless they receive a favourable rating by a research house. One submission to the Interim Report estimated that a fund manager would spend in excess of \$100,000 per year to make a product widely available through this process. Accordingly, the submission noted this cost is prohibitive to very small funds.

Each intermediary levies charges that ultimately flow through to investors. Each intermediary also poses a potential barrier to market access, since a fund which cannot pass a step is unlikely to be able to reach retail investors.

There is a trade-off between the advice and access roles of intermediaries in this market. Acting as gatekeepers in the supply chain, intermediaries provide due diligence on funds before they reach the market and reduce transaction costs for investors. Regulation is designed to ensure that intermediaries provide value to investors, and intermediaries respond to these regulators by ensuring they have appropriate processes in place to meet their best interest duties.

However, these processes impact investor access to funds, by increasing barriers to market access for new funds and barriers to entry for new fund managers. Retail investors have limited access to funds that have not been approved by gatekeeper/s, and time taken in due diligence processes can mean that access to funds is delayed. This also means that investors are subject to any imperfect decision-making processes by intermediaries. The intermediation of the funds management market can also affect incentives for product innovation, due to the time and costs associated with getting a new product approved by intermediaries.

## **6.2 Investment platforms**

Platforms can serve as a cost-effective distribution mechanism for fund managers. Platforms may reduce the need for managers to market their products, and allow fund managers to reach a greater number of retail investors. Funds which are not listed on platforms are unlikely to be considered by advisers and reach investors. This can create barriers to market access for funds and barriers to entry for new fund managers. The role of platforms is described in detail in Section 3.3.1.2.

### **6.2.1 Platforms can create barriers to market access for funds**

Before listing a fund, platforms undertake due diligence on that fund. While there is variation between providers and menus, consultees noted that all platforms are applying more rigour to due diligence processes. This rigour helps to screen potential funds before they reach retail investors, potentially reducing transaction costs and providing some additional level of consumer protections; however the process can reduce access to market for funds.

This process is extensive, and includes:

- reviewing the fund's track record, for example up to three years is expected for active managers
- determining if the fund has received an investment grade rating from at least one research house
- ensuring there is an appropriate level of demand from investors and/or advisers
- conducting own research on the fund — according to the survey conducted for this report, some of the factors platform operators consider in choosing which funds to offer include the governance and corporate structure, performance and the investment team.

Platform providers will also account for commercial considerations, such as the size of the platform menu and the platform strategy, as, for example, they might not be interested in three similar index funds as there is a limited number of menu slots.

Investors and advisers typically only use one or two platforms.<sup>321</sup> If a platform does not list a particular fund, then the investors and advisers that use that platform cannot access that fund. Platforms can, therefore, represent bottleneck infrastructure by restricting fund access to investors (see Box 6.2 below).

### **Box 6.2: Bottleneck infrastructure**

Bottleneck infrastructure refers to facilities that represent essential or strategic positions in an industry. The Australian Competition Policy Review in 2015 identified the following competition principle: "A right to third-party access to significant bottleneck infrastructure should be granted where it would promote a material increase in competition in dependent markets and would promote the public interest."<sup>322</sup>

The length and difficulty of the approval process for fund managers also varies significantly by platform. Consultees described approval processes ranging from reasonably quick and clear to lengthy and onerous, sometimes taking years. On average, the three platform operators responding to the survey reported taking about two months to make a managed fund available on their platform. This can be influenced by the fact that platforms will consider new funds every few months, but only have a certain number of available product slots.

Approval processes are particularly burdensome for incumbent platforms, with some big players, for example, only offering placements to funds that meet minimum fund asset commitments that are negotiated between the platform operator and fund manager.<sup>323</sup> In contrast, specialist, independent platform providers are reported to provide much quicker and more flexible processes for fund approval, for example in offering a more open menu of fund products. The increasing share of net flows attributed to these newer players could alleviate this barrier to market access for fund managers.<sup>324</sup>

The process also varies depending on menus. Consultees noted that the process is more onerous for superannuation and pension menus, as the platform provider has an added level of responsibility as the trustee of a pension. Advisers wanting to offer managed accounts on platforms also often need the expertise of an external investment consultant to be considered by a platform provider.

As discussed in Section 3.2.3, submissions to the Interim Report generally affirmed the support of current barriers to entry, platforms included, given by industry as part of initial consultations. Participants typically cited consumer protection as the primary benefit of platforms restricting choice and applying an additional layer of due diligence. It must be noted, however, that these established players have come through the process and now benefit from the barrier being imposed on emerging funds. One submission expressed a different opinion, suggesting that the platforms and other barriers to entry are prohibitive, difficult to navigate and not necessarily a meritocracy.

<sup>321</sup> Worley, Harrison, 'Advice affordability a growing concern', *Financial Standard* (online), 28 June 2019 <<https://www.financialstandard.com.au/news/advice-affordability-a-growing-concern-138420938>>.

<sup>322</sup> Harper, Ian et al. 'Competition Policy Review' (The Australian Government Competition Policy Review, 2015) <[https://parliament.nt.gov.au/\\_\\_data/assets/pdf\\_file/0006/436119/Appendix-Bii.-Competition-Policy-Review~Professor-Ian-Harper,-Peter-Anderson,-Su-McCluskey,-Michael-OBryan,-March-2015.PDF](https://parliament.nt.gov.au/__data/assets/pdf_file/0006/436119/Appendix-Bii.-Competition-Policy-Review~Professor-Ian-Harper,-Peter-Anderson,-Su-McCluskey,-Michael-OBryan,-March-2015.PDF)>.

<sup>323</sup> Uribe, Alice, 'Netwealth top-ranked platform, says Investment Trends', *The Australian Financial Review* (online), 4 March 2018 <<https://www.afr.com/companies/financial-services/netwealth-topranked-platform-says-investment-trends-20180304-h0wyl3>>.

<sup>324</sup> Uribe, Alice, 'Netwealth top-ranked platform, says Investment Trends', *The Australian Financial Review* (online), 4 March 2018 <<https://www.afr.com/companies/financial-services/netwealth-topranked-platform-says-investment-trends-20180304-h0wyl3>>.

Particular responses to questions posed in the Interim Report are discussed in the following sections.

Consultees and interim submissions also noted that platforms will be impacted by the new DDO regulations from October 2021. At the time of writing, there is still considerable uncertainty regarding exactly how DDO will be demonstrated by both fund managers and platform operators, although consultees indicated that both expect some level of enhanced responsibility and suggested that genuine, industry-wide dialogue is underway to ensure participants are ready for the changes. These new regulatory changes may go some way to addressing issues related to platforms discussed over the course of this chapter. More information on DDO is in Section 2.6.2.

### **6.2.2 Platforms can create barriers to entry for new fund managers**

Due diligence processes can also constitute barriers to entry for new fund managers. Lengthy and onerous approval processes can prevent emerging fund managers from reaching market as they start up, making it harder to grow and break even. There was also a suggestion in one submission to the Interim Report that platform due diligence does not appear to allocate enough resources to pursuing new opportunities. The submission claimed that despite strong performances (for the past 5 to 6 years), no platform has approached this particular fund manager to consider offering these funds.

Other than due diligence processes, other features of platforms can serve as barriers to entry:

- Fund asset requirements can limit the ability of smaller funds management firms to offer their products on platforms.
- The functionality of some platforms creates a limit or restriction on the number of managed funds that can be accessed on a platform. Platform providers may be more likely to offer this limited number of slots to established and larger fund managers.
- The same submission to the Interim Report noted that a focus on fees can limit the access of funds with particular fee structures, irrespective of performance. The example given in the submission is a retail fund providing zero fixed management fee; a fund fully remunerated by performance. The submission claims that since the fee structure means that a wide margin of outperformance would raise fees above the average, platforms have refused to offer the fund.
- A consultee noted that the product fees paid to platform operators can also restrict the ability of smaller firms to reach market, as some platforms charge a fixed fee and product by product fee. This makes it more economical to introduce multiple products to a platform, restricting a new fund manager with only one fund.

### **6.2.3 Platforms do not appear to use market power to lessen competition**

Platform operators have relatively substantial market power when dealing with fund managers. This is because there are fewer platforms than funds, platform providers will not select every fund for their platforms and, most of the time, there is a range of funds competing to meet a given investor demand. This imbalance means that platforms have the ability to decide whether or not to list a particular fund and are not obliged to list any fund.

Dealer groups and advisers tend to only purchase funds that are available on platforms that they use. As a result, platforms can limit advisers' and investors' ability to access and invest in a fund of their choosing.

This has the effect of lessening the ability of fund managers to compete by restricting access to retail investors. However, it does not appear that platform providers' have the intent of lessening competition. Funds do not seem to be restricted through commercial or other arrangements from seeking to be listed on more than one platform.

Platforms operators may choose not to list a fund for a number of legitimate reasons, for example due diligence, or limited space.

The power imbalance between platforms and fund managers can be overcome where:

- platforms add particular funds in response to demand from advisers
- advisory groups allow advisers to use the platform/s that offers the managed funds they want to recommend.

#### **6.2.4 Vertically integrated platforms can create conflicts of interest**

Regulators have raised concerns about conflicts of interest and barriers to entry created by vertical integration in the big banks' provision of retail investment products and platforms. The ACCC has, in the past, opposed big bank acquisitions of retail investment platform providers, on the basis that the market for platforms already experiences high barriers to entry.<sup>325</sup>

Vertically integrated platforms inhibit competition if they give preference to in-house funds, or restrict external funds from using that platform, where this is not in the best interests of investors.

Platforms sometimes provide 'best buy' or 'recommended product' lists. For example, this might be a cut down list of core funds offered at a lower cost to investors.

Using a dataset composed of information from five of the largest banking and financial services institutions in Australia, ASIC analysed the share of products invested in in-house and external products. For retail investor funds invested in platforms, ASIC found that 91% of funds were invested in in-house products, compared with 53% for funds directly invested.<sup>326</sup> The Hayne Royal Commission similarly identified preferential treatment of in-house funds via platforms established by large bank-owned wealth managers.<sup>327</sup>

The high share of in-house funds on platforms in vertically integrated firms can result from the fact that platforms are designed to host the funds of the manufacturer.

Recently, the industry has seen the separation of wealth management and banking services, and the entry of more independent platform operators (see Section 3.4.1). This may alleviate these concerns around vertical integration, by reducing the potential for conflicts of interest in the distribution of managed funds.

### **6.3 Dealer groups and financial advisers**

As with platforms, financial advisers and dealer groups select which funds to feature and recommend. Funds which are not selected by advisers or dealer groups are unlikely to be considered by retail investors.

#### **6.3.1 Dealer groups and financial advisers can create barriers to market access for funds**

A financial adviser typically offers advice regarding managed investment products with the use of an APL, which contains a list of products approved by the licensee (typically the dealer group) to be recommended to clients. The APL process undertaken by advisers can be effective at screening funds and ensuring that they are appropriate for investors but can also affect the ability of fund managers to compete by restricting access to investors.

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<sup>325</sup> Australian Competition Consumer Commission 'National Australia Bank Ltd – proposed acquisition of AXA Asia Pacific Holdings Limited; AMP Ltd – proposed acquisition of AXA Asia Pacific Holdings Limited' (Public Competition Assessment, 9 September 2010) <<https://www.accc.gov.au/system/files/public-registers/documents/D10%2B3673911.pdf>>.

<sup>326</sup> Australian Securities & Investments Commission 'Financial advice: Vertically integrated institutions and conflicts of interest' (Report No 562, January 2018) <<https://download.asic.gov.au/media/4632718/rep-562-published-24-january-2018.pdf>>.

<sup>327</sup> Vickovich, Aleks, 'Industry funds, platforms brace for Vanguard disruption', *The Australian Financial Review* (online), 5 November 2019 <<https://www.afr.com/companies/financial-services/industry-funds-platforms-brace-for-vanguard-disruption-20191105-p537lf>>.

The best interest duty does not require financial advisers to use APLs, but they are commonly used by the sector to ensure that regulatory obligations are met, and to improve efficiency and the quality of advice.<sup>328</sup> The products placed on APLs will strongly influence the pool of funds available to advised retail investors. Managed investment products that are not listed on a given APL are less likely to be considered by advisers who are using that APL.<sup>329</sup>

The process to be listed on an APL or being approved is relatively similar across advisers:

- advisory groups generally establish investment committees, sometimes supported by external consultants, to assess funds
- advisers analyse research produced by research houses and conduct their own research
- investment committees account for this research and asset allocation strategies to narrow down the list of funds, considering quantitative and qualitative factors such as investment philosophy and process, the investment team, performance, fees and the sustainability of the business.

After a fund is accepted on an APL, a fund manager's BDM will engage with advisers to convince them to recommend the fund (see Section 4.2.2.4). While advisers will also consider the broader research and ratings information that the advisory group uses, this step can be very relationship-based, as the performance and reputation of the fund and firm have already been approved in earlier stages.

This process can create barriers to market access for funds. It can take around six months to get a product approved by an advisory group. Further, APL approval does not necessarily imply that the product will be recommended, as advisers have discretion over which APL products to recommend to clients. Under the *Financial Planners and Advisers Code of Ethics 2019*, financial advisers are required to comply with a core set of standards, including acting in the best interests of clients and not deriving benefits from any third-party relationship.<sup>330</sup> However, if overly influenced by BDMs when making recommendations, advisers may not act in the best interests of investors, creating a principal-agent problem.

Some dealer groups and independent financial advisers are willing to recommend products that do not sit on their APLs. Fund managers in consultation indicated that smaller financial advice groups have greater flexibility around how they select managed funds and are more likely to recommend funds that are not on the APL.

Responses from the industry on this particular section of the Interim Report contested claims about the influence of BDMs as well as the height of the barrier presented by the APL. Submissions stated that the concerns presented above are adequately accounted for by the introduction of best interest duties introduced under FOFA (see Box 6.3 below) and also stated that advisory groups have "off-APL" practices to approve the use of financial products not on the APL.

### **6.3.2 Dealer groups and financial advisers can create barriers to entry for fund managers**

Similar to platforms, the length of the APL process can restrict the ability of new fund managers to enter the market. Advisers will sometimes require funds to have a track

<sup>328</sup> Productivity Commission 'Competition in the Australian Financial System' (Inquiry Report No 89, 29 June 2018) <<https://www.pc.gov.au/inquiries/completed/financial-system/report/financial-system.pdf>>.

<sup>329</sup> Productivity Commission 'Competition in the Australian Financial System' (Inquiry Report No 89, 29 June 2018) <<https://www.pc.gov.au/inquiries/completed/financial-system/report/financial-system.pdf>>.

<sup>330</sup> Financial Adviser Standards and Ethics Authority, *Code of Ethics Standard commences 1 January 2020* <<https://www.fasea.gov.au/code-of-ethics/>>.

record of multiple years before considering them, by which time new fund managers may not have been able to grow without access to the advisers' clients.

Further, quality funds can receive a positive rating from a research house, get listed on a platform, and be placed on a dealer group's APL, but then struggle at the adviser stage where BDMs convince financial advisers to recommend funds. As this final step is strongly relationship-based, this process can be a significant barrier to new, unknown funds without connections in the industry.

### 6.3.3 Vertically integrated dealer groups can create conflicts of interest

Vertically integrated financial advice firms deliver financial advice services and also manufacture managed investment products. Vertical integration can represent a conflict of interest by creating an incentive for financial advisers to recommend products produced by the business, even if they are not best suited to the consumer.<sup>331</sup>

The **FOFA** reforms were introduced in July 2013 to manage the conflict of interest related to vertically integrated financial advice firms, improve fee transparency and increase the trust of retail investors in the financial advice sector (see Box 6.3 below).

#### Box 6.3: Future of financial advice reforms

The main elements of the FOFA reforms of July 2013 include:

**-Best interest obligations:** financial advisers have a best interest duty under the *Corporations Act 2001* to put the interests of the client above those of advisers or other related parties

**-Ban on conflicted remuneration and other remuneration:** financial advisers are no longer allowed to be remunerated by fund managers for advising clients to purchase their funds, or more generally for giving advice that would influence clients.

**-Charging ongoing fees to clients:** financial advisers have new reporting obligations to their client, to renew ongoing fee arrangements every two years and provide fee disclosure statements every year.<sup>332</sup>

A 2016 review of advice licensees found that advice licensees appropriately manage conflicts of interest related to in-house products and APLs, with most using a separate research and due diligence team to assess in-house product selection.<sup>333</sup> However, the review also identified areas where conflicts of interest were not adequately managed, including in product selection.

Consistent with this, ASIC analysis of large financial services firms in 2018 found that while only 21% of advice licensees' product lists were in-house products, 68% of the total value of funds invested in by customers who received personal retail advice were in-house products (see Chart 6.1 below).<sup>334</sup>

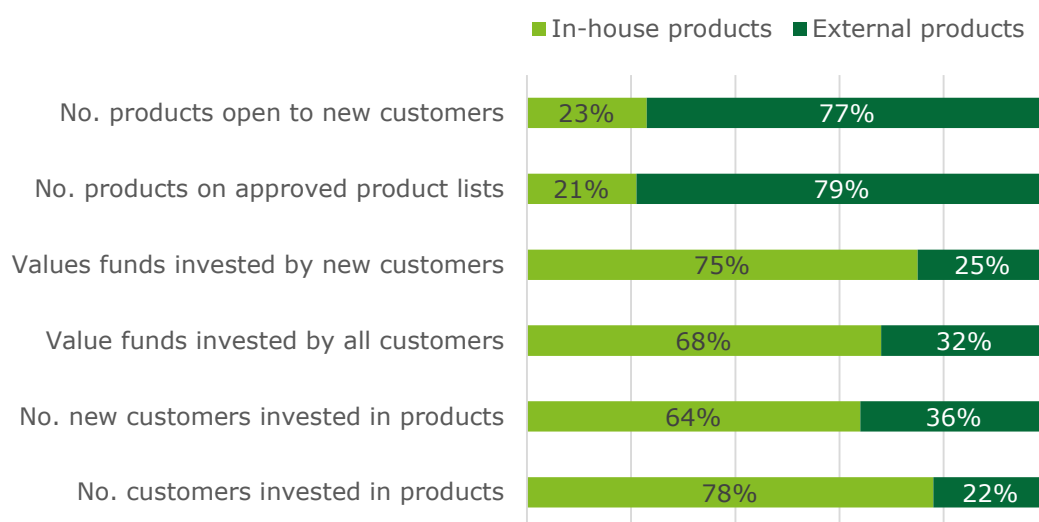
<sup>331</sup> Productivity Commission 'Competition in the Australian Financial System' (Inquiry Report No 89, 29 June 2018) <<https://www.pc.gov.au/inquiries/completed/financial-system/report/financial-system.pdf>>.

<sup>332</sup> Productivity Commission 'Competition in the Australian Financial System' (Inquiry Report No 89, 29 June 2018) <<https://www.pc.gov.au/inquiries/completed/financial-system/report/financial-system.pdf>>.

<sup>333</sup> Australian Securities & Investments Commission 'Culture, conduct and conflicts of interest in vertically integrated businesses in the funds-management industry' (Report 474, March 2016) <<https://download.asic.gov.au/media/3583028/rep474-published-21-march-2016.pdf>>.

<sup>334</sup> Australian Securities & Investments Commission 'Financial advice: Vertically integrated institutions and conflicts of interest' (Report No 562, January 2018) <<https://download.asic.gov.au/media/4632718/rep-562-published-24-january-2018.pdf>>.

Chart 6.1 Proportion of customers and funds invested in in-house or external products



Note: Contents of the chart are described in the paragraph above in Section 6.3.3. Contents can also be found in table form in Appendix F.

Source: ASIC (2018).<sup>335</sup>

If in-house products are in the best interests of the investor, then this does not represent a concern. However, in a review of customer files involving in-house superannuation recommendations, ASIC found that in three-quarters of files, the adviser had not complied with the best interest duty and related obligations. This issue may affect advice relating to other types of financial products, including managed investment products.<sup>336</sup>

Similarly, to platform providers, the divestment of financial advice services from large banking institutions may reduce the potential for conflicts of interest in advisers' recommendations of managed funds.

### 6.3.3.1 The structure of managed accounts presents opportunity for conflicts of interest

In principle, the management fee paid to advisers for managed accounts can represent a **conflict of interest** resulting from vertical integration.<sup>337</sup> Conflicts could potentially emerge where MDA providers put clients into their own investment model portfolio rather than external products, as advisers receive a management fee for doing so.

This reflects a principal-agent problem related to information asymmetry, with the adviser acting in their own best interests rather than in the interests of the investor.

Consultees indicated that conflicts of interest are potentially evident in the growth of small advice businesses that emerged from big bank divestments after the Hayne Royal Commission. Responses to the Interim Report indicated that the number of MDA providers that offer managed investment schemes, and could therefore put their own

<sup>335</sup> Australian Securities & Investments Commission 'Financial advice: Vertically integrated institutions and conflicts of interest' (Report No 562, January 2018) <<https://download.asic.gov.au/media/4632718/rep-562-published-24-january-2018.pdf>>.

<sup>336</sup> Australian Securities & Investments Commission 'Financial advice: Vertically integrated institutions and conflicts of interest' (Report No 562, January 2018) <<https://download.asic.gov.au/media/4632718/rep-562-published-24-january-2018.pdf>>.

<sup>337</sup> Australian Securities & Investments Commission 'Managed discretionary accounts' (Regulatory Guide No 179, September 2016) <<https://download.asic.gov.au/media/4028003/rg179-published-29-september-2016.pdf>>.



funds into MDAs, is limited to a very small number of firms. Acknowledging these issues, the Hayne Royal Commission dealt explicitly with the issue of managed accounts, however, stopped short at recommending the complete separation of product and advice.<sup>338</sup>

Despite the opportunity for these conflicts to occur within the structure, and despite attention received in the wake of the Royal Commission, industry consultees were satisfied that the risks and conflicts are appropriately managed by existing regulation, particularly for MDAs. MDA providers must be licensed by ASIC and, like any advice service, are subject to best interest obligations. ASIC has enforced this issue, most notably by imposing extra licence conditions on AMP Financial Planning in 2019. This led to the removal of MDAs from AMP's offerings, as they were unable to sustain the extra compliance and regulatory costs. Besides this, over the six years to 2019, only six MDA operators were subject to enforcement.<sup>339</sup>

There are no such structures in place to ensure that SMA providers do not allocate their own products to SMAs that they manage. In fact, submissions indicated that this is fairly common practice. However, as noted earlier, consultees suggested that there are no non-advised SMA structures available and financial advisers would be best placed to assess the fit of these products for their client's best interests.

## 6.4 Research houses

Research houses and rating agencies play a critical role in the choice of funds available to investors. Research houses provide signals to players in the industry, reducing transaction costs for financial product distributors and advisers and providing a source of credibility for investors.

Research houses in Australia generally operate under supply- or demand-based business models.

- Under supply-based models, fund managers pay a fee to be rated. Advisers typically also pay for this research once completed, but do not have control over which funds are rated. Research houses that employ the supply-side model typically rate funds on an annual, rolling basis, using data obtained from fund managers.
- Under demand-based models, research houses earn revenue through subscriptions paid for by investors and advisers. Investors and advisers have more control over which funds are rated, as research coverage is based on both analyst research and client demand.

### 6.4.1 Research houses can create barriers to market access for funds

Due to the number of funds, the difficulty of differentiating between them, and the need to protect consumers, platforms and dealer groups will typically not list a fund without that fund acquiring a rating from one of the small number of research houses. In Section 7.1.1, this report produces econometric results demonstrating the influence ratings have on flows. The impact of ratings on distribution means that fund managers largely cannot access investors without receiving a rating.

Receiving a rating can also be a time and resource intensive process. Some consultees said that research houses are supportive, and the process of obtaining a rating is not too difficult or onerous, while others noted that processes can be very long (sometimes more than three years). Research houses have finite resources to provide comprehensive

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<sup>338</sup> Sharpe, Tarn 'Managed account conflicts of interest divide industry', *Professional Planner* (online) 13 February 2019, < <https://www.professionalplanner.com.au/2019/02/managed-account-conflicts-of-interest-divide-industry/>>

<sup>339</sup> Vickovich, Aleks, 'AMP buckles under ASIC licence conditions' *Australian Financial Review* (online), 18 December 2019 <<https://www.afr.com/companies/financial-services/amp-buckles-under-asic-licence-conditions-20191218-p53l2t>>.

analysis on funds and may rate only 800 to 1,000 funds — leaving at least as many unrated. For a research house to rate a fund, there must be:

- sufficient historical track record for the fund (typically at least three years)<sup>340</sup>
- sufficient level of FUM
- sufficient demand from investors for a rating to be provided, particularly for demand-side business models; or
- the fund must pay for a rating to be provided, if under a supply-side business model.

Demand-side business models in particular can restrict small funds that have not yet attracted adviser interest from reaching retail investors.

However, barriers to market access can be lower for research houses than platforms. If the platform does not list a particular fund, then the investors and advisers that use that platform cannot access that fund. In contrast, if a research house does not rate a fund, this does not lock in any investors, as the fund can be rated by another research house to reach investors.

While ratings provided by research houses provide a source of due diligence in assessing the governance and investment processes of fund managers, they have the potential to represent a barrier to market access for fund managers, through their impact on the distribution of funds to customers.

Submissions indicated that, like other areas of the distribution channel, research houses play an important role in screening funds for the end investor. Generally, participants acknowledge that research is the most concentrated component of managed funds distribution, with only three key research providers and that it is difficult for small funds to be rated without sufficient size. One submission criticised the research process for concentrating too heavily on fund size instead of performance, claiming that this particular fund manager struggled to achieve a rating due to its small scale, despite an impressive track record. These competition considerations, according to most submissions, need to be weighed against the governance, due diligence and consumer safeguards that research houses contribute. These barriers are discussed in more detail below. Fund managers also noted that the increasing presence and attention on listed products is creating a viable alternative to acquiring a rating, provided the fund has generated, or can generate, sufficient demand from investors outside the traditional distribution channel.

#### **6.4.2 Research houses can create barriers to entry for fund managers**

The process of obtaining a rating can prohibit the entry of new fund managers. This is considered a supply-related barrier to entry that is identified as an area for further exploration in Section 3.2.3.

Given the above requirements, particularly around a fund track-record, the timeliness of new entrants is affected by the reliance on ratings and distribution channels. Research houses with demand-side business models can specifically restrict small entrants from entering the market, as fund coverage is dependent on investor interest and therefore is more likely to include large fund managers with well-known brands.

For new fund managers that do not have a prior track record with another organisation, or experience overseas, this severely limits the ability to get a rating and successfully enter the market. For these reasons, fund managers indicated in consultations that many new entrants begin as offshoots of a larger fund manager, or are set up by an individual investment manager with a strong personal brand and track-record obtained

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<sup>340</sup> Some exceptions are made if key personnel, such as the investment manager, have extensive history with a different organisation.

in another existing fund. That is, they have a good reputation, personally or by association, allowing to attract sufficient scale before achieving a rating.

These requirements can create a cycle, where fund managers cannot grow by distributing products through platforms and advisers without receiving a rating but must be of a certain size and age to be rated. In recent years, listed funds, such as ETFs, have provided an alternative way for new entrants to enter the market without the requirement for track record or ratings (discussed in Section 4.2.1.1).

#### **6.4.3 Research houses generally do not appear to use market power to lessen competition**

Similar to platform providers, research houses have market power in dealings with fund managers, as there are only a few major research houses rating many funds, and fund managers are strongly reliant on ratings to reach retail investors. As a result, research houses have discretion over which funds they rate. In particular, research houses with:

- supply-side models only rate a fund where the fund manager is willing to pay for the fund
- demand-side business models will not rate a fund if there is not deemed to be sufficient investor interest

Both models have the effect of lessening the ability of fund managers to compete by preventing investor access to some funds and ensuring that ratings results are not representative of the industry. The demand-side model particularly reduces the number of funds available to investors as fund managers are not able to control this access by paying the research house.

It does not appear to be the intent of demand-focused research houses to limit competition, but rather to ensure that rated funds are supported by client demand. However, there are concerns among industry that the supply-side business model can be conflicted and lessen fund managers' ability to compete.

#### **6.4.4 Supply-side research houses create conflicts of interest**

The supply-side business model employed by some research houses represents a potential conflict of interest, as they are remunerated by the fund managers they are rating. This creates incentives to give positive ratings (and not give negative ratings), and it is not required that research houses publish negative ratings as well as positive ratings.<sup>341</sup> The business model also allows fund managers to search for the research house that will provide them with the best rating, then pay for this rating and use it in their advertising material.<sup>342</sup>

ASIC regulates this conflict by requiring research houses to disclose any benefits they receive from the report in their reports or advertisements.<sup>343</sup> However, multiple fund managers expressed concerns with this business model, for example where research houses are only paid for providing a certain rating, indicating that disclosure of conflicts may be insufficient to prevent this misuse of market power. Evidence also indicates that the supply-side model is significantly more likely to generate positive ratings than the demand-side model.<sup>344</sup>

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<sup>341</sup> Australian Securities & Investments Commission and Treasury 'Review of credit rating agencies and research houses' (Report No 143, October 2008) <<https://download.asic.gov.au/media/1343114/rep143.pdf>>.

<sup>342</sup> CFA Institute, *Professionalising Financial Advice* (2019) <<https://www.cfainstitute.org/-/media/documents/article/position-paper/professionalising-financial-advice.ashx>>.

<sup>343</sup> Australian Securities & Investments Commission and Treasury 'Research report providers: Improving the quality of investment research' (Regulatory Guide No 79, December 2012) <<https://download.asic.gov.au/media/1239863/rg79-published-10-december-2012.pdf>>.

<sup>344</sup> Australian Securities & Investments Commission and Treasury 'Research report providers: Improving the quality of investment research' (Regulatory Guide No 79, December 2012) <<https://download.asic.gov.au/media/1239863/rg79-published-10-december-2012.pdf>>.

Consultees said that this conflict is typically managed with Chinese walls that separate the investment arm from the research arm, ensuring that the sales team does not know a fund rating until it is published. Research houses can also avoid this conflict by charging fund managers upfront, rather than at the release of the rating. Consultees also noted that there are clear examples of research houses with supply-side models delivering negative ratings to well-known funds and fund managers.

ASIC has previously considered a range of remedies to manage conflicts related to supply-side research houses including:

- avoiding any conflicts
- separating business units, for example the research business and consulting
- requiring research houses to lodge a compliance report every two years.<sup>345</sup>

## 6.5 Managing fees along the value chain

As a high share of retail consumers access managed funds through distributors it is important that investors recognise the cumulative costs of accessing these products. Investors tend to buy a 'bundle' when investing in a managed fund, which may include advice, the platform, funds management and the third-party services purchased by the fund manager including research and ratings. The choice of 'bundle' and the individual products in the bundle will therefore affect the total fee charged to investors when purchasing any given managed fund.

The actual fund management fee charged by fund managers tends to represent about half of the total fee paid by investors. Consultees indicated that investors typically pay a:

- **Fund management fee:** 70 to 100bps
  - The fund management fee is discussed in detail in Section 4.3.
  - Typically, the fund management fee as presented in PDSs covers the internal costs of investment management as well as third-party costs, which includes the cost of acquiring ratings from research houses (see Chapter 5).
- **Platform fee:** 15 to 30bps
  - This administration fee covers the cost to the provider of running the platform.<sup>346</sup> Evidence suggests that platform providers have been reducing fees to remain competitive.<sup>347</sup>
  - Consultees also noted that before FOFA, the platform component of the final fee charged to investors was significantly higher, but the unbundling of various fees and commissions has reduced the platform fee substantially.
  - In the survey conducted for this report, 64% of respondents agreed that platform fees have gone down in the last five years.
- **Advisory group fee:** 60 to 100bps
  - This is typically a fee for ongoing advice but can also be a percentage-based fee based on the value of assets held.<sup>348</sup>

As noted in Box 6.1, this chapter only considers distribution for unlisted funds that are accessed via platforms and advisers. It may be that where listed funds are associated with less intermediation, they may also be associated with lower overall costs to retail investors as they are not charged the platform and/or adviser fee. However, it should be noted that neither fund managers nor investors are required to transact through

<sup>345</sup> Australian Securities & Investments Commission and Treasury 'Research report providers: Improving the quality of investment research' (Regulatory Guide No 79, December 2012) <<https://download.asic.gov.au/media/1239863/rg79-published-10-december-2012.pdf>>.

<sup>346</sup> The New Daily, *How much are you really paying in fees on investment platforms?* (20 August 2018) <<https://thenewdaily.com.au/sponsored/2018/08/17/paying-fees-investment/>>.

<sup>347</sup> Richardson, Tom, 'Charting the incredible rise of Hub24 and Netwealth' *Australian Financial Review* (online), 21 January 2020 <<https://www.afr.com/markets/equity-markets/charting-the-incredible-rise-of-hub24-and-netwealth-20200121-p53t9f>>.

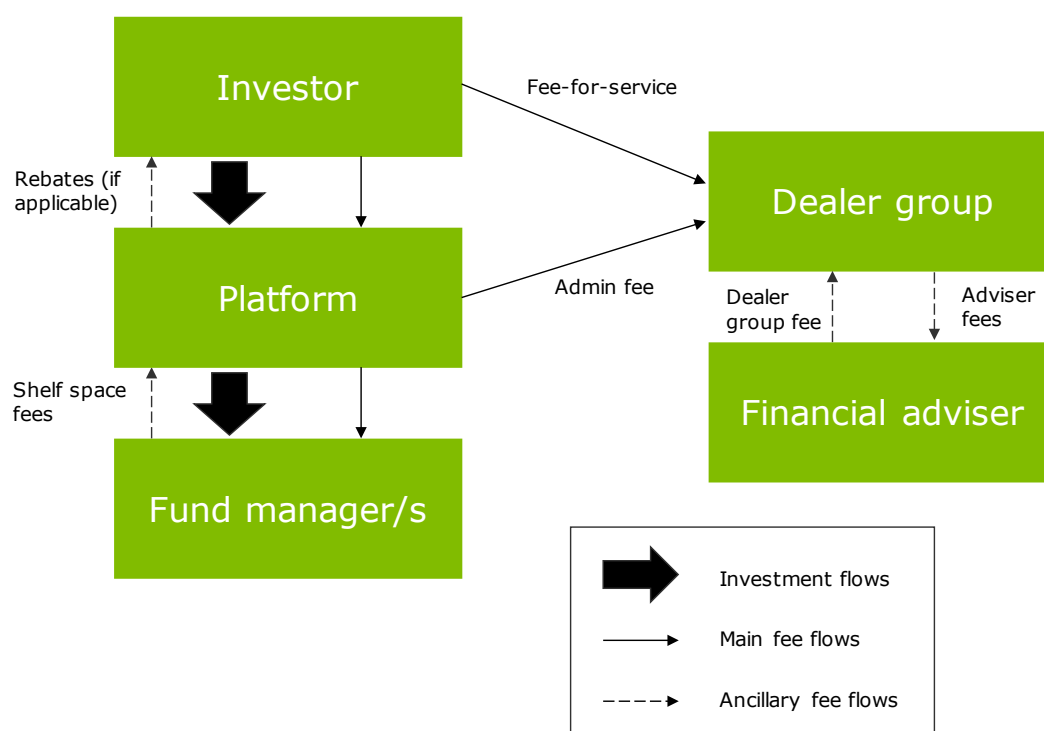
<sup>348</sup> Australian Securities and Investments Commission, *Financial advice costs* (2020) <<https://moneysmart.gov.au/financial-advice/financial-advice-costs>>.

demand-side intermediaries, even in purchasing listed funds. There are an increasing number of options available to transact with fewer intermediaries (see, for example, Section 4.2.1.1).

Fund managers cannot control the other 50% of the total fee paid by investors, as this occurs in the platform and advisory markets. Fund managers also have limited ability to control the charges they pay to intermediaries. This is because fund managers have limited bargaining power in negotiations with intermediaries, as distribution via these players is generally necessary to reach investors. Heightened regulatory scrutiny of the supply chain has also seen regulations enforced to stop managers paying commissions, particularly volume-based commissions, to both platform providers and financial advisers.

Figure 6.2 depicts an example of the fee flows along the supply chain for a typical retail investor, who uses both a financial adviser and platform to access managed funds.

Figure 6.2: Typical fee flows along the supply chain for retail investors



Note: The contents of the Chart are described below in Section 6.5.

Source: Deloitte Access Economics (2021) and Arnhem Investment Management (2012).<sup>349</sup>

Under the model depicted in Figure 6.2:

- the **investor** makes payments to their platform, who distributes a portion of this payment to the fund manager(s)
- the **platform** receives shelf space fees from the fund managers, returns any rebates on the fund management fee to investors and pays dealer groups an administrative fee
- the **dealer group** receives a fee from the investor, and receives and makes payments to its financial advisers.

This structure is not necessarily consistent across the industry, with various options available to investors to access funds, and a range of fees and costs charged between players.

### 6.5.1 Fund managers do not have much control over fees paid to platforms

Fund managers and other investment product providers can pay two types of payments to **platform providers**:

- rebate payments
- shelf space or administration fees.<sup>350</sup>

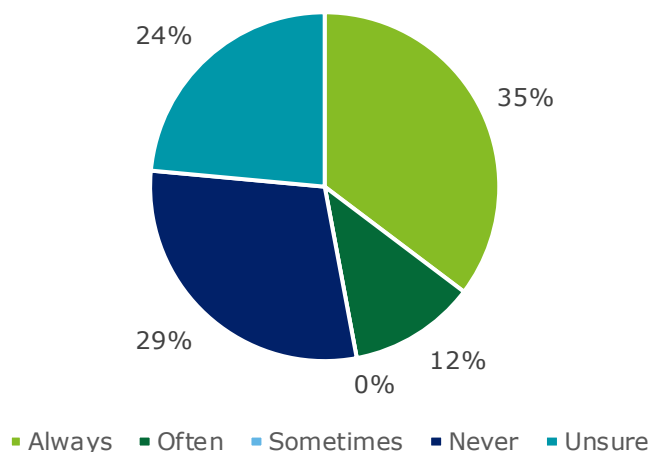
Nearly half of the 17 retail managed funds responding to the survey paid shelf space or administration fees to platforms, while 29% of the funds had never paid shelf space fees

<sup>349</sup> Arnhem Investment Management, *Too much of a good thing: The future of the Australian Wealth Management Industry* (2012) <<https://docfinder.is.bnpparibas-ip.com/api/files/2BF02551-99AE-409A-8205-56F72F8F5EE1>>.

<sup>350</sup> Australian Competition Consumer Commission 'National Australia Bank Ltd – proposed acquisition of AXA Asia Pacific Holdings Limited; AMP Ltd – proposed acquisition of AXA Asia Pacific Holdings Limited' (Public Competition Assessment, 9 September 2010) <<https://www.accc.gov.au/system/files/public-registers/documents/D10%2B3673911.pdf>>.

to platforms (see Chart 6.2).

Chart 6.2: Frequency that funds that pay shelf space or administration fees to platforms (% of respondents)



Note: Sample size is 17, reflecting the number of retail managed funds. These funds are held by nine fund managers.

Note: Contents of the Chart are described in the paragraph above in Section 6.5.1.

Source: Deloitte Access Economics survey (2020).

The FOFA reforms introduced in Australia in 2013 prevent fund managers from paying platforms asset-based rebates for displaying their products. Further, platforms must return any rebates on the fund management fee to investors (see Section 4.4.3). Shelf-space fees, where charged, are paid to the platform provider for including the product on the platform.<sup>351</sup> They are typically flat fees that are paid per fund, and/or by the fund manager or responsible entity. Consultees indicated the flat fund fee may be between \$2,500 to \$10,000 per annum and survey analysis found that the average shelf space or administration fee for the year ending 30 June 2019 was \$6,400.

While under the *Corporations Act 2001*, platforms are not allowed to accept volume-based shelf space fees, there are exceptions where volume-based benefits are not considered to be conflicted remuneration. For example, under the fee-for-service exclusion, the platform is considered to be providing a service to the fund manager, and fees reflect the platform operator's costs in listing a product on a platform or providing information to the fund manager.<sup>352</sup>

A part of fund managers competing in the intermediated market is price competition. Fund managers compete for the limited resource of being featured on a platform and consultees indicated that they tend to be price takers when paying platform providers. Fund managers have limited bargaining power in managing the costs of platform providers as:

- it is largely an essential requirement to reaching the end consumer
- there are a relatively low number of competitors in the platform market, and
- platform providers already compete down the fund management fees, providing little scope for fund managers to negotiate the fees they pay to platform operators.

<sup>351</sup> Australian Securities & Investments Commission 'Sale and distribution of investment products to retail investors' (Regulatory Guide No 246, June 2009) <<https://download.asic.gov.au/media/4566844/rg246-published-7-december-2017.pdf>>.

<sup>352</sup> *Corporations Act Commonwealth – SECT 964A* (2001).

### 6.5.2 Fund managers no longer pay commissions to advisory groups

As demonstrated in Figure 6.2, fund managers do not directly make payments to financial advisers and dealer groups. This was demonstrated in the survey conducted for this report, where none of the fund managers reported paying fees to have their products available on the approved product lists of dealer groups or independent financial advisers. This has not always been the case, as increased regulation has banned certain payments to intermediaries that were otherwise common and used by fund managers to compete in the advisory space.

The FOFA reforms banned the practice of fund managers paying financial advisers commissions for advising clients to select their funds (see Section 6.3).<sup>353</sup> Grandfathered commissions, which allow advisers to charge consumers commissions for investments made before the FOFA legislation was passed, were not repealed under FOFA. Research by ASIC in 2014 found that about one-third of financial advice licensees income came from grandfathered commissions, demonstrating the continued prevalence of commissions as a means to gain access to the advisory network one year after the implementation of the reforms.<sup>354</sup>

However, recent legislation that banned grandfathered commissions, came into effect on 1 January 2021.<sup>355</sup> Regulation has therefore limited the ability of fund managers to compete for advisers through volume-based commissions.

While these commissions have been banned in the unlisted space since 2014, concerns grew in recent years around commissions paid to financial advisers recommending listed products such as listed investment companies and listed investment trusts (see Box 6.4 below).

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<sup>353</sup> Productivity Commission 'Competition in the Australian Financial System' (Inquiry Report No 89, 29 June 2018) <<https://www.pc.gov.au/inquiries/completed/financial-system/report/financial-system.pdf>>.

<sup>354</sup> Australian Securities & Investments Commission 'Review of the financial advice industry's implementation of the FOFA reforms' (Report No 407, September 2014) <<https://download.asic.gov.au/media/1845586/rep407-published-17-september-2014.pdf>>.

<sup>355</sup> Vickovich, Aelks, 'How the ban on financial adviser commissions could hit hip pockets' *Australian Financial Review* (online), 23 October 2019 <<https://www.afr.com/wealth/personal-finance/how-the-ban-on-financial-adviser-commissions-could-hit-hip-pockets-20191021-p532u3>>.



### **Box 6.4: Stamping fees – commission exemptions for listed products**

The 2013 FOFA reforms prevent fund managers from paying commissions to financial advisers for recommending unlisted managed investment products, and other products like ETFs, to retail investors. However, this legislation did not apply to advisers, including stockbrokers, accepting commissions (or 'stamping fees') from fund managers for selling stock exchange-listed investment products, including newly listed LICs or LITs to retail investors.<sup>356</sup>

This stamping exemption led to concerns about conflicts of interest in the distribution of LICs or LITs. For example, ASIC research indicated that some stockbrokers were misclassifying retail investors as wholesale investors, to sell them poor-performing listed investment companies or trusts and receive commissions from fund managers.<sup>357</sup> There was also evidence that higher stamping fees were correlated with underperforming listed funds.<sup>358</sup>

In May 2020, following a Treasury probe into whether to retain, remove or modify the stamping fee exemption from the ban on conflicted remuneration, Treasurer Josh Frydenberg announced that conflicted remuneration for newly floated LICs and LITs will be banned.<sup>359</sup>

Despite the banning of commissions on unlisted funds, there are two circumstances under which fund managers make payments to financial advisers and dealer groups:

- as volume-based rebates on the fund management fee when advisers recommend a certain amount of FUM to their clients, which may be retained by the advisory group (see Section 4.4.3)
- in the supply of funds for managed accounts, which similarly tend to be volume-based payments (see Section 4.4.5).

Both of these payments are used as a means for fund managers to access the retail market. It appears that fund managers do not have much control over these charges, given the necessity of accessing investors through advisers.

### **6.5.3 Fund managers do not have much control over research house costs**

Chapter 5 discussed the willingness and ability of fund managers to control the costs and quality of third-party services. Where research houses employ a supply-side model and fund managers pay to be rated, fund managers generally have the incentive to manage this cost to reduce the total management fee paid by investors. The fee per fund may be between \$10,000 and \$20,000.

<sup>356</sup> Kehoe, John, 'ASIC targets brokers over 'poor' funds' *Australian Financial Review* (online), 9 January 2020 <<https://www.afr.com/companies/financial-services/asic-targets-brokers-over-poor-funds-20200107-p53pfy>>.

<sup>357</sup> Kehoe, John, 'ASIC targets brokers over 'poor' funds' *Australian Financial Review* (online), 9 January 2020 <<https://www.afr.com/companies/financial-services/asic-targets-brokers-over-poor-funds-20200107-p53pfy>>.

<sup>358</sup> Kehoe, John, 'ASIC targets brokers over 'poor' funds' *Australian Financial Review* (online), 9 January 2020 <<https://www.afr.com/companies/financial-services/asic-targets-brokers-over-poor-funds-20200107-p53pfy>>.

<sup>359</sup> Kehoe, John & Vickovich, Aleks, 'Treasurer bans listed fund commissions' *Australian Financial Review* (online), 21 May 2020 <<https://www.afr.com/companies/financial-services/treasurer-bans-listed-fund-commissions-20200521-p54v7e#:~:text=Stamping%20fees%20are%20an%20upfront,broker%20raises%20from%20a%20client>>.

However, fund managers do not have much bargaining power in negotiations with research houses and many fund managers in consultation indicated that it is difficult to control the costs of research houses. This is because:

- similar to other markets for third-party services such as custodians, there are a limited number of research houses in the Australian industry, including in comparison to the US and UK, and
- fund managers need a rating to operate, to be approved by platforms and dealer groups.

Consultees also indicated that research houses tend to add services rather than compete on price, adding complexity and cost to investors.

# 7 Retail investor engagement

## **This chapter finds that:**

There are a range of factors that retail investors can consider when selecting a fund and fund manager, including fund characteristics, fund manager characteristics, and historical returns, fees and discounts. The factors that are most important will depend on an investor's individual circumstances and the information presented to them. Regression analysis conducted for this report on factors influencing net fund flows found that flows are most significantly driven by fund ratings (likely influenced by adviser recommendations) and past performance.

Information on fund features is readily available to retail investors. For example, fund managers use advertising to inform and attract retail investors. However, retail investors find it difficult to interpret, assess and act on this information, due to complexity, information overload and the way information is presented. In some instances, advertising is misleading. There is no single source that allows for direct comparison between funds.

There are many intermediaries between fund managers and retail investors. For example, advisers assist investors in interpreting information to make decisions. However, these principal-agent relationships can create issues for investors related to incentive alignment, transparency and conflicts of interest.

Analysis conducted for this report indicates that inflows and outflows as a share of FUM are relatively high and that changes in fund ratings, both upgrades and downgrades, significantly impact net fund flows. However, there is limited evidence on how frequently retail investors change funds.

There is evidence of barriers to transacting such as transaction costs and 'red tape'. Economic transaction costs such as the capital gains tax liability can prevent investors from selecting, and moving to, the fund that is in their best interests, however, these costs are not unique to managed funds.

As a result of product and market complexity, and transaction costs, retail investors are not highly engaged with funds management. Consumer disengagement can create a degree of stickiness whereby consumers are not actively switching or assessing products.

Retail investors rarely invest directly in managed funds. Most retail investors engage with managed funds through institutional investors, particularly superannuation, and the remainder mostly access funds through a range of intermediaries, including platforms and advisers (see Chapter 6). While the number of retail investors that access the market outside superannuation remains relatively low, this number is growing, enabled by digital platforms. This chapter focuses on those retail investors who purchase funds via intermediaries. While not the focus of this chapter, it is also noted that growth in more accessible traded and listed products has made it easier for retail investors to access managed funds without intermediaries, for example via online exchanges.

Engaged and motivated consumers actively seek the products that offer the best value for money. In doing so, engaged consumers put pressure on suppliers to compete with one another, over price and other factors, to increase and retain their market share.<sup>360</sup>

In the managed funds industry, engaged and motivated consumers would be:

- well informed: aware of all the potential factors that can be considered in assessing a fund, able to access information about any given fund's performance or characteristics with respect to each factor, and have a good understanding of their own preferences
- savvy: have strong financial literacy, the capacity and capability to make assessments about funds using information
- self-aware and rational: have a good understanding of their own preferences, needs and investment goals, and act in accordance with these
- active: regularly re-evaluating funds and their own preferences and needs, and making changes accordingly where warranted.

The extent of consumer engagement in a market can be influenced by a range of factors. These include:

- search costs: the time, cost and/or difficulty associated with finding products, and information about products
- economic transaction costs: the time, cost and/or difficulty associated with buying or changing products (economic transaction costs differ from the transaction costs associated with managing a fund as defined in Table 4.1)
- behavioural biases: for example, inertia, myopia, loss aversion, framing.

Although researching and deciding between funds is timely, actual costs to retail investors are relatively low. Vast amounts of information are available to retail investors from a range of sources. Mandatory disclosures of fees and expenses, as well as intermediary services and marketing materials, mean that information asymmetry is mostly limited. However, disclosure of portfolio holdings is lacking in Australia and lagging global best practice.

Economic transaction costs can be high for retail investors. While it is theoretically simple to invest in a fund, withdraw from a fund, and enter a new fund, there are monetary and non-monetary costs associated with moving money in and out of managed funds. For example, redeeming units from a fund can increase an investor's tax burden, while investing in a fund can be a timely and onerous process.

The complexity of funds management products, as well as the level of intermediation in the industry, detracts from retail investor engagement. While retail investors have access to information, they often do not have the capability to assess and act on this information to make investment decisions in their best interests. Behavioural biases may impact on their ability to make decisions (see Box 7.1 below). As a result, investors commonly employ other services, such as financial advisers, to assist with decision-making.

While not investigated in detail in this report, intermediaries including advisers will also be subject to behavioural biases, adding another layer of complexity. For example, heuristics and biases affect the choices of many finance professionals, which can be positive (a successful strategy) or negative (a misinformed strategy) for the retail consumer. Many of these professionals admit to being prone to biases such as trend-chasing bias, familiarity bias, and herd mentality.<sup>361</sup>

<sup>360</sup> Productivity Commission 'Competition in the Australian Financial System' (Inquiry Report No 89, 29 June 2018) <<https://www.pc.gov.au/inquiries/completed/financial-system/report/financial-system.pdf>>.

<sup>361</sup> Wismer, David, 'Do behavioral biases also affect financial advisors?', *Proactive Advisor Magazine* (31 January 2018) <<https://proactiveadvisormagazine.com/behavioral-bias-affect-financial-advisors/>>.

## Box 7.1: Behavioural biases

Consumer engagement in any market tends to be affected by a range of behavioural biases. Most people do not act 'rationally' when purchasing a product or service. Instead, consumers tend to be influenced by a range of behavioural biases, such as inertia, present bias and framing, which prevent them from making the most rational decision based on their circumstances and preferences, and the options available.<sup>362</sup>

Investor choices and preferences are also affected by a range of circumstances and contextual factors, for example:

- A 2014 report found that Australians between the **ages** of 15 and 24 hold 42% of their portfolio in platforms, managed funds and life products — the highest out of all age groups. This is most likely ascribed to the diversity and liquidity of managed funds and the high engagement with technology among young people, which makes it easier to access investment products online. In contrast, people aged 75 and above hold 55% in cash and term deposits, partly reflecting the high-risk aversion of this age group.<sup>363</sup>
- Investors with poor **financial literacy** and limited knowledge of investment products are particularly susceptible to advertising that targets investor psychology, generating positive emotions and influencing investors to view particular funds as more favourable.<sup>364</sup>
- However, investors who are financially knowledgeable can be even more prone to bias. A **perceived illusion of control and overconfidence** often leads highly sophisticated market participants to select active funds, believing that they have the ability to beat the market. These investors are less likely to perceive adverse performance objectively, and are overly optimistic in chasing past returns.<sup>365</sup> Financial literacy is discussed further at the end of Section 7.2.3.1.<sup>366</sup>

The structure, conduct and performance of the funds management industry affects retail investor engagement. For example, increased mandatory fee transparency has contributed to increased consumer confidence to compare funds and demand lower fees.<sup>367</sup>

However, the extent of retail investor engagement can also influence the structure, conduct and performance of the funds management industry. For example, low engagement can lead to a long tail of funds, where fund managers uneconomically support a 'legacy' fund that investors have not switched out of despite the existence of new, better value funds.

<sup>362</sup> Bowerman, Robin, *Does your mind help or hinder your investment success?* (18 October 2019) Vanguard <<https://www.vanguardinvestments.com.au/retail/ret/articles/insights/research-commentary/investment-principles/does-your-mind-help-or-hinder.jsp>>.

<sup>363</sup> Rice Warner, *Investor Preferences – By Age and Wealth* (31 August 2016) <<https://www.ricewarner.com/investor-preferences-by-age-and-wealth/>>.

<sup>364</sup> Haslem, John A., 'Mutual Funds and Investor Choice: 'Paths to the Wizards of Advertising and Overconfidence'' (2010) 16 (6) *SSRN Electric Journal* 42.

<sup>365</sup> Lichtenstein, Donald R., Kaufmann, Patrick J., and Bhagat, Sanjai, 'Why Consumers Choose Managed Mutual Funds Over Index Funds: Hypotheses from Consumer Behavior' (1999) 33 (1) *Journal of Consumer Affairs* 187.

<sup>366</sup> Lichtenstein, Donald R., Kaufmann, Patrick J., and Bhagat, Sanjai, 'Why Consumers Choose Managed Mutual Funds Over Index Funds: Hypotheses from Consumer Behavior' (1999) 33 (1) *Journal of Consumer Affairs* 187.

<sup>367</sup> Morningstar, *Global Investor Experience Study: Fees and Expenses* (17 September 2019) <[https://www.morningstar.com/content/dam/marketing/shared/pdfs/Research/GIE\\_2019\\_v4.5.pdf?utm\\_source=eloqua&utm\\_medium=email&utm\\_campaign=&utm\\_content=18780](https://www.morningstar.com/content/dam/marketing/shared/pdfs/Research/GIE_2019_v4.5.pdf?utm_source=eloqua&utm_medium=email&utm_campaign=&utm_content=18780)>.

This chapter includes:

- Section 7.1 — factors important to retail investors when selecting a fund manager or managed fund
- Section 7.2 — information transparency and comparability, including how features of funds are promoted or communicated to potential investors and the extent to which potential investors rely on these features
- Section 7.3 — transaction costs, including retail investor switching behaviour.

## **7.1 Factors important to retail investors when selecting a fund manager or managed fund**

This section discusses some of the factors that are important to retail investors when making investment decisions. It is important to note that investors may not be aware of all factors they should be considering when making decisions, or able to provide due consideration to these factors. Many retail investors, therefore, use financial advisers to help them identify and prioritise these factors.

### **7.1.1 There is a range of factors that investors can consider in selecting a fund and fund manager**

When making investment decisions, the objective of retail investors is to achieve the highest possible risk-adjusted return after fees. Within this, investors have different goals and needs. For example, a 2017 survey of high-net-worth investors found that the fund investment goal of 25% of investors is to beat inflation, while one-fifth aim to achieve a specific return each year, and 18% want to generate an income in retirement.<sup>368</sup>

Investors cannot know the risk-adjusted return after fees a particular fund will deliver before the fact. Instead, each investor considers a range of factors that might affect the extent to which a given fund might meet their needs.

As discussed in Section 4.1 these include, but are not confined to, past performance on risk-adjusted return after fees.<sup>369</sup> The factors that investors can consider are equivalent to the factors that fund managers compete over. These are:

- fund characteristics
- fund manager characteristics
- historical returns, fees and discounts.

Within each category is an extensive range of considerations (as detailed in Chapter 4). Given the complexities of funds management products, awareness of considerations varies between investors.

Outside these three dimensions, Deloitte Access Economics' analysis suggests that **fund ratings** are a statistically significant predictor of future fund flows (see Box 7.2 below). Research house ratings are constructed as a composite of many of the factors listed in the sections below, so this finding is intuitive. Financial advisers and advisory groups often use ratings to inform APLs and recommendations. This, in turn, shapes retail investor decisions (though anecdotal evidence suggests that most retail investors do not directly engage with fund ratings and research).

This section briefly identifies some of the factors that are most commonly considered by investors when making investment decisions.

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<sup>368</sup> Investment Trends, *Survey Highlights: 2017 Investment Product and Advice Needs Survey* (2017) <[https://www.cromwellpropertygroup.com/\\_\\_data/assets/pdf\\_file/0015/24144/Highlights-from-the-Investment-Trends-2017-Investment-Product-and-Advice-Needs-Survey.pdf](https://www.cromwellpropertygroup.com/__data/assets/pdf_file/0015/24144/Highlights-from-the-Investment-Trends-2017-Investment-Product-and-Advice-Needs-Survey.pdf)>.

<sup>369</sup> This report finds that past performance is not a strong predictor of future performance. For more details, refer to Chapter 8.

#### 7.1.1.1 Fund characteristics

Investors will typically be aware of fund characteristics such as asset class, active and passive investment styles, and listed and traded status.

Investors may attach greater importance to what a fund invests in, as opposed to how it achieves a certain return. For example, retail investors are increasingly making investment decisions based on ethical and 'responsible investment' considerations, reflecting a stronger emphasis on fund objectives. Responsible investing covers a range of investment strategies, such as the use of an environment, social and governance (ESG) framework, where non-financial factors are explicitly accounted for in traditional financial analysis and investment decisions. For example, a growing trend in funds management is the exclusion of sectors related to climate risk and fossil fuels.<sup>370</sup>

Environmental, social and governance objectives are examples of fund characteristics that investors may have strong preferences over but are unaware that funds can be differentiated on this basis. While there are mandatory disclosures around a range of fund characteristics, as discussed in Section 7.2.2, there are some factors such as responsible or sustainable investing that are not mandated in disclosure, although it appears that many investors care about it, and it could influence outcomes. This means that investors may not assess funds against responsible investing, although they would otherwise consider it an important consideration.

As demonstrated in Section 4.2.1.1, product differentiation is an important factor to many investors, as there is an increasing willingness and ability for retail investors to invest in funds that differ from 'traditional managed funds', in particular listed and traded funds. For example, ETFs are increasingly appealing to a broad range of investors and investment strategies. ETF ownership in Australia is skewed towards retail investors, with few wholesale clients opting for this type of product.<sup>371</sup> According to BetaShares, in December 2019, 70% of the 455,000 ETF investors in Australia were self-directed investors, while the remaining 30% were SMSFs.<sup>372</sup> However, although retail investors make up the majority of ETF investors, ETFs still do not represent a majority of retail investor managed funds.<sup>373</sup>

#### 7.1.1.2 Fund manager characteristics

There is evidence that retail investors consider fund manager characteristics in assessing funds.

The **brand and reputation** of the fund manager can be important for retail consumers making investment decisions. Investors are more likely to feel that their investment will be protected and deliver strong returns if they recognise the company name.<sup>374</sup>

Analysis undertaken for this report did not find evidence of a relationship between **fund manager size** and fund flows. However, this does not necessarily imply that fund manager size is not commonly considered by retail investors. Further detail is provided in Appendix D.

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<sup>370</sup> Canstar, *Responsible investment now 47% of the managed funds industry* (18 July, 2016) <<https://www.canstar.com.au/managed-funds/responsible-investment-now-50-of-the-managed-funds-industry/>>.

<sup>371</sup> Morningstar, *Global Investor Experience Study: Fees and Expenses* (17 September 2019) <[https://www.morningstar.com/content/dam/marketing/shared/pdfs/Research/GIE\\_2019\\_v4.5.pdf?utm\\_source=eloqua&utm\\_medium=email&utm\\_campaign=&utm\\_content=18780](https://www.morningstar.com/content/dam/marketing/shared/pdfs/Research/GIE_2019_v4.5.pdf?utm_source=eloqua&utm_medium=email&utm_campaign=&utm_content=18780)>.

<sup>372</sup> BetaShares, *BetaShares / Investment Trends ETF Report* (December 2019) <<https://www.betashares.com.au/insights/betashares-investment-trends-etf-report-2019/>>.

<sup>373</sup> Morningstar, *Global Investor Experience Study: Fees and Expenses* (17 September 2019) <[https://www.morningstar.com/content/dam/marketing/shared/pdfs/Research/GIE\\_2019\\_v4.5.pdf?utm\\_source=eloqua&utm\\_medium=email&utm\\_campaign=&utm\\_content=18780](https://www.morningstar.com/content/dam/marketing/shared/pdfs/Research/GIE_2019_v4.5.pdf?utm_source=eloqua&utm_medium=email&utm_campaign=&utm_content=18780)>.

<sup>374</sup> Walter, Ingo, 'The Global Asset Management Industry: Competitive Structure, Conduct and Performance' (1998) *Department of Finance Working Paper Series 1998*, New York University.

Investors groups such as Millennials, as well as investors more generally, increasingly expect technology-driven interfaces when accessing managed funds, which are convenient, low cost, transparent and tailored to their preferences. Consumers have higher demand for improved service across digital channels and better communications.<sup>375</sup>

### 7.1.1.3 Historical performance, fees and discounts

Retail investors consider **historical returns** to be an important consideration when selecting a fund and fund manager. As indicated in Box 7.2, regression analysis conducted for this report found historical risk-adjusted returns to be an important determinant of fund flows, with a one unit change in the risk-adjusted return (Sharpe ratio) of the previous year increasing fund flows by 1.4%. Although this appears small for such an important metric, this must be considered within appropriate investment horizons and acknowledging that past performance is not an indicator of future performance. Australian evidence from 1991 to 2013, based on net cash flows data, indicates that high historical returns are a strong determinant of investment allocation decisions, while risk factors are not strong influences on investment decisions.<sup>376</sup> Fund managers also noted in consultation that past performance is important to most retail investors.

**Fees** can be a large determinant of investor selection of funds. As discussed in Section 4.3.4.1, investor awareness of, and interest in, fund management fees has increased in recent years. This has contributed to a decline in management fees in the industry. Most retail investors are sensitive to fees, with exceptions being relatively sophisticated investors such as HNWI's who value returns over fees.<sup>377</sup> Consultees also identified that investors consider fees to be a top consideration when comparing funds and that fees are closely scrutinised by investors.

In comparison, **discounts** cannot be a top factor that investors consider when selecting a fund, as discounts are not as transparent to investors as fees. The lack of transparency around discounts suggests that, as investors care about how much they are paying for a service, they may be using the wrong metrics to assess this. In using management fees rather than management fees net of discounts, they may be overestimating fees and this may affect choice of fund and competition between funds.

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<sup>375</sup> Accenture, *High Performance Asset Management* (2015) <[https://www.accenture.com/us-en/~media/Accenture/Conversion-Assets/DotCom/Documents/Global/PDF/Industries\\_5/Accenture-CM-AWAMS-High-Performance-Asset-Management.pdf](https://www.accenture.com/us-en/~media/Accenture/Conversion-Assets/DotCom/Documents/Global/PDF/Industries_5/Accenture-CM-AWAMS-High-Performance-Asset-Management.pdf)>.

<sup>376</sup> Gupta, Rakesh & Jithendranathan, Thadavillil, 'Fund flows and past performance in Australian managed funds' (2012) 25(2) *Accounting Research Journal* 131.

<sup>377</sup> Frost, James, 'Fund managers to appease investors by cutting fees' *Australian Financial Review* (online), 21 January 2019 <<https://www.afr.com/companies/financial-services/fund-managers-to-appease-investors-by-cutting-fees-20190121-h1ab4u>>.



## **Box 7.2: Regression analysis on primary drivers of fund flows**

This report used regression analysis to extract the factors that have the largest impact on net flows. The full results of this regression can be found in Appendix D. This analysis demonstrated the importance of fund ratings in determining flows, with 'highly recommended' and 'recommended' funds respectively attracting an additional 16% and 10% FUM. In addition to ratings, past performance, specifically the prior years' performance, proved to be a significant factor, adding an additional 1% in fund flows for each unit change in the Sharpe ratio.

Branding and reputation were more difficult to account for in regression analysis. The report expects these factors to affect investor decisions, however, the regression analysis required proxy variables to estimate these impacts. The proxies used for branding included the size of the fund in FUM, the number of funds operated by the fund manager and the fund manager's total FUM. However, these variables were not significant in terms of percentage fund flows. This could be due to the correlation between large, reputable funds and higher ratings that remove some of the explanatory power that may otherwise be attributed to size variables.

### **7.1.2 Investors have varied awareness and understanding of factors**

All of the factors discussed above determine, to varying degrees, the extent to which a fund meets investor preferences. Each individual investor will assign different levels of importance to each factor in selecting funds. However, many investors will not be aware of all criteria, perhaps due to the volume of factors that can be considered, and may not know that they are not considering all possible criteria. This distorts investor decision-making if the criteria that investors are unaware of would have otherwise been important in their selection process.

At a minimum, retail investors are likely to be aware of factors presented in marketing and communications material, including disclosure.

The information displayed to investors through these sources is important as this influences their understanding of what criteria they should consider when making choices, as well as what choices are available. For example, in Australia, it is not required that disclosure includes sustainability considerations.<sup>378</sup> As a result, an investor may not consider whether a fund manager is engaged in responsible investing if only comparing PDSs, even though this information might have changed how they selected a fund and fund manager.

However, investors will usually supplement disclosures and marketing material provided by fund managers with a range of other tools and services, such as advisers, comparison websites and news sources (discussed further in Section 7.2.4).

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<sup>378</sup> Morningstar, *Global Investor Experience Study: Regulation and Taxation* (27 April 2020) <<https://www.morningstar.com/lp/global-investor-experience-tax-and-regulation>>.

### **7.1.3 Few retail investors have a good understanding of which funds will best meet their needs**

Even where investors are aware of factors that they could consider, few are confident in which factors they *should* consider, and how to assess funds against these criteria.

Retail investors often:

- have limited understanding of how important various factors are to meeting a particular investment goal
- do not have the capability, time or appetite to examine how each fund performs with respect to factors.

The criteria that investors consider to be most important when selecting a fund and fund manager may not, in practice, be the factors that matter in meeting their investment needs. The complexity of investment markets and products means that developing a good understanding may require specialised knowledge, particularly for active funds. Assessing funds may require information that is not publicly available or is costly to access.

Investor capacity to understand and assess their own preferences, and assess funds against them, will vary with levels of financial knowledge and time and resources to engage with the market. Investors have valid concerns regarding how biases, transaction costs, search costs and a lack of knowledge may lead them to make sub-optimal choices over managed funds.

As a result of these and other considerations, many retail investors engage financial advisers to provide guidance and information to inform choices over funds.

### **Box 7.3: Retail investing and speculation during and after the COVID-19 pandemic**

Despite the economic conditions in 2020 caused by the COVID-19 pandemic, there has been a large increase in self-directed investors. Research from Investment Trends estimates a 34.8% increase in the number of active traders, as a result of an additional 435,000 first time investors in the share market.<sup>379</sup>

With this, there has been concerns from regulators and consumer groups that investors have been lured into chasing a quick profit by playing the market over a short term.<sup>380</sup> Research from ASIC showed that during the recovery in 2020, retail investors were generally mis-timing equity market trades leading to suboptimal and ineffective investment strategies.<sup>381</sup> ASIC has expressed concerns for, and has increased its monitoring of, online chat rooms that encourage speculative behaviour.<sup>382</sup> In January 2021, amid the GameStop short-squeeze in the United States, the proportion of retail trades on the Australian share market peaked at 20%, up from 10% before the COVID-19 outbreak.<sup>383</sup>

Although not as central, similar concerns were raised about the uptake in managed funds during COVID-19, particularly relating to listed products and the lack of diversification.<sup>384</sup>

In consultation, some participants suggested that the Interim Report underestimated the level of sophistication of direct retail investors in managed funds. While evidence was anecdotal, the reasoning behind the argument stemmed from the size and significance of Australia's pension system that largely negates the need for unsophisticated, or disengaged investors to participate in managed funds. Those that choose to are, therefore, likely to have a reasonable degree of sophistication, such as self-managed superannuation funds. Unfortunately, this could not be verified within the scope of this study, since no specific retail investor survey was conducted to determine the extent to which investors engage with and understand the products they invest in.

#### **7.1.4 Advisers consider a range of fund features to assist investors with issues of awareness and understanding**

One reason that investors engage financial advisers is because advisers have greater awareness of the factors that should be considered when selecting a fund and fund manager.

<sup>379</sup> Aleks Vickovich, 'First time traders hit 400,000 during pandemic', (March 2021), Australian Financial Review, <<https://www.afr.com/companies/financial-services/first-time-traders-hit-400-000-during-pandemic-20210311-p579qm>>

<sup>380</sup> ASIC, Retail investors at risk in volatile markets (May 2020) <https://asic.gov.au/about-asic/news-centre/find-a-media-release/2020-releases/20-102mr-retail-investors-at-risk-in-volatile-markets/>

<sup>381</sup> Whyte, Jemima, 'ASIC warns investors against 'playing the market' as losses mount', *Australian Financial Review* (online), 6 May 2020, < <https://www.afr.com/markets/equity-markets/retail-investors-hunt-risk-in-rush-to-trade-asic-20200506-p54q9t>>

<sup>382</sup> CNBC, 'After WallStreetBets frenzy, Australia's securities regulator steps up security of trading forums', 27 April 2021, < <https://www.cnn.com/2021/04/27/australian-regulator-ups-scrutiny-of-trading-forums-after-wallstreetbets.html>>

<sup>383</sup> Ibid.

<sup>384</sup> Whitson, Rhiana, 'ETFs attracting 'corona-generation' investors to share market, but they hold risks', *ABC News* (online), 18 May 2021, < <https://www.abc.net.au/news/2021-05-18/exchange-traded-funds-attracting-new-investors-to-market-but-the/100131442>>

Advisers may consider different factors compared to investors. Advisory groups in consultation indicated that they consider a broader list of fund manager characteristics than retail investors, including:

- sustainability of business: the financial stability of the funds management firm
- governance and ownership structure — board structure, the use of any external parties, and how the firm is run
- investment team and process: key person risk, the quality of personnel and the investment process (how assets are selected and portfolios are developed)
- risk management: independent risk processes and people
- relationships with distributors: the relationship between the business development manager and the adviser as well as the relationship between fund managers and platform providers, as this affects the ability of advisers to use and recommend funds.

Compared to individual investors, advisers have greater expertise and resources, including time, to make decisions about funds. However, it should be noted that they will still be affected by decision-making biases, which may be conscious or unconscious.<sup>385</sup>

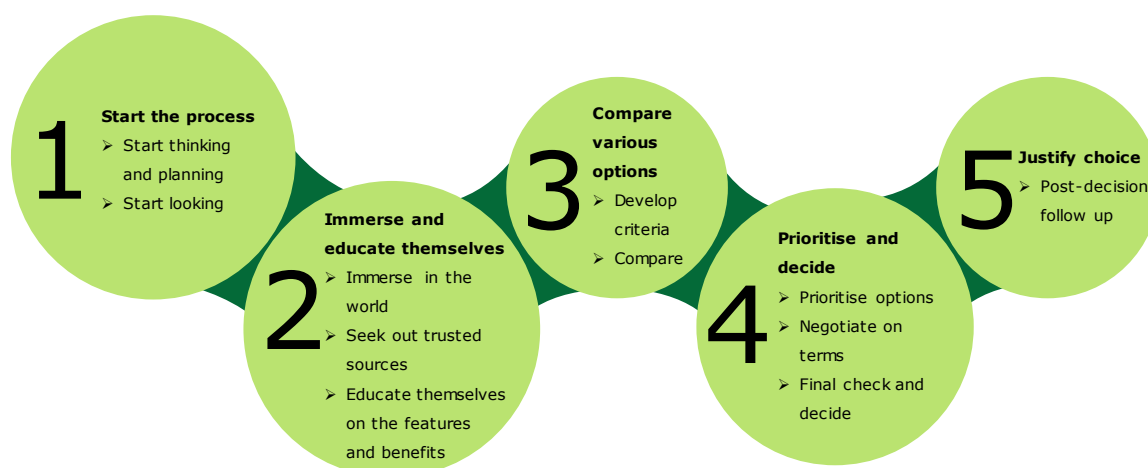
## **7.2 Information transparency and comparability**

Ideally, retail investors follow a structured decision-making process when investing in a managed fund, similar to that in Figure 7.1. This process depends on transparent fund information that allows investors to educate themselves, and comparable information that allows investors to assess one fund against another (steps 2 and 3), to be able to prioritise and decide, and justify choice (steps 4 and 5). Transparency and comparability provide investors with the best chance of effectively assessing and acting on information to make a decision in their best interests. However, even an investor with transparent and comparable information may struggle to interpret it and use it to make decisions. This can be due to a range of factors, including transaction costs and difficulty assessing information.

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<sup>385</sup> Australian Securities & Investments Commission 'Financial advice: Vertically integrated institutions and conflicts of interest' (Report 562, January 2018) <<https://download.asic.gov.au/media/4807789/rep-562-published-04-july-2018.pdf>>.

Figure 7.1: Decision-making process for consumers making decisions around financial products



Source: Deloitte Access Economics (2021) and ASIC (2019).<sup>386</sup>

This section discusses the:

- sources that retail investors use to obtain information on fund features
- features presented on these sources of information
- ability of retail investors to understand, assess and act on this information
- services that investors use to assist in interpreting this information.

### 7.2.1 The intangibility of managed funds creates information problems for investors

Funds management products are characterised by intangibility. It is not possible to 'try before you buy' with funds management services. For example, investors cannot know beforehand precisely what return they will receive from their investment and cannot assess quality ex ante. Managed funds are also intangible because quality is affected by exogenous factors. For example, returns on funds invested depend not only on the quality of the investment manager but also on volatility in financial markets and economic conditions.

The intangibility of managed funds means investors must base their buying decisions on other factors, such as the reputation of the fund manager.

Intangibility typically distinguishes services from goods and creates information problems for investors.<sup>387</sup> Intangibility in the funds management industry, as well as heterogeneity (see following section), may affect the standardisation of service outputs, or the value for money received by the investor.

An industry body, or regulatory body such as ASIC, can lessen the information problems for investors by enforcing standards of conduct and 'ticket to play' qualifications on market participants, both individual practitioners and firms.

### 7.2.2 Retail investors have access to information on managed funds

Financial products including managed funds are associated with a large amount of information, such as costs, benefits, and risks.

<sup>386</sup> Australian Securities & Investments Commission and the Dutch Authority for the Financial Markets 'Disclosure: Why it shouldn't be the default' (Report 632, October 2019) <<https://download.asic.gov.au/media/5303322/rep632-published-14-october-2019.pdf>>.

<sup>387</sup> LC, Britton et al., 'Modify or Extend? The Application of the Structure Conduct Performance Approach to Service Industries' (1992) 12(1) *The Service Industries Journal* 34.

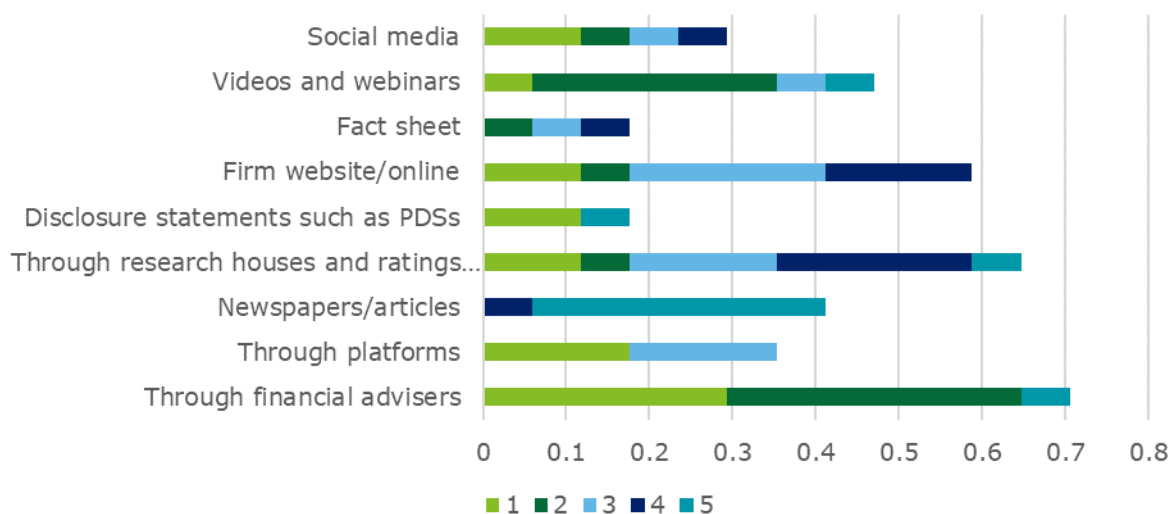
This information is, for the most part, readily available to retail investors via a range of sources:

- fund manager disclosure documents (such as PDSs) directed at potential and current investors
- fund manager websites
- fund manager marketing and advertising
- platforms
- research house fund ratings and research
- fund comparison websites and other media
- financial advisers (see Section 7.2.4).

The fund features that are most commonly presented across these sources are fees and costs, and historical returns. This is likely to affect how retail investors make investment decisions.

Chart 7.1 shows survey responses regarding the most common methods of promoting managed funds to potential retail investors. Respondents were asked to rank methods of promotion from one to five. Acknowledging the low sample size, the chart demonstrates that fund managers principally promote their funds through distributors, particularly financial advisers and research houses, while firm websites and videos and webinars are also common ways of reaching potential investors.

Chart 7.1: Most common methods of fund promotion (% of respondents)



Note: Sample size is 17, reflecting the number of retail managed funds. These funds are held by nine fund managers.

Note: Contents of this chart are found in table form in Appendix F.

Source: Deloitte Access Economics survey (2020).

**Disclosure** laws ensure that people are provided with disclosure in a particular form whether they seek it or not. All fund managers are required to meet regulatory disclosure requirements when promoting and communicating to retail investors.

Disclosure is intended to promote competition by both improving the ability for consumers to make informed investment decisions and allowing industry professionals,

such as financial advisers and research houses, to benchmark and analyse the industry.<sup>388</sup>

Information disclosure is intended to improve consumer decision-making by enabling investors to:

- understand the features of the products they purchase<sup>389</sup>
- compare products based on consistent and transparent metrics.<sup>390</sup>

Disclosure statements must include clear and concise information on the following features:

- fees and costs payable in respect of the product (the fees and costs that must be displayed in PDSs for managed investment products are listed in Section 4.3.1)
- risks of the product, such as if a product is guaranteed
- benefits of the product
- significant characteristics of the product, such as any conflicts of interest.<sup>391</sup>

As noted in Section 7.1.1.1, fund managers in Australia are not required to disclose any sustainability considerations, such as ESG factors. While many fund managers will voluntarily disclose sustainability factors, Australia is lagging many other countries that have introduced ESG-related frameworks in funds management. For example, the European Union's Sustainable Finance Action Plan (SFAP) will formalise consideration of ESG factors in disclosure and investment processes.<sup>392</sup> This report notes, however, concerns of instances in Australia and in other jurisdictions where fund managers have used false environmental credentials ('greenwashing') to mislead and attract investment funds.<sup>393,394,395</sup> In March this year, as part of SFAP, the European Union introduced Sustainable Finance Disclosure Regulation to limit the ability of fund managers to 'greenwash' by requiring a financial service provider to disclose how sustainability issues are reflected at an entity and product level.<sup>396</sup>

Morningstar's 2020 Global Investor Experience Study identified Australia as having the weakest disclosure regime out of 26 countries, due to a lack of ESG disclosure but also no sales, portfolio holdings or stewardship disclosure. Failure to apply a portfolio holdings disclosure regime is unique to Australia within the study.<sup>397</sup>

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<sup>388</sup> Australian Securities & Investments Commission 'Disclosing fees and costs in PDSs and periodic statements' (Regulatory Guide No 97, July 2020) <<https://download.asic.gov.au/media/5700977/rg97-published-24-july-2020.pdf>>.

<sup>389</sup> Australian Securities & Investments Commission 'Disclosure: Product Disclosure Statements (and other disclosure obligations)' (Regulatory Guide No 168, October 2011) <<https://download.asic.gov.au/media/1240931/rg168-published-28-october-2011.pdf>>.

<sup>390</sup> Australian Securities & Investments Commission 'Disclosing fees and costs in PDSs and periodic statements' (Regulatory Guide No 97, July 2020) <<https://download.asic.gov.au/media/5700977/rg97-published-24-july-2020.pdf>>.

<sup>391</sup> Australian Securities & Investments Commission 'Disclosure: Product Disclosure Statements (and other disclosure obligations)' (Regulatory Guide No 168, October 2011) <<https://download.asic.gov.au/media/1240931/rg168-published-28-october-2011.pdf>>.

<sup>392</sup> Morningstar, *Global Investor Experience Study: Regulation and Taxation* (27 April 2020) <<https://www.morningstar.com/lp/global-investor-experience-tax-and-regulation>>.

<sup>393</sup> Stephen Bartholomeusz, "'Greenwashing' is rife as ethical investing dollars roll in" (27 April 2021), <<https://www.smh.com.au/business/markets/green-washing-rife-as-investors-jump-on-the-esg-bandwagon-20210427-p57mr2.html>>

<sup>394</sup> Simon Jessop and Kate Abnett "EU prepares to turn the screw on asset managers over greenwashing", (9 March 2021), Reuters, <<https://www.reuters.com/article/us-europe-regulations-finance-focus-idUSKBN2B11LM>>

<sup>395</sup> Simon Constable, "What is Greenwashing? Here is what you need to know" (8 November 2020), Wall Street Journal, <<https://www.wsj.com/articles/what-is-greenwashing-here-is-what-investors-need-to-know-11604881371>>

<sup>396</sup> KPMG, *SFDR – a snapshot: changes effective from 10 March 2021*, (March 2021), <<https://assets.kpmg/content/dam/kpmg/ie/pdf/2021/03/ie-sustainable-finance-disclosure-reg-sfdr.pdf>>

<sup>397</sup> Morningstar, *Global Investor Experience Study: Disclosure* (14 December 2020).

Fund managers also promote fund features to potential investors through content on **websites**, including comparison tools, videos, monthly reports, fact sheets and articles.

Fund manager websites typically provide information on fund features through a comparison of available funds. These comparisons typically allow investors to search for products based on fund characteristics, including product type, asset class, investment style and listed status. The features of funds that are commonly communicated on fund manager websites include:

- fees — typically the management fee, and sometimes other fees such as the performance fee and entry and exit fees
- past performance — historical returns over various timeframes
- minimum investment requirements
- distribution policies
- what the fund invests in — for example the number of companies or stocks.

Some funds management firms advertise funds with fact sheets and other website content. Fact sheets typically include more detailed information on the fund, for example on what the fund invests in, the investment team, past performance, risks, and the market, while fund managers increasingly promote funds online through videos and graphs describing and highlighting fund features in more detail, such as historical performance.

Apart from disclosure documents and websites, funds also **advertise** their funds via other sources such as newspapers, billboards and social media. Social media advertising allows fund managers to connect to digitally inclined audiences and provides scope to interact with potential customers.<sup>398</sup> Firms are able to digitally gather consumer data and use this to target consumers.<sup>399</sup> Fund managers typically advertise high-level fund features such as past performance and fees, and may selectively present certain features that best market a fund.

To varying extents, **platforms** also communicate fund features to retail investors. The survey conducted for this report indicated that platforms usually display fees and PDSs, but not necessarily research or performance. Some platforms only allow existing investors, and not potential investors to compare funds, and some only provide access to advisers. However, many platforms, particularly larger ones, allow potential investors to search and compare the managed funds that are available on the platform, for example allowing investors to compare performance data, costs and asset allocation, and filter by fund characteristics like asset class (such as on the Netwealth website depicted in Figure 7.2).<sup>400</sup>

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<sup>398</sup> Mardiney, Sarah, *Fund Managers & Advertising: A Millennial's Perspective* Kurtosys (2016) <<https://www.kurtosys.com/blog/2016/04/22/fund-managers-advertising-millennials-perspective/>>.

<sup>399</sup> Australian Securities & Investments Commission and the Dutch Authority for the Financial Markets 'Disclosure: Why it shouldn't be the default' (Report 632, October 2019) <<https://download.asic.gov.au/media/5303322/rep632-published-14-october-2019.pdf>>.

<sup>400</sup> Netwealth, *Compare Funds and Models* (2020) <<https://netwealth.com.au/nw/Fund/CompareFundsAndModels>>.



Figure 7.2: Netwealth search and comparison tool for managed funds

**Search**

Keyword...

**Filter** [Clear all](#)

**Lists**

- ☒ Approved for Super
- ☒ Approved for Wrap
- ☐ Investor rewards

**Investment Type**

- ☒ Managed Funds
- ☒ Managed Models

**Investment Category**

- ☐ Alternative Investment
- ☐ Australian Equities - General
- ☐ Australian Equities - Specialist
- ☐ Australian Fixed Interest
- ☐ Australian Property
- ☐ Cash
- ☐ International Equities
- ☐ International Equities - Specialist

**Sub-Category**

**Manager**

**1 Year Performance**

**Details | Performance | Commentary by 1Yr Performance**

[Compare](#) [Export](#) Clear selection 585 assets displayed

<input type="checkbox"/>	NAME • CODE	MANAGER • CATEGORY • SIZE • COST	VIDEO	SUB-CATEGORY	INFO
<input type="checkbox"/>	Baillie Gifford Long Term Global Growth... FSF5774AU	Colonial First State International Equities - Specialist \$26m • 1.13%		Equity World Large Growth	...
<input type="checkbox"/>	Nikko AM ARK Global Disruptive Innovati... NIK1854AU	Nikko AM International Equities - Specialist \$49.45m • 1.35%		Equity World Large Blend	...
<input type="checkbox"/>	Lakehouse Global Growth Fund OMF1140AU	Lakehouse Capital International Equities - Specialist \$185.69m • 3.34%		Equity World Large Growth	...
<input type="checkbox"/>	Loftus Peak Global Disruption Fund MMC0110AU	Equity Trustees International Equities \$79.34m • 1.48%		Equity World Large Growth	...
<input type="checkbox"/>	Franklin Global Growth Fund W Class FRT0009AU	Franklin Templeton International Equities \$295.56m • 1.13%		Equity World Large Growth	...
<input type="checkbox"/>	Franklin Concentrated Global Equity ex-... MACC000177	Franklin Templeton International Equities \$0m • 0.941%			...
<input type="checkbox"/>	Ophir Global Opportunities Fund OPH2093AU	Ophir Asset Management International Equities - Specialist \$0m •		Equity World Mid/Small	...
<input type="checkbox"/>	AMP Capital Global	AMP			

Source: Netwealth (2020).<sup>401</sup>

Platforms may also provide potential investors with links to more information including PDSs, fact sheets and fund or fund manager profiles, and sometimes summarise the managed funds available on their software by publishing their approved product list of funds. However, the latter does not readily allow potential investors to effectively compare managed funds relative to searching and comparison tools.

**Fund comparison websites and research houses** also provide readily accessible information on managed funds to retail investors, allowing them to compare fund features. Financial comparison websites such as Canstar and research houses allow potential investors to search for funds based on asset class and minimum investment amount, and compare funds based on metrics including performance, costs, distribution and operation. Research houses and some comparison websites also produce ratings and recommendations on the quality of funds.

These sources compare a wider range of funds than fund websites or platforms, providing investors access to more information. However, investors may assume that these sites cover the entire market, when they will only cover some of the available products and providers in funds management (see Section 6.4 on how the business models of research houses affect the types and quantity of funds that are rated).<sup>402</sup>

<sup>401</sup> Netwealth, *Compare Funds and Models* (2020)

<<https://netwealth.com.au/nw/Fund/CompareFundsAndModels>>.

<sup>402</sup> MoneySmart, *Using comparison websites* <<https://moneysmart.gov.au/using-comparison-websites>>.

### 7.2.3 Retail investors have limited capability to assess and act on information provided

Despite the amount of information available on managed funds, retail investors often struggle to understand, assess and act on this information. This can be due to the complexity of financial products, the volume of information and choice and the way information is presented. Investor capability to assess and act on information appears to be a larger constraint to investor engagement than information asymmetries.

Investor disengagement may allow fund managers to exercise market power, as highly disengaged investors are unlikely to actively search and switch. For example, disengaged consumers in the electricity market have allowed incumbents to retain high-priced products.<sup>403</sup> However, unlike electricity, funds management is not an essential product. There are a range of substitutes to managed funds that investors can choose from. This limits the extent to which fund managers can exercise market power even where investors are disengaged as retail investors have alternative assets they can invest in and many are also likely to receive advice from financial advisers.

One issue which has arisen in recent years is that the threshold for being considered a sophisticated investor has not been indexed over time. This issue is discussed in Box 7.4 below.

#### Box 7.4: Retail investor definition

Under the *Corporations Act 2001*, an investor can classify as a wholesale investor if their annual income exceeds \$250,000 or their net assets exceed \$2.5 million.<sup>404</sup> In 2020, the Australian Financial Complaints Authority expressed concerns that financial advisers are classifying an increasing numbers of unsophisticated, but wealthy, investors as wholesale as a result of these current thresholds.<sup>405</sup> This classification may reduce the extent of disclosure and safeguards provided to these investors.

This section discusses the ability of retail investors to assess and act on information provided to them, particularly through disclosure.

#### 7.2.3.1 It is difficult for retail investors to assess information

Managed funds, like other financial products, are often **complex** and difficult for consumers to understand. Funds have complex operational and investment structures, such that consumers may not fully comprehend the features of the products being sold to them and have difficulties differentiating between, and making decisions over, various products.<sup>406</sup> This cannot easily be solved by disclosure, as simplifying complicated products does not reduce their underlying complexity.<sup>407</sup> It is now legislated that new financial advisers must have tertiary qualifications to operate under the new FASEA

<sup>403</sup> Australian Competition and Consumer Commission 'Restoring electricity affordability and Australia's competitive advantage: Retail Electricity Pricing Inquiry—Final Report' (June 2018) <[https://www.accc.gov.au/system/files/Retail%20Electricity%20Pricing%20Inquiry%E2%80%94Final%20Report%20June%202018\\_Exec%20summary.pdf](https://www.accc.gov.au/system/files/Retail%20Electricity%20Pricing%20Inquiry%E2%80%94Final%20Report%20June%202018_Exec%20summary.pdf)>.

<sup>404</sup> Australian Securities & Investments Commission, "Certificates issued by a qualified accountant" (March 2006), <<https://asic.gov.au/regulatory-resources/financial-services/financial-product-disclosure/certificates-issued-by-a-qualified-accountant/>>

<sup>405</sup> John Kehoe and Aleks Vickovich, "Misclassifying sophisticated investors 'widespread'" (March 2020), Australian Financial Review < <https://www.afr.com/wealth/investing/misclassifying-sophisticated-investors-widespread-20200226-p544ie>>

<sup>406</sup> Susan Bell Research, *Consumer testing of the fees and costs tools for superannuation and managed investment schemes* (report commissioned by ASIC, 2019) <<https://download.asic.gov.au/media/5381781/rep638-published-29-november-2019.pdf>>.

<sup>407</sup> Australian Securities & Investments Commission and the Dutch Authority for the Financial Markets 'Disclosure: Why it shouldn't be the default' (Report 632, October 2019) <<https://download.asic.gov.au/media/5303322/rep632-published-14-october-2019.pdf>>.

education and Code of Ethics regime, evidencing the complexity of the industry in that a degree is needed to advise on it.<sup>408</sup>

For example, it is difficult for consumers to understand features of managed funds including:

- terminology such as switching (between options), transaction costs and the buy-sell spread
- multi-part numeric expressions, for example percentages mixed with dollar amounts and expressions presented over different timeframes
- percentages to express fee charges.<sup>409</sup>

This is not unique to managed funds. Investors experience similar difficulties in assessing information in other financial products. A survey of superannuation members found that nearly 60% of respondents do not understand their fees and charges.<sup>410</sup>

**Fund naming conventions, fund objectives and benchmarking** in the industry can add to this complexity. As discussed in Section 4.2.2.5, fund managers and distribution teams typically nominate the name of a fund, including asset allocation, as well as the fund objective and performance benchmark.

There are no formal regulatory definitions or requirements which govern how fund managers describe their fund. This means that, for example, a product might be described as 'property equities', when in fact its asset allocation is predominantly government bonds. This has led to concerns that managers have labelled products in a way that is misleading to investors.

A lack of transparency around the classification of exchange-traded products (ETPs) has also led to concerns that retail investors cannot easily compare and assess ETPs, for example with investors incorrectly considering all ETPs to be ETFs. Large ETP issuers in the US have argued for classification reform that would separate ETPs into four separate categories, to assist investors in making informed decisions on ETPs.<sup>411</sup> In contrast, analysis conducted for this report finds that funds labelled as 'active' and 'passive' are not being widely misclassified (see Section 8.1.2).

Fund objectives can allow investors to gauge the expected return of a fund. Benchmarks assist with measuring and tracking performance, ideally improving the ability of investors to assess and compare funds.<sup>412</sup> However, the choice of objective and benchmark is not governed by regulation or legislation, enabling fund managers to select objectives and benchmarks that best represent a fund. Selective and inconsistent use of objectives and benchmarks can therefore distort decision-making, as well as lead to financial harm for investors.

Relatedly, investors may struggle to assess fund manager advertising due to **incomplete or misleading information**. Fund managers use advertising to influence investors' preferences and decisions, communicating fund features in a way that will make them appear most favourable to investors. For example, advertisements which

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<sup>408</sup> Financial Adviser Standards and Ethics Authority, *Education Standard commenced 1 January 2019* <<https://www.fasea.gov.au/education-requirements/>>.

<sup>409</sup> Susan Bell Research, *Consumer testing of the fees and costs tools for superannuation and managed investment schemes* (report commissioned by Australian Securities & Investments Commission, 2019) <<https://download.asic.gov.au/media/5381781/rep638-published-29-november-2019.pdf>>.

<sup>410</sup> Productivity Commission 'Superannuation: Assessing Efficiency and Competitiveness' (Inquiry Report No 91, 21 December 2018) <<https://www.pc.gov.au/inquiries/completed/superannuation/assessment/report/superannuation-assessment.pdf>>.

<sup>411</sup> Selby, Ally, 'Global ETF leaders push for reform' *Financial Standard* (online), 5 June 2020 <<https://www.financialstandard.com.au/news/global-etf-leaders-push-for-reform-165316373>>.

<sup>412</sup> Selby, Ally, 'Calls for index industry disruption' *Financial Standard* (online), 22 June 2020 <<https://www.financialstandard.com.au/news/calls-for-index-industry-disruption-166677282>>.

target fund performance in market upturns capture the typical investor sentiment to overemphasise favourable past performance.<sup>413</sup> Evidence suggests that fund manager marketing materials are not always representative of underlying funds, for example, with fund managers placing greater emphasis on features that are attractive to investors such as high returns, compared to other factors such as risk.<sup>414</sup>

While acknowledging that this can and does occur, fund managers indicated that representation of funds is already covered within existing legislation and it is illegal for fund managers to intentionally misrepresent their product. Despite this, the Australian Financial Complaints Authority found that the most common complaint made regarding investments (including managed funds) in the year to 30 June 2020 was 'misleading product/service information'.<sup>415</sup>

This is likely to particularly impact the listed space where consumers are less likely, or are not required, to seek intermediation. In this case, consumers of financial products may be influenced by the quantity of advertisements rather than the content. Investors who constantly see advertising are also less likely to rely on disclosure to make decisions.<sup>416</sup> Again, fund managers acknowledged that advertising was a significant contributor to brand power which may foster investor confidence, however, they argued that this does not necessarily constitute false differentiation. One fund manager in consultation did not agree with this, instead suggesting that average or poor performance can be overcome by large advertising budgets.

Investors may also find it difficult to compare funds if fund features are **inconsistently presented** across different sources. Evidence on the consistency of information presentation is mixed:

- research ratings: comparability across different research houses can be difficult due to the range of ratings systems employed, such as star ratings, rankings, and buy/sell recommendations<sup>417</sup>
- performance metrics: these are often presented on fund websites and ratings sites to compare funds, but are presented over different timeframes across different sources, and some may be risk-adjusted or net of fees while others are not
- performance fees: Morningstar's Global Investor Experience Study indicated that the terms of performance fees, for example conditions under which they are applied, are clearly stated to investors in disclosure in Australia, with the ICR allowing investors to estimate costs for the current year and past year.<sup>418</sup> However, the ICR will no longer be required in PDSs under RG97.
- management and performance fees: many consultees noted that fee and cost transparency and comparability has improved in recent years, and that retail investors receive detailed and transparent fee and cost information through PDSs and Statements of Advice.

The large number of funds available to consumers can lead to **choice overload**, which in turn can impede decision-making. While variety and choice are valuable features of

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<sup>413</sup> Haslem, John A., 'Mutual Funds and Investor Choice: 'Paths to the Wizards of Advertising and Overconfidence'' (2010) 16 (6) *SSRN Electric Journal* 42.

<sup>414</sup> Sood, Kanika, 'ASIC warns funds to clean up adverts', *Financial Standard* (online), 16 June 2020 <<https://www.financialstandard.com.au/news/asic-warns-funds-to-clean-up-adverts-166080566>>.

<sup>415</sup> Australian Financial Complaints Authority, *AFCA Snapshot – 1 July 2019 to 30 June 2020* (2020) <<https://www.afca.org.au/media/967/download>>.

<sup>416</sup> Australian Securities & Investments Commission and the Dutch Authority for the Financial Markets 'Disclosure: Why it shouldn't be the default' (Report 632, October 2019) <<https://download.asic.gov.au/media/5303322/rep632-published-14-october-2019.pdf>>.

<sup>417</sup> Australian Securities & Investments Commission and Treasury 'Review of credit rating agencies and research houses' (Report No 143, October 2008) <<https://download.asic.gov.au/media/1343114/rep143.pdf>>.

<sup>418</sup> Morningstar, *Global Investor Experience Study: Fees and Expenses* (17 September 2019) <[https://www.morningstar.com/content/dam/marketing/shared/pdfs/Research/GIE\\_2019\\_v4.5.pdf?utm\\_source=eloqua&utm\\_medium=email&utm\\_campaign=&utm\\_content=18780](https://www.morningstar.com/content/dam/marketing/shared/pdfs/Research/GIE_2019_v4.5.pdf?utm_source=eloqua&utm_medium=email&utm_campaign=&utm_content=18780)>.

competitive markets, choice overload can overwhelm consumers and lead them to make decisions based on only one or two product features or take no action.<sup>419</sup> Choice overload may also prevent investors from making comparisons, due to the high associated transaction costs.<sup>420</sup>

Similarly, investors are likely to experience **information overload**, both in the number of information sources and the pieces of information presented to them, which can be overwhelming and affect decision-making.<sup>421</sup> Even educated people make suboptimal decisions about complex products, particularly when comparing between products with two or three product attributes.<sup>422</sup>

More appropriately targeted advertising could assist with these issues. The implementation of the Design and Distribution Obligations, set to commence on 5 October 2021, will require product issuers to identify a target market for their products and design products that are appropriate for these markets and optimise consumer outcomes.<sup>423</sup> These obligations may help to ensure that fund manager marketing is less misleading for investors.

Poor **financial literacy** can contribute to the difficulties in understanding complex financial products. There is evidence that many consumers struggle with financial concepts, for example an ASIC survey found that the trade-off between risk and return is understood by less than one in three Australians.<sup>424</sup> However, consultants noted that the majority of retail investors are advised and also suggested that investors in managed funds have relatively higher levels of financial literacy than the average Australian. Future research could explore financial literacy specific to investment products by conducting a detailed retail investor survey (out of scope for this report).

### 7.2.3.2 This affects investors' ability to use information to inform decisions

As retail investors are constrained in assessing the information provided to them, they are less able to effectively act on information to choose the best value product for them.

Broadly, when consumers are faced with complex decisions regarding financial products, **behavioural biases** affect their decision-making.

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<sup>419</sup> Productivity Commission 'Competition in the Australian Financial System' (Inquiry Report No 89, 29 June 2018) <<https://www.pc.gov.au/inquiries/completed/financial-system/report/financial-system.pdf>>.

<sup>420</sup> Productivity Commission 'Superannuation: Assessing Efficiency and Competitiveness' (Inquiry Report No 91, 21 December 2018) <<https://www.pc.gov.au/inquiries/completed/superannuation/assessment/report/superannuation-assessment.pdf>>.

<sup>421</sup> Susan Bell Research, *Consumer testing of the fees and costs tools for superannuation and managed investment schemes* (report commissioned by Australian Securities & Investments Commission, 2019) <<https://download.asic.gov.au/media/5381781/rep638-published-29-november-2019.pdf>>.

<sup>422</sup> Australian Securities & Investments Commission and the Dutch Authority for the Financial Markets 'Disclosure: Why it shouldn't be the default' (Report 632, October 2019) <<https://download.asic.gov.au/media/5303322/rep632-published-14-october-2019.pdf>>.

<sup>423</sup> Australian Securities & Investments Commission 'Product design and distribution obligations' (Consultation Paper 325, March 2020) <<https://download.asic.gov.au/media/5423121/cp325-published-19-december-2019.pdf>>.

<sup>424</sup> Susan Bell Research, *Consumer testing of the fees and costs tools for superannuation and managed investment schemes* (report commissioned by Australian Securities & Investments Commission, 2019) <<https://download.asic.gov.au/media/5381781/rep638-published-29-november-2019.pdf>>.

Investors use a range of heuristics and strategies to simplify decision-making:

- shortcuts such as framing, where the way a product is presented influences a consumer's likelihood of purchasing it
- preferences influenced by emotions and psychological experiences such as present bias, where products are bought to fulfil short-term needs rather than based on the long-term financial impact of the product
- rules of thumb such as over-extrapolation, where a few years of investment returns are extrapolated to the future.<sup>425</sup>

These biases lead to imperfect decision-making, with investors failing to act in their own best interests as they are not accounting for all relevant information. For example, consumers may be over reliant on the advice of friends and family or only consider a selection of available products.<sup>426</sup>

Behavioural biases may affect not just an investor's selection of fund and fund manager, but also their ability to assess whether they should exit a fund. For example, inertia related to an inability to assess information may prevent an investor from leaving an underperforming fund (the issue of persistent underperformance is discussed in detail in Section 8.2.4). Low levels of retail investor engagement may also prevent an investor from exiting an underperforming 'legacy' fund — a fund with a relatively low amount of FUM that is typically not open to new investors.<sup>427</sup> Some legacy funds have been found to be poor performing while charging higher than average fees, while it is also uneconomical for fund managers to maintain them.<sup>428</sup> Investors failing to switch out of legacy funds may be reflective of exclusionary behaviour of fund managers. Issues with legacy funds — or 'zombie' funds, which fail to attract the investment needed to breakeven — has caused regulators in other countries to encourage fund managers to close 'subscale' funds.<sup>429</sup>

The complexity of products and difficulty interpreting information presented in **disclosure** documents means that they are not widely used to make investment decisions. An analysis of six quantitative research studies across a range of financial products found that only 20% of consumers read or used mandated disclosure and/or information.<sup>430</sup> Research on product dashboards for superannuation products found only 5% used all or almost all of the information provided to make decisions.<sup>431</sup> Consultees similarly indicated that investors rarely read PDSs, relying instead on advisers.

Disclosure documents are intended to ensure that funds are presented comparably to investors. However, other sources of information including fund manager websites and advertising will present some fund features and not others, and present them differently to other sources. If retail investors are not using disclosure to make decisions, this means they may rely on inconsistent and commercially-driven communications of fund features, which could distort decision-making.

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<sup>425</sup> Productivity Commission 'Competition in the Australian Financial System' (Inquiry Report No 89, 29 June 2018) <<https://www.pc.gov.au/inquiries/completed/financial-system/report/financial-system.pdf>>.

<sup>426</sup> Productivity Commission 'Competition in the Australian Financial System' (Inquiry Report No 89, 29 June 2018) <<https://www.pc.gov.au/inquiries/completed/financial-system/report/financial-system.pdf>>.

<sup>427</sup> Money Management, *Few managers justify higher than average fees* (2018) <<https://www.moneymanagement.com.au/features/few-managers-justify-higher-average-fees>>.

<sup>428</sup> Money Management, *Few managers justify higher than average fees* (2018) <<https://www.moneymanagement.com.au/features/few-managers-justify-higher-average-fees>>.

<sup>429</sup> Riding, Siobhan, 'More than €1tn of investor money is stuck in 'zombie' funds' *Financial Times* (online), 10 February 2020 <<https://www.ft.com/content/a99ef2f9-acfe-4e3b-baec-fc6bf6784cd7>>.

<sup>430</sup> Australian Securities & Investments Commission and the Dutch Authority for the Financial Markets 'Disclosure: Why it shouldn't be the default' (Report 632, October 2019) <<https://download.asic.gov.au/media/5303322/rep632-published-14-october-2019.pdf>>.

<sup>431</sup> Australian Securities & Investments Commission and the Dutch Authority for the Financial Markets 'Disclosure: Why it shouldn't be the default' (Report 632, October 2019) <<https://download.asic.gov.au/media/5303322/rep632-published-14-october-2019.pdf>>.

Industry acknowledged that the process of assessing funds is complex for the average retail investor. The common view among managers consulted for this report was that the focus should not be on reducing complexity, rather improving comparability. In most conversations, this took the form of a fund comparison website, such as that seen in superannuation. Participants were sceptical of its practicality given the reliance on research houses, who already provide a form of this comparison at a cost to subscribers.

### **7.2.3.3 Investors need to use intermediaries to act on information**

Regardless of an investor's ability to assess fund information, an investor should ideally be able to *act* on information by investing in the fund and fund manager of their choice. However, in practice, even a very informed investor will have limited capacity to act on information, because buying and selling managed funds for retail investors generally requires access to intermediaries.

Retail investors can directly invest in managed funds; however, this can be a time consuming and difficult process for the typical retail investor, since many unlisted funds will not deal with retail clients directly. As a result, retail investors will mostly use platforms to buy and sell managed funds, with advisers generally undertaking the transactions on behalf of their clients. These intermediaries notionally reduce transaction costs for investors. The best interests duty should mean that advisers account for the preferences and needs of investors, including any assessments investors make of various funds and fund managers, but ultimately it will be advisers who practically invest retail investors' money in certain funds, through platforms.

There are some exceptions to this, as indicated at the start of the chapter. Technological advancements and innovation in the distribution of funds has provided opportunities for retail investors to invest in managed funds without the use of intermediaries, for example through an exchange. However, while this is potentially a growth area, the majority of retail investors are still not directly acting on fund information, but indirectly doing so through intermediaries.

### **7.2.4 Services assist retail investors to interpret and act on information**

There is a range of services available to assist retail investors in interpreting and acting on managed fund information. As noted in the previous section, while investors are not obliged to use intermediaries to access managed funds, in practice it is rare that retail investors invest in the market directly. Investors can use platforms, ratings services and financial advisers to obtain and assess funds information.

In practice, retail investors' direct use of **platforms and ratings services** is limited. While retail investors can access information via a platform, most investors will only access platforms through their financial adviser.<sup>432</sup> Similarly, while research houses allow retail investors to access fund information and comparisons, consultees indicated that investors rarely use ratings research directly.<sup>433</sup> This can be because it is difficult for investors to use these services, for example, as some platforms do not allow new investors to access their fund information, or because investors pay advisers to access these services on their behalf, for example most investors access ratings through their advisers.

**Advisers** play a key role in assisting retail investors to assess and choose managed fund products. The relationship between the adviser and investor is best described as a principal-agent relationship, where the adviser is an agent who is acting on behalf of the investor, or principal (see Section 4.4.6 for a definition of a principal-agent relationship).

<sup>432</sup> Productivity Commission 'Competition in the Australian Financial System' (Inquiry Report No 89, 29 June 2018) <<https://www.pc.gov.au/inquiries/completed/financial-system/report/financial-system.pdf>>.

<sup>433</sup> Australian Securities & Investments Commission and Treasury 'Review of credit rating agencies and research houses' (Report No 143, October 2008) <<https://download.asic.gov.au/media/1343114/rep143.pdf>>.

The best interests duty should ensure that advisers prioritise the interests of their clients over their own when providing advice.<sup>434</sup>

However, this dynamic can create principal-agent problems as the investor cannot be assured that the adviser is acting in their best interests.<sup>435</sup> Research indicates that investors are unable to determine whether advisers are recommending appropriate products for them, creating information asymmetry. For example, a survey found that while 86% of consumers rated their financial advice as good and 81% trusted the advice 'a lot', an assessment of the quality of advice of financial cases indicated that only 3% were good, 58% were adequate, and 39% were poor.<sup>436</sup>

Consultees noted the importance of advisers to the industry, and the negative implications of regulations that have reduced the number of advisers in Australia, in leading to higher cost advice that is increasingly inaccessible for low-income investors who need it most.

Investors do not have to use advisers. However, despite the potential limitations of advice, retail investors typically do not have the time, resources and skills to individually effectively assess and act on funds information. Financial advisers provide value in helping investors navigate some of the issues discussed in Section 7.2.3. Advisers:

- make more information available to investors (see Section 7.1.4)
- recommend products that investors cannot find on their own
- provide expertise in financial matters
- notify clients of detailed fund terms and conditions and other information.<sup>437</sup>

Institutional investors are also assisted by investment consultants, improving the institution's ability to compare and assess funds by undertaking independent research. This dynamic is distinctly different to that between retail investors and advisers. Institutions have considerably more resources at hand to investigate investment options, evident in that many conduct their own in-house research, while retail investors rely significantly more on financial advisers to assist in their selection and monitoring of funds.

### 7.3 Transaction costs

Economic transaction costs, including the time, cost and/or difficulty associated with buying or changing products, reduce the ability of investors to engage with managed funds. This is because high transaction costs create less capacity to engage or ensure that there is less benefit associated with engaging.

Transaction costs also detract from switching. While switching in and out of funds is easy, transaction costs make consumers more 'sticky' by detracting from consumers' ability to credibly threaten to switch, and discouraging actual switching (the relationship between switching and competition is discussed in Box 7.5 below).

Through these effects, transaction costs detract from competition and consumer outcomes. High transaction costs prevent consumers from moving out of funds that are no longer in their best interests and from moving into funds that are better value. With some investments in managed funds held for a long time, the best product for an investor is likely to change over time, such that high costs associated with withdrawing

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<sup>434</sup> Australian Securities & Investments Commission 'Future of Financial Advice: Best interests duty and related obligations' (Regulation Impact Statement, December 2012) <<http://download.asic.gov.au/media/2125918/rg175-ris.pdf>>.

<sup>435</sup> The CFA Institute Research Foundation, *The Principal-Agent Problem in Finance* (2014) <<https://www.cfainstitute.org/-/media/documents/book/rf-lit-review/2014/rflr-v9-n1-1-pdf.ashx>>.

<sup>436</sup> Productivity Commission 'Competition in the Australian Financial System' (Inquiry Report No 89, 29 June 2018) <<https://www.pc.gov.au/inquiries/completed/financial-system/report/financial-system.pdf>>.

<sup>437</sup> Australian Securities & Investments Commission 'Financial advice: What consumers really think' (Report 627, August 2019) <<https://download.asic.gov.au/media/5243978/rep627-published-26-august-2019.pdf>>.



from a fund can be particularly problematic for investors. Transaction costs reduce competition by preventing investors from exerting demand-side pressure on fund managers, and discouraging innovation.

### **Box 7.5: Switching in a competitive market**

Switching can enable individuals to move between products when this best suits their needs, forcing firms to ensure that they are providing value for their customers.<sup>438</sup>

However, it is not only the level of switching that is important for effective competition, but the ability to switch. A credible threat of switching supports consumer outcomes but also encourages suppliers to compete with one another over price and quality, to retain customers that are able to switch to another provider with a superior product. Research from the banking industry shows that if consumers threaten to switch, their bank will offer better service or a better deal, indicating the importance of switching for competition.<sup>439</sup>

Barriers to transacting can reduce switching, thereby impeding competition and preventing consumers from moving to the best value product for their circumstances.

While high switching rates can represent high levels of consumer engagement, it should not be interpreted in isolation. For example, managed funds investments are intended to be held over a suitable investment period to allow for market fluctuations. Significant churn could indicate speculative behaviour with adverse outcomes for investors. A lack of switching can be interpreted in some markets as an indicator of satisfaction.

These considerations highlight the importance that the presence of a credible threat to switching is established, not only that switching occurs.

#### **7.3.1 There is limited evidence of retail investor transaction behaviour**

Investors will withdraw from a fund, enter a new fund, or switch from one fund to another if the expected benefits of doing so exceed the expected costs. For example, a retail investor might switch out of a fund if another fund has:

- a better price (lower fees and costs)
- better historical returns
- more favourable fund characteristics
- more favourable fund manager characteristics.<sup>440</sup>

Evidence from the financial services sector more broadly found that consumers often do not search for a better alternative once they have chosen a product, due to the range of monetary and non-monetary costs associated with exiting one product and entering into another. This makes financial products 'sticky' as switching rates tend to be relatively low.<sup>441</sup>

<sup>438</sup> Productivity Commission 'Competition in the Australian Financial System' (Inquiry Report No 89, 29 June 2018) <<https://www.pc.gov.au/inquiries/completed/financial-system/report/financial-system.pdf>>.

<sup>439</sup> Deloitte Access Economics, *Consumer choice in banking* (report commissioned by the Australian Banking Association, 2019) <<https://www.ausbanking.org.au/wp-content/uploads/2019/10/Deloitte-Choice-in-Banking-2019-Report.pdf>>.

<sup>440</sup> Productivity Commission 'Competition in the Australian Financial System' (Inquiry Report No 89, 29 June 2018) <<https://www.pc.gov.au/inquiries/completed/financial-system/report/financial-system.pdf>>.

<sup>441</sup> Productivity Commission 'Competition in the Australian Financial System' (Inquiry Report No 89, 29 June 2018) <<https://www.pc.gov.au/inquiries/completed/financial-system/report/financial-system.pdf>>.

A 2019 survey of more than 25,000 global investors examined how often investors alter their investments and found that despite experts recommending that investments are held for around five years, the average holding period for investments (excluding pensions and property) is 2.6 years, and 2.7 years in Australia.<sup>442</sup> This is significantly lower than other advanced economies such as Japan (4.5 years), the USA (4.2 years) and Canada (4.1 years), indicating that Australian investors switch investment products relatively frequently. This could be an indicator of low transaction costs, if investors are moving in and out of funds with relative frequency. However, this could also be reflective of the investment products that are popular in Australia (which may be more suited to being held for less time, for example products invested in liquid assets or traded products), or of the relative impatience of Australian investors.<sup>443</sup>

Analysis of fund inflows and outflows was conducted for this report to consider the extent to which retail investors invest in, and withdraw from, managed funds. Chart 7.2 depicts fund inflows and outflows as a percentage of FUM from a random sample of fund manager groups across quintiles.<sup>444</sup> Each bar represents the inflow or outflow of an individual fund manager in 2019. Fund inflows across the whole sample of 134 fund manager groups were, on average, 24% of FUM from 2018, with more consistent inflows appearing for funds in the highest quintiles. On average, fund outflows in 2019 were 23% of FUM from 2018 and are relatively consistent across quintiles. This report also notes that this analysis does not identify instances where a retail investor might switch between two funds operated by the same RE.

Chart 7.2: Fund inflows (1) and outflows (2) as a percentage of FUM by quintile (2019)



Note: For visualisation, charts are based off a sample of randomly selected funds across quintiles. Numbers inside circles represent quintile of funds under management from largest (5) to smallest (1). Percentage of FUM calculated using current year flows over previous years FUM.

Note: Contents of the Chart are discussed in the paragraph above in Section 7.3.1.

Source: Deloitte Access Economics (2021) and Plan For Life (2020).

The extent of fund inflows and outflows provides some evidence that investors are able to transact in the market for managed funds. The outflows data in particular suggests that it is relatively common and possible for investors to exit funds. However, it is important to note that this analysis cannot differentiate flows between retail and

<sup>442</sup> Schroders, *Global Investor Study* (2019) <[https://www.schroders.com/en/sysglobalassets/\\_global-shared-blocks/gis-2019/theme-1/global\\_investor\\_study\\_2019\\_t1.pdf](https://www.schroders.com/en/sysglobalassets/_global-shared-blocks/gis-2019/theme-1/global_investor_study_2019_t1.pdf)>.

<sup>443</sup> Schroders, *Global Investor Study* (2019) <[https://www.schroders.com/en/sysglobalassets/\\_global-shared-blocks/gis-2019/theme-1/global\\_investor\\_study\\_2019\\_t1.pdf](https://www.schroders.com/en/sysglobalassets/_global-shared-blocks/gis-2019/theme-1/global_investor_study_2019_t1.pdf)>.

<sup>444</sup> Fund manager groups can represent multiple fund managers.

wholesale investors. Therefore, it is not possible with this data to definitively show the extent of retail switching, since it is possible that these flows represent wholesale investors that account for the majority of FUM.

To further assess the extent to which transacting occurs, econometric analysis (described in Appendix D) also examined the impact of a change in fund rating on net flows. If switching is an option for consumers, it could be expected that investors are sensitive to fund ratings and move funds according to a significant change in the opinion of a fund. This analysis showed that, in the current year, an upgrade in the rating variable on average contributes an additional 12.6% in flows. Similarly, a downgrade in the same period results in an outflow of 9.2%. The effect of both an upgrade and a downgrade is preserved when the rating change variable is lagged.

These results suggest that transacting is relatively prevalent in the retail market. However, they do not illustrate how frequently retail investors in particular change funds.

### 7.3.2 Barriers to transacting restrict retail investor movement in and out of funds

Theoretically, it is easy for a retail investor to transact in the funds management industry, simply by redeeming units in one fund, or investing in another. However, retail investors may be unmotivated to exit a fund or switch to another due to actual and perceived barriers to transacting. Barriers to transacting in funds management can include:

- switching costs — one-time costs incurred in exiting a fund and/or investing in a new fund
- regulatory or 'red tape' barriers — required processes or fees that reduce the attractiveness of investing in a fund or switching funds, for example excessive paperwork
- consumer effort in redirecting recurring payments
- structural restrictions on redemptions
- behavioural barriers — for example, consumers perceive the switching process to be more difficult or expensive than it actually is.<sup>445</sup>

While Section 7.3.1 showed some evidence of transaction behaviour, research and consultation also indicated that moving in and out of funds can be inconvenient and costly, with **transacting costs, restrictions on redemptions and 'red tape' barriers** identified as key barriers to transacting in the Australian funds management industry.<sup>446</sup>

High transaction costs mean that many retail investors do not have the capacity, capability or willingness to engage directly with fund managers. Generally, intermediaries alleviate barriers to transacting for investors, for example by undertaking paperwork on their behalf, but can also be the source of barriers as discussed in the following sections. Declining fees and industry innovation are also assisting in reducing transaction costs.

#### 7.3.2.1 Transacting costs can represent a significant barrier to investors

Where imposed, the member activity related fees and costs identified in Table 4.1, including exit fees, withdrawal fees, establishment fees and switching fees, represent costs to redeeming units from a fund or switching funds. However, within the current low fee environment, many of these fees are not charged, with fee structures consisting only of management and performance fees. Of the 17 retail managed funds analysed in this

<sup>445</sup> Productivity Commission 'Competition in the Australian Financial System' (Inquiry Report No 89, 29 June 2018) <<https://www.pc.gov.au/inquiries/completed/financial-system/report/financial-system.pdf>>.

<sup>446</sup> Fund management Research Centre, *A Review of the Research on the Past Performance of Managed Funds* (report commissioned by the Australian Securities & Investments Commission, 2002) <[https://download.asic.gov.au/media/1337666/FMRC\\_Report.pdf](https://download.asic.gov.au/media/1337666/FMRC_Report.pdf)>.

report's survey, none reported charging withdrawal or exit fees, and only one charged a switching fee. Investors can also choose funds that do not charge these fees to avoid this barrier; however, this may mean that the cost to the fund manager of the investor switching funds is embedded in a higher management fee.<sup>447</sup>

A member activity related cost that can represent a cost to exiting or entering a fund is the **buy-sell spread**. The survey conducted for this report found that 71% of the retail managed funds analysed charged buy-sell spreads at an average rate of 15bps. The COVID-19 crisis has demonstrated that the buy-sell spread can be a significant switching cost during times of low returns and poor liquidity. Many fund managers have increased the buy-sell spread for fixed income funds during the crisis, as higher volatility increases fund manager costs and makes it harder to price.<sup>448,449</sup> High buy-sell spreads penalise redemptions and entry into new funds, sometimes costing as much as a fund's yield, presenting a barrier to moving money in and out of funds.<sup>450</sup>

It should be noted that higher spreads are not typically retained by the fund manager, but by the fund itself. While a rise in the buy-sell spread is intended to create liquidity to allow investors to redeem investments, the rise in the spread can occur without prior notice given to investors, creating a transaction cost that investors cannot account for when selecting funds.<sup>451</sup> RG97 currently requires responsible entities to disclose increases in the buy-sell spread (provided that they represent genuine market costs) as soon as practically possible, up to three months after the change.<sup>452</sup>

The **tax treatment** of managed funds can also be a transaction cost. Analysis of global best practice, in terms of the tax burden of managed funds for investors, indicates that the ideal taxation system does not tax income related to managed funds.<sup>453</sup> For example, investors in managed funds in Hong Kong and Singapore do not pay capital gains tax. In Australia, capital gains from funds are treated as income in the hands of investors and taxed at an investor's marginal income tax rate. This discourages investors from investing in managed funds.<sup>454</sup>

Taxation also creates a transaction cost related to exiting a fund. There is a disincentive for investors, or their advisers, to redeem units from a fund to avoid triggering a capital gains tax (CGT) liability.<sup>455</sup> Capital gains on assets are taxed at a discount of 50% if the asset is owned for 12 months or more, imposing a financial penalty on investors that move money out of underperforming funds within the first year of investment.<sup>456</sup> This discount period prevents excessive churning in the system, but also reduces willingness for investors to make timely switches to better performing funds. It should be noted that although investments in managed funds are generally expected to be held for long time periods (see Section 7.3.1), it is still important for investors to be able to exit a fund at

<sup>447</sup> 2020 DIRECTINVEST, *Managed fund fees* (2020) <<https://www.2020directinvest.com.au/investor-education/investment-fees.aspx>>.

<sup>448</sup> Sood, Kanika, 'Bond fund spreads widen', *Financial Standard* (online), 23 March 2020 <<https://www.financialstandard.com.au/news/bond-fund-spreads-widen-156594925>>.

<sup>449</sup> Analysis in this Interim Report was undertaken in 2020 during the height of the COVID-19 crisis in Australia. Discussion of the impact of buy-sell spreads in the Final Report will consider evidence from 2021.

<sup>450</sup> McArthur, Elizabeth, 'It's Showtime' (2020) 18(10) *Financial Standard* p14.

<sup>451</sup> Allens, *Impact of Covid-19 on investment funds* (31 March 2020) <<https://www.allens.com.au/insights-news/insights/2020/03/impact-of-covid19-on-investment-funds/>>.

<sup>452</sup> Australian Securities and Investments Commission, *20-167MR ASIC releases minor updates to RG 97* (24 July 2020) <<https://asic.gov.au/about-asic/news-centre/find-a-media-release/2020-releases/20-167mr-asic-releases-minor-updates-to-rg-97/>>.

<sup>453</sup> Morningstar, *Global Investor Experience Study: Regulation and Taxation* (27 April 2020) <<https://www.morningstar.com/lp/global-investor-experience-tax-and-regulation>>.

<sup>454</sup> Morningstar, *Global Investor Experience Study: Regulation and Taxation* (27 April 2020) <<https://www.morningstar.com/lp/global-investor-experience-tax-and-regulation>>.

<sup>455</sup> Walter, Ingo, 'The Global Asset Management Industry: Competitive Structure, Conduct and Performance' (1998) *Department of Finance Working Paper Series 1998*, New York University.

<sup>456</sup> Australian Taxation Office, *The discount method of calculating your capital gain* (28 June 2019) <<https://www.ato.gov.au/General/Capital-gains-tax/Working-out-your-capital-gain-or-loss/Working-out-your-capital-gain/The-discount-method-of-calculating-your-capital-gain/>>.

any time, including within one year of investment, to respond to fund performance and other factors.

This barrier to switching or exiting funds was highlighted when the Federal Government announced the banning of grandfathered commissions to financial advisers in 2019 (discussed in Section 6.3). The repeal aimed to prevent another barrier to switching in the industry, whereby advisers were incentivised to keep investors in older funds to continue receiving commissions, even if newer products were better suited to the investor. However, the requirement to transition customers out of older products also triggers the capital gains tax for investors.<sup>457</sup>

Switching platforms as well as funds can also trigger a capital gains tax event, if there is a change in the beneficial ownership of assets. Consultees indicated that this reduces investor interest in moving between platforms, which creates a barrier to switching to a fund not offered on the investor's current platform. This can be avoided through an 'in-specie transfer', where managed funds are transferred from one platform to another without selling the underlying investment.

In-specie transfer avoids triggering the buy-sell cost related to the transfer of the investment.<sup>458</sup> It was noted in consultation that platform operators' use of white-labelling creates an issue with in-specie transfer, as a white-labelled or re-badged fund does not exist on other platforms. This means that the fund cannot be transferred to another platform if the investor wants to switch platform provider, so the investor would have to exit the re-labelled fund and trigger a tax event.

The disincentive to exit a fund created by the CGT has exacerbated a problem with 'legacy' funds (see Section 7.2.3.2). While fund managers keep legacy funds open to ensure that existing investors can continue to invest with the fund if desired, the CGT liability discourages investors from exiting legacy funds, even if other funds provide better value for money. This indicates that it is transaction costs, rather than fund managers exercising market power, that is contributing to the issue of legacy funds.

Although CGT and buy-sell spreads represent a barrier to switching, this report acknowledges that these transaction costs are not unique to managed funds. Buy-sell spreads occur in direct markets (such as equity markets) and the imposition of taxation is not at the discretion of fund managers.

### **7.3.2.2 Restrictions on redemptions reduce transacting, particularly in crises**

Funds can introduce restrictions on redemptions which provide a barrier to retail investors withdrawing money from the fund. For example, some funds only allow withdrawals at certain times of the year.

Funds may also suspend redemptions in times of crisis, for example if there is a run on redemptions or if it becomes harder to value underlying assets. This occurred in 2020 with property funds in the UK as a result of COVID-19, and occurred with unlisted funds in Australia during the GFC.<sup>459</sup>

Redemptions may also be frozen on the basis of illiquidity. In this situation, the fund declares itself 'non-liquid' under the *Corporations Act 2001* and stops accepting redemption requests, preventing investors from exiting out of the fund if desired. This

<sup>457</sup> Vickovich, Aelks, 'How the ban on financial adviser commissions could hit hip pockets' *Australian Financial Review* (online), 23 October 2019 <<https://www.afr.com/wealth/personal-finance/how-the-ban-on-financial-adviser-commissions-could-hit-hip-pockets-20191021-p532u3>>.

<sup>458</sup> 2020 DIRECTINVEST, *Switching wrap accounts with in-specie transfers* (2019) <<https://www.2020directinvest.com.au/investor-education/wrap-account-inspecie.aspx#:~:text=SWITCHING%20WRAP%20ACCOUNTS%20WITH%20IN,without%20selling%20the%20underlying%20investment.>>.

<sup>459</sup> Allens, *Impact of Covid-19 on investment funds* (31 March 2020) <<https://www.allens.com.au/insights-news/insights/2020/03/impact-of-covid19-on-investment-funds/>>.

practice has created concern around funds naming themselves 'liquid' to attract funds when they are inherently illiquid (see Section 4.2.2.5).<sup>460</sup>

Although redemptions pose a possible threat to transacting, the recent COVID-19 pandemic provided a suitable test of fund managers' liquidity and redemption policies. A review conducted by ASIC between June and November 2020 concluded that, not only was there a limited decrease in liquidity, liquidity risks and frameworks (including the right to stagger and suspend redemptions) were adequate and transparent.<sup>461</sup>

### 7.3.2.3 'Red tape' barriers restrict investor and adviser transacting

The **time and resources** involved in investing in, and switching, funds is a 'red tape' barrier to direct investors and advisers. Consultees indicated that the amount of paperwork required to undertake an investment in a managed fund is onerous for direct investors. Similarly, advisers must complete a Statement of Advice (SOA) to switch a client into a new fund, or to another platform. It can also be inefficient for an adviser to spend time actively monitoring individual funds and client portfolios, reducing the likelihood of an investor being moved into a more appropriate fund.

The use of APLs by AFS licensees can present a barrier to advisers recommending that investors switch out of products. If a product is not on an adviser's APL, the adviser will need to dedicate time to researching and assessing the product. This means that the additional time associated with researching a product that is not on the APL may prevent an adviser from switching an investor into a non-APL product that better suits their interests. An adviser may also be less inclined to switch an investor out of an existing, underperforming product if it is not on the adviser's APL.<sup>462</sup>

There is also an administrative burden associated with advisers moving retail investors from one platform to another. While it is generally easy for advisers to choose their preferred platform for new accounts, Investment Trends research noted that only 27% of advisers switched platforms in 2019, potentially due to the inconvenience and added paperwork related to moving clients' money from one platform to another.<sup>463</sup> Evidence from 2019 also indicates that since 2009, on average, financial advisers have discarded one platform. It is now more common for planners to only use two platforms, and channel 56% of FUM on the primary platform.<sup>464</sup>

### 7.3.3 Some products and systems reduce transaction costs

**Traded and listed managed funds** reduce the paperwork associated with investing in a new fund. As discussed in Section 4.2.1.1, there is a more streamlined process associated with investing in traded and listed products, for example through online brokers.

**Managed accounts** also make it easier for advisers, and through them, investors, to switch funds. This is because advisers do not need client consent, for example a Statement of Advice, for each investment change made under a managed account. Reducing this administrative burden for advisers ensures that they are able to more quickly move investors into the fund that best suits their investment need. However,

<sup>460</sup> Allens, *Impact of Covid-19 on investment funds* (31 March 2020) <<https://www.allens.com.au/insights-news/insights/2020/03/impact-of-covid19-on-investment-funds/>>.

<sup>461</sup> Australian Securities and Investments Commission '21-091MR ASIC review finds retail managed funds responded well to the COVID-19 challenges in 2020' (30 April 2021), <<https://asic.gov.au/about-asic/news-centre/find-a-media-release/2021-releases/21-091mr-asic-review-finds-retail-managed-funds-responded-well-to-covid-19-challenges-in-2020/>>

<sup>462</sup> Australian Securities & Investments Commission 'Licensing: Financial product advisers—Conduct and disclosure' (Regulatory Guide 175, November 2017) <<https://download.asic.gov.au/media/4698465/rg175-published-10-april-2018.pdf>>.

<sup>463</sup> Richardson, Tom, 'Charting the incredible rise of Hub24 and Netwealth' *Australian Financial Review* (online), 21 January 2020 <<https://www.afr.com/markets/equity-markets/charting-the-incredible-rise-of-hub24-and-netwealth-20200121-p53t9f>>.

<sup>464</sup> Worley, Harrison, 'Advice affordability a growing concern', *Financial Standard* (online), 28 June 2019 <<https://www.financialstandard.com.au/news/advice-affordability-a-growing-concern-138420938>>.

while managed accounts reduce some barriers to transacting, some barriers still remain under these structures and it creates new barriers in terms of switching managed account providers. For example, CGT issues will still be prevalent and cause friction for the adviser acting on behalf of the investor.

# Part III: Performance



If market power enables exclusionary behaviour, incumbent firms are able to extract abnormal benefits, often at the expense of consumers.

Indicators include supernormal profits, poor value for money and low consumer satisfaction.

## 8 Performance of fund managers and investor outcomes

### **This chapter finds that:**

While high, fund manager profit margins do not appear excessive compared to other industries, however, the report acknowledges that this finding relies on imperfect metrics resulting from data limitations. Profit margins appear to be somewhat affected by market conditions although margins have recovered and remained stable since dropping sharply in 2011.

There is little evidence to suggest that active funds are operating passive strategies, which suggests that active fund managers are trying to pursue specific investment strategies.

On average, fund managers underperform the index benchmark net of fees, however, this does not necessarily indicate poor value for money. Investors may still be receiving positive returns, and in low interest environments the opportunity cost (interest on deposits, for example) is often lower.

Funds do not demonstrate an ability to maintain outperformance over short or medium-term horizons. Except for Australian property funds, the proportion of funds underperforming the index were greater over five to ten-year horizons compared to one year.

Relative to their peers, fund manager returns are volatile with funds shifting in and out of performance quintiles over a two-year period. Over a five-year period, only 1% of funds were able to remain in the highest quintile (on risk adjusted returns) for the duration of the period.

Higher fee funds do not necessarily achieve better risk-adjusted performance once their higher fees are taken into account and there is some evidence to suggest that these funds may underperform after accounting for fees, although the evidence is not conclusive. In other words, there is some evidence that higher fee funds may perform slightly better but not sufficiently to more than outweigh their higher fees. On the whole, investors are not necessarily better or worse off for selecting higher fee funds.

Larger funds do not appear to achieve better performance, however, fund managers appear to be subject to decreasing returns to scale once funds reach a certain size.

In a perfectly competitive market, profits are equal to the cost of capital. Firms compete over prices and products, until their costs of production (including capital costs) are equal to the market price.

Supernormal profits can be an indicator of market power and/or exclusionary conduct. If a firm has market power, it may be able to charge and maintain prices which are higher than their costs. These firms may use exclusionary conduct to prevent competitors from

eroding their profits. If there are few substitutes, then firms may not deliver value for money, resulting in suboptimal consumer outcomes.

Outcomes for both firms and consumers can thus provide evidence on market power and/or exclusionary conduct. Supernormal profits or consumers paying fees which are not commensurate with value can both indicate the existence of market power and/or exclusionary conduct. Analysis in this chapter considers both ends of the market.

Section 8.1 examines profitability of fund managers and the service they provide, to determine whether there is evidence of supernormal profits or high fees being charged where passive investment strategies are adopted.

Sections 8.2 and 8.3 look at consumer outcomes by considering the extent to which investors choose high-performing funds (measured by returns net of fees), and investor satisfaction.

This chapter is structured as follows:

- Section 8.1 examines the performance of fund managers through profitability and activity to test for demonstrations of market power.
- Section 8.2 examines the performance of individual funds to assess value for money
- Section 8.3 examines whether investors are satisfied, providing a qualitative discussion regarding retail consumers.

The analysis in this chapter draws on several datasets for different pieces of analysis. The data used are:

- FE fundinfo — fund performance and characteristics as well and index returns
- Lonsec — fees and fund ratings
- ASIC FS70 forms — revenues, expenses and profitability for responsible entities
- ASIC 388 forms — revenues, expenses and profitability for individual funds
- Company360 (illion) — financial reports of funds management companies.

## 8.1 Fund manager performance

In a contested market with price sensitive consumers, competition will be driven by price and profit margins will decline over time.<sup>465</sup> Furthermore, if margins were unusually high in a particular industry, this would attract more competitors until margins return to a more normal level.<sup>466</sup>

On the other hand, in an uncontested market, such as one characterised by high barriers to entry or exclusionary power, firms will be able to protect and maintain excessive profits margins through the use of market power.<sup>467</sup> As such, assessing firm profitability is a core component of structure-conduct-performance analysis.<sup>468</sup>

### 8.1.1 Fund manager profits are high but not necessarily excessive

The use of profitability metrics in structure-conduct-performance analysis is not without criticism. First, structural factors, as discussed in Section 3.2, may cause profit margins to remain high despite high levels of competition.

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<sup>465</sup> Minifie, Jim, *Competition in Australia: Too little of a good thing?* (December 2017) Grattan Institute <<https://grattan.edu.au/wp-content/uploads/2017/12/895-Competition-in-Australia-Too-little-of-a-good-thing-.pdf>>.

<sup>466</sup> LLC, Britton et al., 'Modify or Extend? The Application of the Structure Conduct Performance Approach to Service Industries' (1992) 12(1) *The Service Industries Journal* 34.

<sup>467</sup> Minifie, Jim, *Competition in Australia: Too little of a good thing?* (December 2017) Grattan Institute <<https://grattan.edu.au/wp-content/uploads/2017/12/895-Competition-in-Australia-Too-little-of-a-good-thing-.pdf>>.

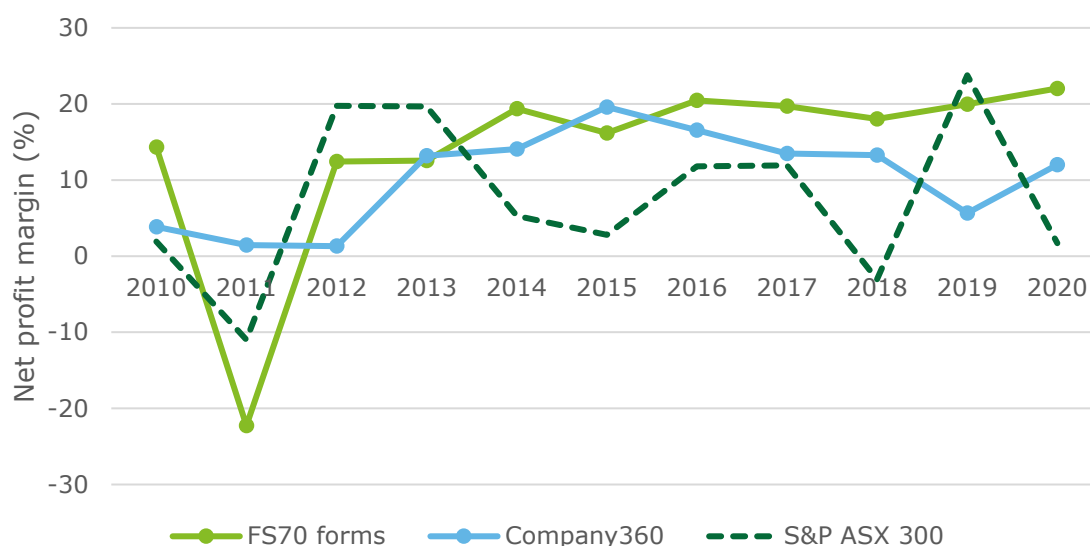
<sup>468</sup> Sutton, J., 'Market structure and performance' (2001) *International Encyclopaedia of the Social and Behavioural Sciences*.

Another issue in interpreting profitability as an indicator of competition is the difficulty in assigning causality to the relationship between profitability and market share. For example, one interpretation suggests that market power allows firms to charge prices greater than the marginal cost.<sup>469</sup> The second interpretation is that higher efficiencies generate higher margins and higher market shares.<sup>470</sup> Nonetheless, this report considers profitability analysis in the context of the other findings presented in this report.

This analysis uses two separate sources of company profits to assess the profit margins of fund managers. The first data set is a compilation of fund manager financial reports from the Company360 database. The second data source compiles historic FS70 reports that are submitted annually by responsible entities directly to ASIC.

Using these two sources of data, Chart 8.1 shows the average net profit margins of fund managers over the 10 years between 2010 and 2020. Since 2013, the net profit margins have largely ranged between 15–20%, having experienced a sharp decline in profitability in 2011. This pattern was not replicated in 2020, with net profit margins increasing in 2020, although FS70 forms covered the period only up to June 2020. Future analysis may be able to comment more on the impact of COVID-19 on profit margins.

Chart 8.1: Net profit margin of fund managers over time



Note: Company360: n = 21 fund managers, FS70: n = 34 fund managers. Both samples randomly selected fund managers from quintiles based on FUM.

Notes: Contents of the Chart described in the paragraph above and below in Section 8.1.1.

Source: Deloitte Access Economics (2021), ASIC FS70 forms and Company360 (2021).

The dotted line in Chart 8.1 shows the performance of the S&P ASX 300 over time and acts as a proxy for market and economic conditions. The purpose of including the index in Chart 8.1 is to demonstrate that profit margins are somewhat influenced by market conditions. A number of fund managers in consultation suggested that profits were cyclical and highly subject to economic conditions since market increases and decreases drive asset values. Sensitivity to underlying market conditions is not unique to funds management however, and fund managers should be able to sufficiently diversify to

<sup>469</sup> Dudu, H. & Kilicaslan, Y., *Concentration, profitability and (in)efficiency in large scale firms* (Productivity, Efficiency, and Economic Growth in the Asia-Pacific Region, Springer, 2009).

<sup>470</sup> Demsetz, Harold, 'Industry Structure, Market Rivalry, and Public Policy' (1973) 16(1) *The Journal of Law and Economics* 1.

avoid sensitivity to most local macroeconomic fluctuations.<sup>471</sup> Chart 8.1 shows that profitability was affected in 2011 but has been less sensitive to market movements in the years after, noting the index is an imperfect benchmark for all funds. Unlike in 2011, there has so far been no decline in profitability as a result of COVID-19. In both datasets, profitability for 2020 experienced an increase on 2019, noting that these financials cover the financial year and will not capture any losses incurred in the second half of the year. In any case, market conditions need to be considered when considering the appropriateness of profit margins in a given year.

Compared with the findings of similar research in the United Kingdom, the profit margins of fund managers in Australia are not of the same magnitude. In 2016, the FCA found that fund managers frequently attracted profit margins in excess of 30%.<sup>472</sup> The FCA determined that profit margins of fund managers appeared high relative to other industries with similar business structures (high human capital and relatively low physical or financial capital) that tended to exist within a range of 4%–30%.<sup>473</sup>

Chart 8.2 shows the profit margins of a diverse range of Australian industries in 2019. Although profit margins for fund managers are high (more than twice the non-weighted average of all industries), they do not appear to be as excessive as they have been found to be in some international markets.<sup>474</sup> Similarly, Chart 8.2 appears to show that, unlike in the UK, profit margins are not in excess of comparable industries such as private equity, superannuation, professional services, recruitment and financial planning.

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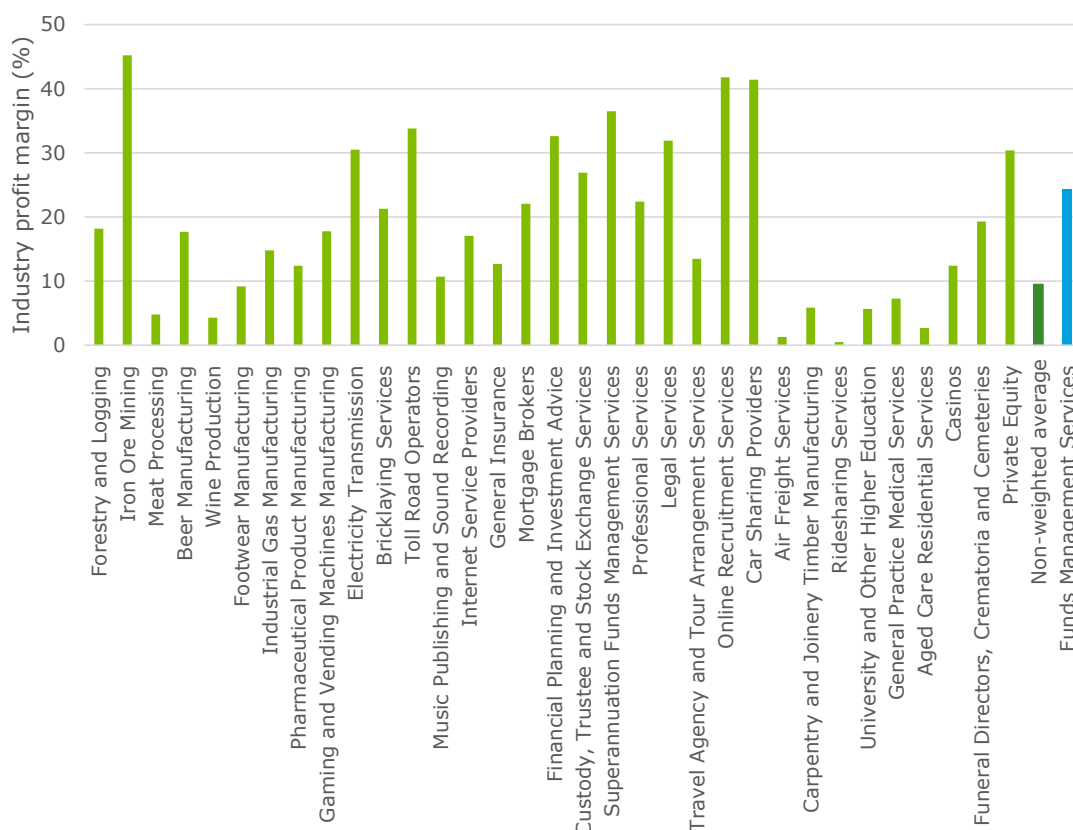
<sup>471</sup> Financial Conduct Authority 'Asset Management Market Study Interim Report' (Market Study 15/2.2, November 2016) <<https://www.fca.org.uk/publication/market-studies/ms15-2-2-interim-report.pdf>>.

<sup>472</sup> Ibid.

<sup>473</sup> Ibid.

<sup>474</sup> Ibid.

Chart 8.2: Profit margins by industry (2019)



Note: For consistency in reporting, this chart uses the IbisWorld profit margin for funds management. IbisWorld reports the funds management profit margin to be 24%, higher than the findings of this report. Non-weighted average is calculated based on the full sample of 756 industries in IbisWorld data.

Note: Contents of this chart are found in table form in Appendix F.

Source: IbisWorld (2019).<sup>475</sup>

In consultations, fund managers repeatedly made the point that they believed the fee environment in Australia was extremely competitive and as such, margins are declining. As has been discussed in several parts of this report, Australia has the lowest fee structure in the global funds management space.<sup>476</sup> However, even with tight fee pressures, profitability can be sustained particularly in economies of scale (see Section 8.2.6).

#### 8.1.1.1 Profitability would be better compared using return on capital employed

The analysis of profitability in Chart 8.2 has limitations. Profit margins are not directly comparable across industries since they have different risk profiles and capital requirements. Large profits in a highly capital-intensive industry may be appropriate to compensate investors for the level of risk associated with the endeavour. For example, while iron ore mining has high profit margins (Chart 8.2), it also requires significant capital and returns are risky. Submissions and consultations concurred that this analysis is difficult to conduct across industries.

<sup>475</sup> IBIS World, *Fund management Services in Australia industry trends (2014-2019)* (2019).

<sup>476</sup> Morningstar, *Global Investor Experience Study: Fees and Expenses* (17 September 2019)

<[https://www.morningstar.com/content/dam/marketing/shared/pdfs/Research/GIE\\_2019\\_v4.5.pdf?utm\\_source=eloqua&utm\\_medium=email&utm\\_campaign=&utm\\_content=18780](https://www.morningstar.com/content/dam/marketing/shared/pdfs/Research/GIE_2019_v4.5.pdf?utm_source=eloqua&utm_medium=email&utm_campaign=&utm_content=18780)>.

The Interim Report put it to industry that the ideal way to compare profitability across industries would be using a metric such as return on capital. Return on capital better captures the profit accruing to all stakeholders in the business — equity and debt holders. Consistently high returns on capital would thus be an indicator of suboptimal competition.<sup>477</sup>

One fund manager noted that they regularly undertake profitability analysis when considering investments in listed fund managers, however, disagreed that return on capital was a suitable metric. Instead, the submission proposed a ratio of revenue or earnings before interest and tax (EBIT) to average FUM. This measure, according to this submission, will highlight instances of a fund manager making supernormal profits.

Ideally these metrics would be measured at a fund level, since the ratios will vary depending on features of a fund such as strategy, investor and asset.

In the absence of fund-level revenue data, this report tried to replicate these metrics at a fund manager level to test any instances within the sample where margins appeared abnormal. As above, the report could not be confident that the profitability metrics derived from ASIC data (FS70 and 388 forms) were reflective of only the fund manager entity and the profitability reports extracted from Company360 were occasionally unreliable and used slightly different profitability metrics. As a result, this analysis was inconclusive; the ranges derived from the sample were large and uninterpretable based on the limitations described above. The Final Report, therefore, notes that this issue is unresolved and identifies it as an area for further research.

### **8.1.2 Funds branded as active strategies do appear to deviate from index performance**

Section 7.2.3.1 of this report considered the possibility of fund managers misrepresenting their product type. While it is not possible with the available data to assess whether a fund is meeting its mandate in terms of asset ownership or risk profile, this report attempts to identify the extent to which funds are operating as 'partly active'. Partly active funds are an instance of fee-for-no-service; funds that market themselves and charge fees as actively managed funds yet deliver returns similar to the market benchmark over a sustained time period.<sup>478</sup> The existence of partly active funds would constitute evidence that competition is not working effectively.

This section mirrors analysis conducted by the FCA that compares ongoing fund charges against tracking error. Tracking error is calculated from the standard deviation of returns from the benchmark index. Tracking error is used as a measure of fund activity since it is expected that more active funds experience greater deviation from the index benchmark (for more detail on methodology refer to Appendix C). Note that tracking error is not concerned with positive or negative deviation (over or underperformance), only the absolute deviation from the index benchmark. Over and underperformance are considered in more detail in Section 8.2.4.

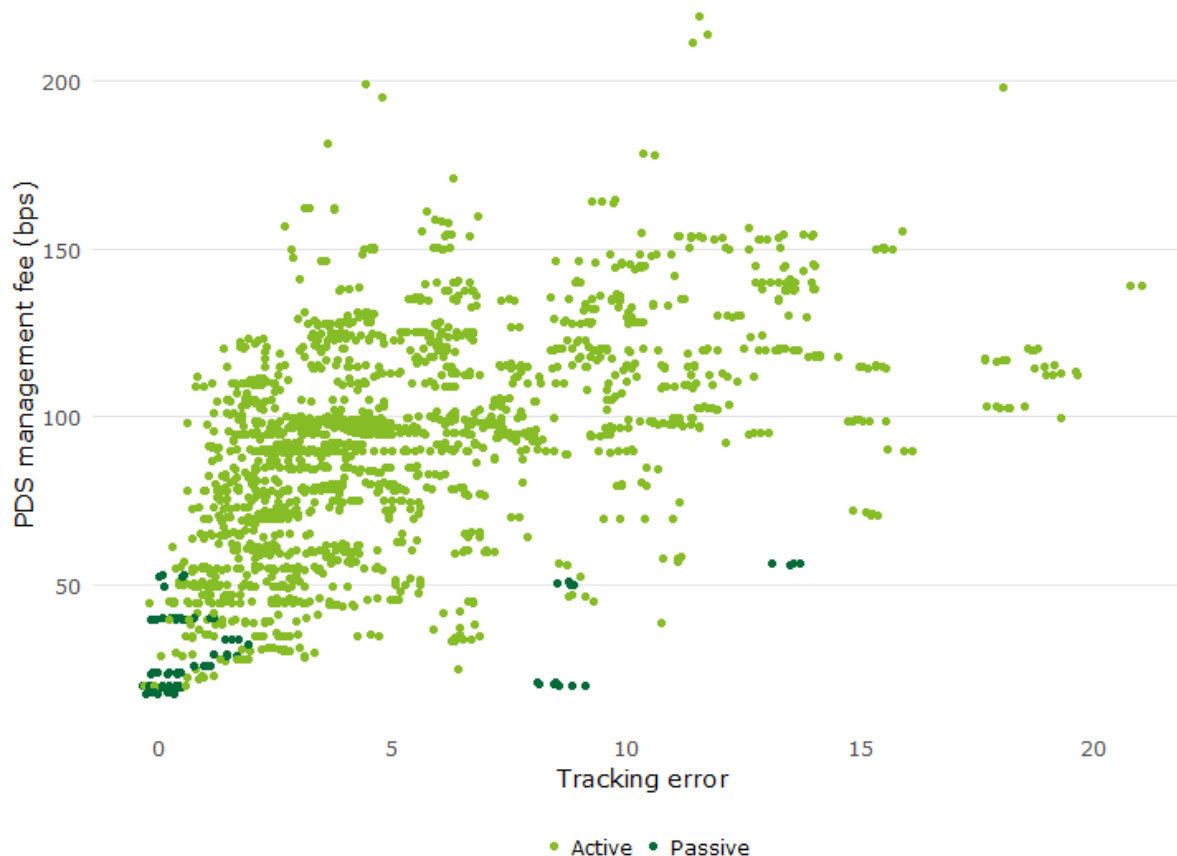
Chart 8.3 shows the distribution of tracking error across the range of fees. This chart suggests that while there are some funds with a very small tracking error, the clear majority of funds charging higher fees appear to be engaging in a more active strategy (shown by greater deviation from the index). If partly active funds were present in the sample, they would appear in Chart 8.3 as charging high fees while achieving a tracking error not dissimilar to the passive funds (dark green points). On the contrary, the results show that some passive funds are poorly tracking the index benchmark, represented by a high tracking error. Although this report has not weighted these data points by funds

<sup>477</sup> Financial Conduct Authority 'Asset Management Market Study Interim Report' (Market Study 15/2.2, November 2016) <<https://www.fca.org.uk/publication/market-studies/ms15-2-2-interim-report.pdf>>.

<sup>478</sup> Financial Conduct Authority 'Asset Management Market Study Interim Report' (Market Study 15/2.2, November 2016) <<https://www.fca.org.uk/publication/market-studies/ms15-2-2-interim-report.pdf>>.

under management, this suggests that there is not strong evidence that partly active funds are a significant issue in Australian managed funds.

Chart 8.3: Distribution of fees and tracking error of annual returns — active vs passive management



Note: Contents of the Chart are described in the paragraph above in Section 8.1.2.

Source: Deloitte Access Economics (2021), FE fundinfo (2020) and Lonsec (2020).

The findings of Section 8.1.1 and Section 8.1.2 do not characterise industries where market power can be exercised by firms. Despite limitations, analysis of profitability yielded that firms were not earning supernormal profits as seen in the United Kingdom, for example. Similarly, Section 8.1.2 was unable to find compelling evidence that partly active funds are commonplace in Australia.

Section 8.2 continues the analysis, seeking any evidence that consumer outcomes are adversely affected by a lack of competition.

## 8.2 Fund performance and consumer outcomes

This section of the report analyses consumer outcomes for evidence of market power. As mentioned above, a contested market will be characterised by fund managers seeking to attract and retain investors by competing to deliver value for money. If consumers are not receiving value for money, this could indicate a lack of competition.

### 8.2.1 Fund manager remuneration and incentive structures

The structure of incentives and remuneration for fund managers is important to consider since it shapes the understanding of how an effective and competitive managed funds market should operate. Fundamentally, a competitive funds management industry would see funds attract and retain investors based on performance.



Many of the issues, or potential issues, discussed in this report derive from a basic principal-agent problem; investors trust managers to act in their best interests by achieving the highest return on their investment net of fees.

The most effective way to address the principal-agent problem is to ensure that the incentive structure is designed such that the objectives of the agent (fund manager) and the principal (investor) are aligned.

Since the objective of the investor is to maximise their investment return net of fees and the objective of the fund manager is to maximise fees, these objectives can potentially create a conflict, although such a conflict can be addressed through regulation or competition in the sector.

In a competitive market, with a tangible and substitutable product or service, providers compete to provide value for money to minimise the risk of customers switching providers. Competition creates the same incentive structure in managed funds; fund managers will seek to protect and grow their existing asset base by providing the best service to investors. If competition is functioning, this should generate an alignment between the interests of principal and agent resulting in positive consumer outcomes.

Fund managers are remunerated through a series of fees charged on funds under management. The most significant of these being the management fee and, if applicable, a performance fee.

As mentioned in Chapter 4.3.1, ongoing fees and costs for managed investment products are commonly charged using an ad valorem model, as a percentage of funds under management. The ad valorem fee structure incentivises fund managers to grow the size of FUM as long as the marginal cost of increasing inflows is less than the marginal revenue achieved from this increase.<sup>479</sup> Although fund manager costs rise with the level of funds under management, they do not rise proportionally. The presence of economies of scale (see Section 3.2.3.2) combined with the ad valorem fee structure creates a positive correlation between funds under management and profitability, which is demonstrated in Section 8.2.6.

Actively managed funds typically charge an additional performance fee, should the fund outperform its prescribed benchmark. A performance fee is in place to incentivise the fund manager to seek to outperform on the investors' behalf. Although this fee structure is in place to incentivise performance, as Section 8.2.4.1 shows, funds typically struggle to outperform the index.

The intersection of these two findings creates a possible conflict between the incentives to grow funds under management and to achieve the best performance for investors. This feature was also highlighted in the FCA study of asset managers in the United Kingdom.<sup>480</sup> Since funds under management can grow either by achieving higher inflows or by achieving higher performance, and good performance is difficult to achieve (and even more difficult to achieve consistently), funds may be incentivised to grow the fund through inflows rather than through performance.

This can be detrimental to investor outcomes if better performance is more difficult to achieve with higher levels of FUM. Moreover, while better performance may also lead to greater inflows, there may be an incentive for some fund managers to focus on marketing at the expense of performance.

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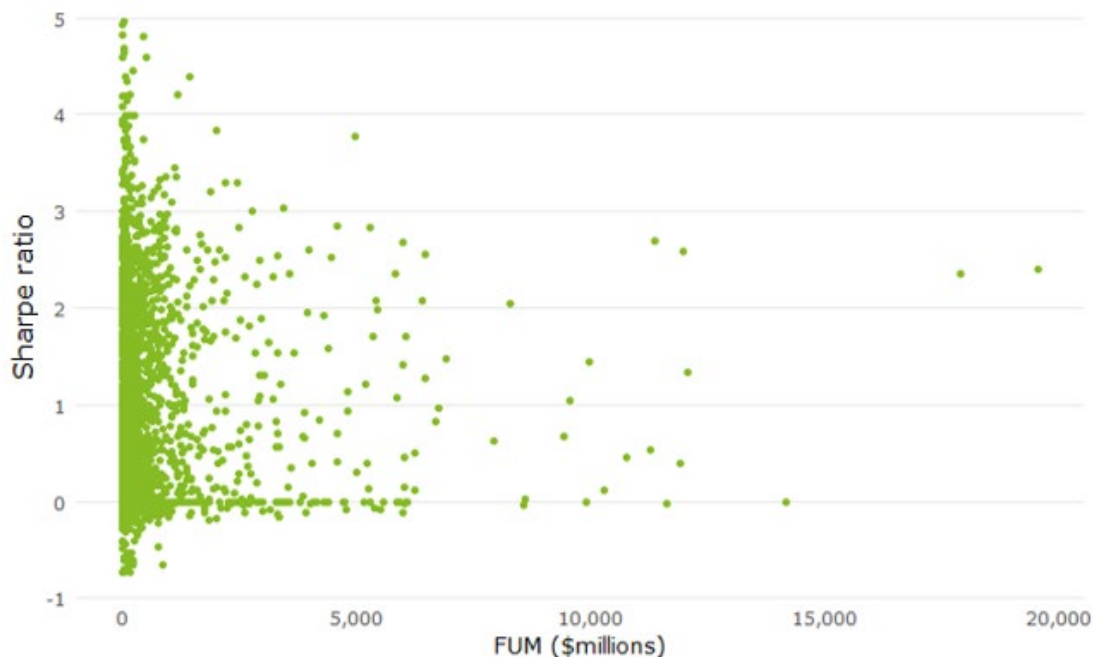
<sup>479</sup> Financial Conduct Authority 'Asset Management Market Study Interim Report' (Market Study 15/2.2, November 2016) <<https://www.fca.org.uk/publication/market-studies/ms15-2-2-interim-report.pdf>>.

<sup>480</sup> Financial Conduct Authority 'Asset Management Market Study Interim Report' (Market Study 15/2.2, November 2016) <<https://www.fca.org.uk/publication/market-studies/ms15-2-2-interim-report.pdf>>.

### 8.2.2 Funds under management is not correlated with performance

If the funds management industry competed to deliver value to the customer, FUM should be correlated with higher risk adjusted returns net of fees. Investors would identify funds that are achieving the best returns and, in turn, these managers would receive higher management fees as funds under management increases.

Chart 8.4: Correlation between performance and funds under management — all funds



Note: Sharpe ratio is calculated net of fees. Simple correlation is not statistically significant ( $p$  value=0.60).

Note: Contents of the Chart are described in the paragraph below in Section 8.2.2.

Source: Deloitte Access Economics (2021) and FE fundinfo (2020).

Chart 8.4 shows no clear relationship between performance and funds under management. Larger funds do not appear to achieve better than average risk adjusted returns measured by the Sharpe ratio, with a large proportion of funds with more than \$5 billion in assets under management having a Sharpe ratio below 1 (see Section 8.2.3 or Appendix C on the Sharpe ratio). This result could indicate several hypotheses:

- risk adjusted returns net of fees is an incomplete measure of performance
- it is difficult for retail investors to identify better performing funds ex ante
- funds cannot maintain above average returns over short, medium or long-terms
- better performing funds are more expensive nominally and net of fees, reducing their value to parity with more average performers
- larger funds experience decreasing returns to scale beyond a certain level of FUM or
- there are inadequate incentives (competition) in the industry to encourage fund managers to deliver value.

The remaining sections of this chapter attempt to assess the validity of these hypotheses and the implications this may have for the nature of competition.

### 8.2.3 A fund's performance is relative to the investor's preferences

Performance of a fund, or the quality of service provided by the fund manager, is typically judged by returns on investment net of fees. Although returns are an important component of value for money, there are other elements that may be relevant considerations for investors. For many investors, funds management provides other

benefits including greater access to less liquid investment opportunities, such as property, as well as benefits of diversification.

The first, and often most considered component of fund performance, is the return on investment generated by the fund. Since markets and investment products are inherently risky, the return a fund achieves needs to be considered relative to the risk associated with the underlying assets. Without accounting for risk, returns for different asset classes (even products within the same asset class) cannot be compared like-for-like.<sup>481</sup> This report uses two types of adjusted return measures to account for the risk of underlying assets:

- the Sharpe ratio accounts for risk by comparing the returns of the fund or portfolio relative to a risk free option and the volatility of the fund or portfolio
- excess return ('alpha'), is measured as the percentage point difference in returns of the fund and an appropriate benchmark index.

Both of these risk adjusted measures of fund performance are calculated net of fees for use in this report (See Appendix C for more on these performance measures). The way most fund managers communicate a fund's objectives or target return is in relation to a benchmark index. This gives the fund manager some flexibility when market or economic conditions significantly affect asset values, provided they are still able to outperform the index. The index chosen by the fund manager is selected to reflect the asset class, and typically, the risk or expected performance of that fund.

This method of measuring and assessing performance is often useful, however, it is not always the most appropriate. First, funds with more ambitious targets may appear to be underperforming relative to less ambitious benchmarks. For example, a fund promising S&P ASX 300 +2% may appear to be underperforming a fund seeking only S&P ASX 300 +0%, despite obtaining nominally higher returns. Second, returns relative to a benchmark do not always appropriately account for risk. Although one fund may have received higher returns than another fund, relative to an index, this does not indicate that all investors will be appropriately serviced by the fund with higher returns. The strategy or assets used to outperform the index in a given timeframe may have come with greater exposure to risk that is not captured by the fund's performance.

Investors also consider the personal cost of time and money that would be required of them to undertake this activity themselves. Although investment managers may not, on average, outperform an index, retail investors may not have the time and skill to manage an active portfolio themselves. Even for low cost passive funds (that will still on average underperform after fees) most retail investors do not (realistically) have the capital to recreate an index. This does not excuse investment managers from poor performance. In the end, investors should seek the highest returns for a given fee and risk appetite; however, retail investors may still be earning a positive, if not greater than benchmark, performance over time. In a low yield environment such as investors have experienced over the past decade, this return may still be attractive relative to cash holdings.<sup>482</sup>

In addition to returns net of fees, there are other associated features of a fund that influence performance, or an investor's perception of performance, that are not accounted for in price or return on investment (see Section 4.2). An example of such a factor is the performance of the fund against ESG objectives. An investor may select a

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<sup>481</sup> Australian Securities & Investments Commission, 'A review of the research on the past performance of managed funds' (Report No 22, June 2003)  
<[https://download.asic.gov.au/media/1337666/FMRC\\_Report.pdf](https://download.asic.gov.au/media/1337666/FMRC_Report.pdf)>.

<sup>482</sup> Bassanese, David, *Investing for income in a low interest rate environment* (October 2019)  
<<https://www.betashares.com.au/insights/investing-for-income-in-a-low-interest-rate-environment/>>.

fund that seeks a lower return for a given risk appetite based on what they perceive to be more responsible investment objectives or practices as discussed in Section 2.6.1.4.

The metrics used in this report (Sharpe ratio and alpha) are not able to account for other performance considerations such as opportunity cost or positive externalities generated through ESG. Therefore, it is possible that these measures do not capture the full range of metrics used to assess performance of a fund, as perceived by the investor.

As a result of these additional considerations, this report cannot identify one individual product or provider (or group of products and providers) as the superior option for investors. Objectives or performance criteria are slightly different between each investor, however there are common goals such as seeking the highest risk adjusted performance subject to the other parameters. This chapter uses risk adjusted returns to measure performance, however, notes that this is only one metric investors may consider in choosing between funds.

#### **8.2.4 Outperformance is difficult to achieve and harder to maintain**

This section of the report considers the performance received by investors over the last 10 years across a number of different asset classes. The analysis has two components:

- how funds (both active and passive) have historically tracked against certain specified indices and whether investors on average, are achieving greater returns than the index
- how outperformance and/or underperformance persists over time.

Consistent with other research in the field, this analysis finds that on average, investors receive performance lower than the index across both active and passive funds.<sup>483</sup> This report measures performance against a benchmark by excess returns ('alpha'); the percentage point difference in the returns of the fund and the returns of the index. This report has considered survivorship bias in the sample, however, there is no reason to believe this has significantly influenced the results presented in this section.

#### **Box 8.1: Survivorship bias**

Survivorship bias is a form of sample selection bias that occurs when data does not consider observations from entities (in this case, funds) that are small or have failed. As such, the data only reflect funds that have managed to 'survive' and are likely to present results biased towards stronger performers.

It is difficult to entirely rule out the presence of survivorship bias; however, this report has no reason to believe that it is a significant issue in this analysis. The primary data used in this analysis, FE fundinfo, is a comprehensive sample of both existing and ceased Australian funds and unlike other sources of data does not rely on survey responses to extract information.

The Lonsec ratings data (used in Appendix D) is, by its nature, subject to survivorship bias since fund ratings are intentionally skewed towards stronger funds. Since this is the feature being tested in Appendix D, it is unlikely that any results are a result of unidentified survivorship bias.

This report uses performance terms that are net of fees since a proportional fee structure significantly reduces the benefit received by the end investor.

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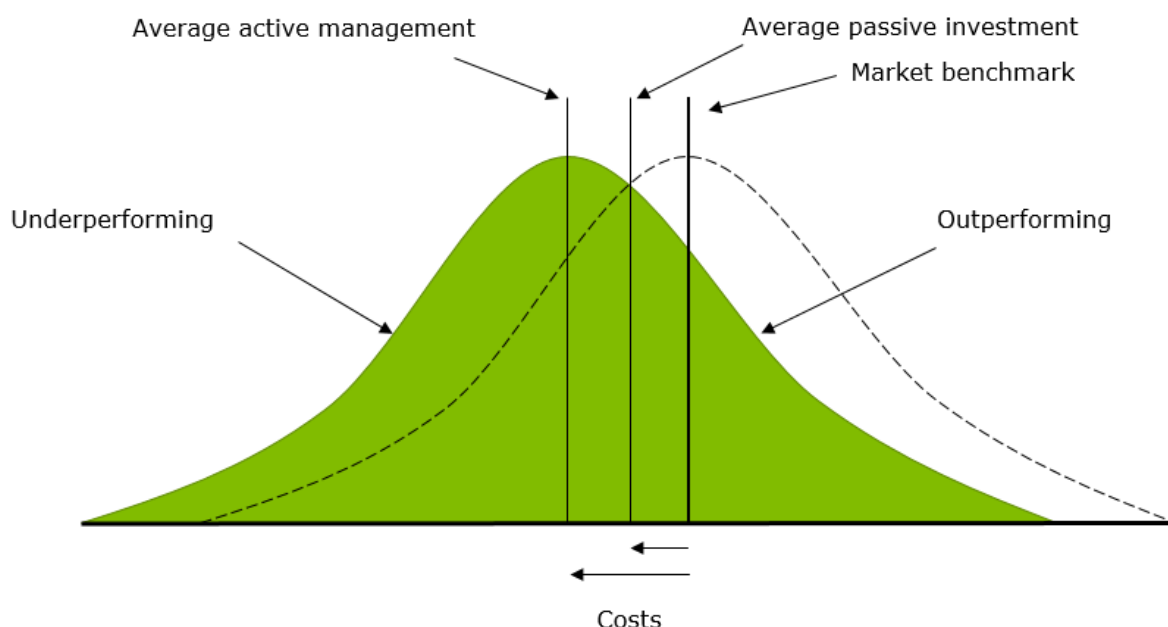
<sup>483</sup> Martijin Cremers, K.J., Fulkerson, Jon A. & Riley, Timothy B., 'Challenging the conventional wisdom on active management: A review of the past 20 years of academic literature on actively managed mutual funds' (2019) *Financial Analysts Journal* (forthcoming).

Note that, due to the proximity to the recent market downturn, data reflecting the economic environment sparked by COVID-19 is not captured in this analysis. This event is likely to significantly influence the outcomes of this analysis and this may be an important consideration in future research.

#### 8.2.4.1 How do funds compare to benchmarks?

Although funds and fund performance are often compared to an index benchmark, outperforming funds, net of fees, are expected to be in the minority. Consider the theoretical distribution of returns in Figure 8.1.<sup>484</sup> The distribution represented by the dashed line depicts the returns of active managed funds in the market before fees, where the average return is approximately the market benchmark. Passive funds, if tracking the index correctly, should receive returns in line with the market benchmark before fees. Therefore, the average active and passive returns should be approximately the market benchmark before fees, assuming no other market participants, such as direct investors (wholesale and retail). Active investors, however, engage in the upside and downside risk associated with the distribution of funds either side of the market index.

Figure 8.1: The effect of fees on the distribution of market returns



Note: Contents of the Chart described in the paragraph above in Section 8.2.4.1.

Source: FCA (2016).<sup>485</sup>

The second (solid) distribution to the left represents the actual active returns after the consideration of fees. The distribution of active funds is shifted to the left by the amount of active charges and the returns of passive funds should remain approximately equal to the returns of the benchmark less fees. The amount of active (money weighted) funds outperforming the index is now less than half. Active investors seeking to 'outperform' the market, therefore hope to identify the funds positioned in the shaded area to the right of the market benchmark.

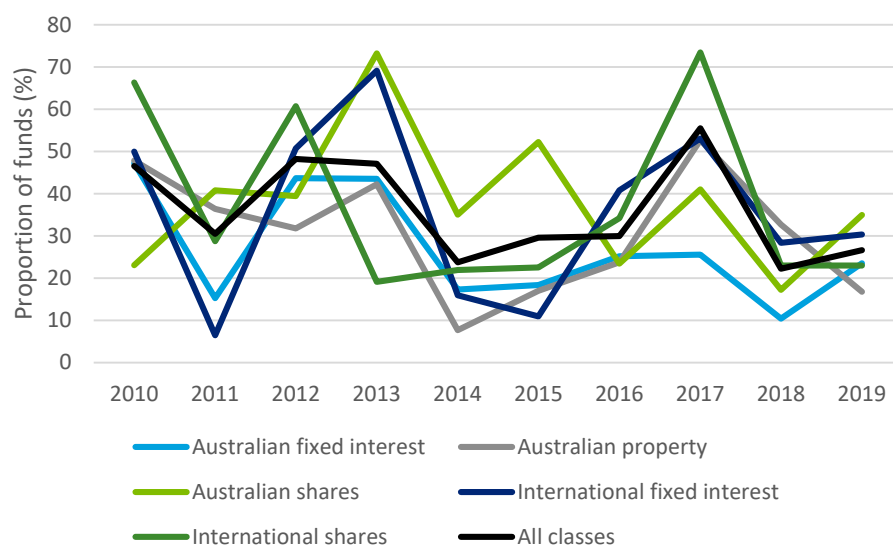
<sup>484</sup> Financial Conduct Authority 'Asset Management Market Study Interim Report' (Market Study 15/2.2, November 2016) <<https://www.fca.org.uk/publication/market-studies/ms15-2-2-interim-report.pdf>>.

<sup>485</sup> Financial Conduct Authority 'Asset Management Market Study Interim Report' (Market Study 15/2.2, November 2016) <<https://www.fca.org.uk/publication/market-studies/ms15-2-2-interim-report.pdf>>.

Figure 8.1 serves to demonstrate that the hypothesis of the analysis that follows is funds, on average, underperform the benchmark.

This analysis considers five broad asset classes and matches the performance of appropriate indices based on comparable analysis (selected indices are found in the notes under Chart 8.5).<sup>486</sup> The measure of performance described in this section is the excess return funds achieve above the benchmark index ('alpha').<sup>487</sup> The analysis subtracted index performance from the performance of each fund in a particular asset class, returning the proportion of funds that under/over performed and by what magnitude. The results of this analysis suggest that on average, funds do not outperform the index after fees (see Chart 8.5).

Chart 8.5: Proportion of all funds (%) outperforming the index – 1 year (non-weighted)



Note: Performance calculated net of fees. Benchmarks: Australian fixed interest (Bloomberg AusBond Composite 0+ Years TR in AU), Australian property (S&P ASX 300 AREIT (Sector) TR in AU), Australian shares (S&P ASX 300 TR in AU), International fixed interest (Bloomberg Barclays Global Aggregate Hedge AUD ATR in AU), International shares (MSCI World ex Australia ATR in AU). Sample = 14,674.

Note: Contents of this chart are found in table form in Appendix F.

Source: Deloitte Access Economics (2021) and FE fundinfo (2020).

Chart 8.5 shows a time series of the proportion of funds that are achieving a return greater than the relevant index returns for that year. From this it is clear to see that performance relative to the benchmark varies considerably, with overachievers being in the minority across most asset classes and years. The average proportion of funds outperforming the relevant index in the sample is 36% across the 10 years.

While Chart 8.5 suggests that funds do not typically outperform an index, it is important to consider that the funds' performance are net of fees. It is possible that at least some of these funds are outperforming or matching the index on a gross fee basis.

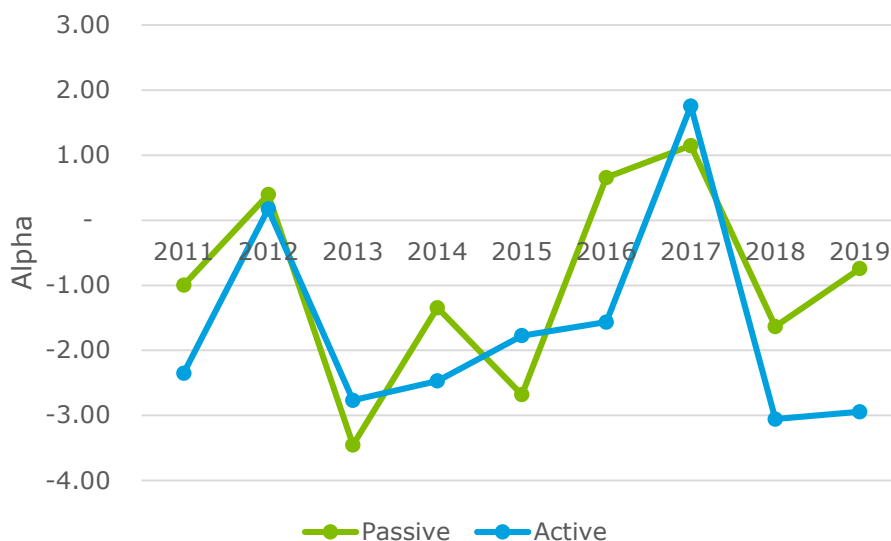
Of greater interest to the end investor is the difference in returns between the fund and the index. Chart 8.6 shows the magnitude of under and over performance of active and passive funds over the sample period. This Chart shows that over time, the average (unweighted) deviation from the index for both active and passive funds are similar once

<sup>486</sup> Financial Services Council & Morningstar, *Australian Managed Funds Industry* (19 July 2016) <<https://www.fsc.org.au/resources-category/publication/791-2016-fscmorningstar-austnmanagedfundsindustryreport/file>>.

<sup>487</sup> Another common way of calculating alpha is by a regression of fund returns on a benchmark return.

fees have been deducted, although on an asset weighted basis passive funds show a smaller deviation from the index as a result of lower fees (see Table 8.1). This is consistent with the intuition described above in Figure 8.1.

Chart 8.6: Average alpha\* over time (non-weighted) – selected asset classes



Note: \* Alpha calculated as the percentage point difference in returns between the fund and the benchmark index. Performance calculated net of fees. Benchmarks: Australian fixed interest (Bloomberg AusBond Composite 0+ Years TR in AU), Australian property (S&P ASX 300 AREIT (Sector) TR in AU), Australian shares (S&P ASX 300 TR in AU), International fixed interest (Bloomberg Barclays Global Aggregate Hedge AUD ATR in AU), International shares (MSCI World ex Australia ATR in AU).

Note: Contents of the Chart are described above in 8.2.4.1.

Source: Deloitte Access Economics (2021) and FE fundinfo (2020).

Table 8.1 shows the average excess return of different fund types over the 10-year sample net of fees. Although this suggests that performance differs considerably between these cohorts, what it more likely indicates is the difference in fee structures. Wholesale and retail for example, may achieve similar returns at the fund level, however, the investors receive different net performance since retail investors typically pay higher fees. Similarly, this does not necessarily suggest that passive funds outperform active funds although, on an asset weighted basis, returns relative to the benchmark are higher. At an asset weighted measure, average alpha is closer to (in absolute value) to the benchmark, consistent with expectations that weighted returns converge to the benchmark.<sup>488</sup> Asset-weighted values should be considered with some caution since historic FUM data obtained from FE fundinfo is incomplete and subject to missing values across the FUM distribution, which reduces overall sample size.

<sup>488</sup> Eugene F. Fama and Kenneth R. French, *Luck versus skill in the cross-section of mutual fund returns*, (October 2010), the Journal of Finance, Vol 65. No.5.

Table 8.1: Non-weighted and weighted average yearly excess returns (2010–2019) net of fees.

Fund type	Equity		All	
	Alpha	N	Alpha	N
Active	-1.57	9,737	-1.49	13,863
Active (weighted)	-0.94	4,677	-0.82	6,542
Passive	-0.93	499	-0.74	812
Passive (weighted)	-0.61	259	-0.46	451
Wholesale	-1.25	3,376	-1.12	5,235
Wholesale (weighted)	-0.38	1,563	-0.28	2,395
Retail	-1.69	6,860	-1.64	9,439
Retail (weighted)	-1.05	3,373	-0.93	4,598
All funds (weighted)	-0.86	4,936	-0.74	6,993

Note: Asset weighted includes active and passive funds and is only available from 2014. Historic FUM not available for all funds in FE fundinfo so weighted averages may differ from actual.

Performance calculated net of fees. Benchmarks Australian fixed interest (Bloomberg AusBond Composite 0+ Years TR in AU), Australian property (S&P ASX 300 AREIT (Sector) TR in AU), Australian shares (S&P ASX 300 TR in AU), International fixed interest (Bloomberg Barclays Global Aggregate Hedge AUD ATR in AU), International shares (MSCI World ex Australia ATR in AU). Active and passive flags based on advice from FE fundinfo. Wholesale / retail split based on minimum investment. Wholesale minimum set at >\$100,000.

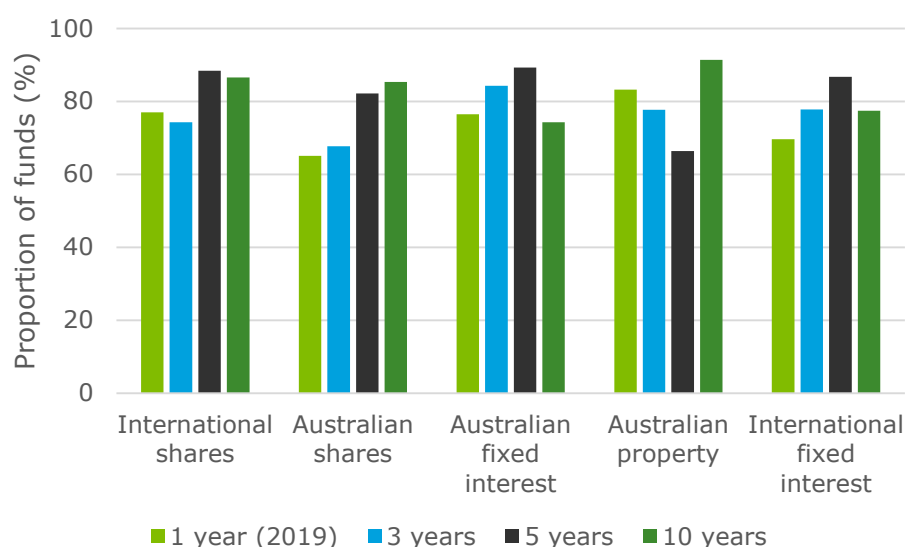
Source: Deloitte Access Economics (2021) and FE fundinfo (2020).

So far, the analysis has concentrated on performance measures at a point in time. Given that investors typically invest for periods longer than one year and markets are inherently volatile, fund performance over time is an important consideration for investors. To test whether more funds tended to outperform the index over a longer term, this report also considers the compounded returns of funds at 3-year (2017–2019), 5-year (2015–2019) and 10-year (2010–2019) intervals and compared these to the equivalent compounded index returns.

Chart 8.7 shows the proportion of funds that were outperformed by the relevant index across numerous investment horizons. This analysis shows that, on average, underperformance was consistent across short-medium term and that longer investment horizons did not necessarily increase share of outperformance. In fact, in all asset classes there is some evidence that longer investment horizons (either 5 or 10 years) tend to increase the proportion of funds underperforming the index.



Chart 8.7: Funds (non-weighted) outperformed by the index across various investment periods



Note: 3, 5 and 10-year returns reflect compounded yearly returns up till 2019. Performance calculated net of fees. Benchmarks Australian fixed interest (Bloomberg AusBond Composite 0+ Years TR in AU), Australian property (S&P ASX 300 AREIT (Sector) TR in AU), Australian shares (S&P ASX 300 TR in AU), International fixed interest (Bloomberg Barclays Global Aggregate Hedge AUD ATR in AU), International shares (MSCI World ex Australia ATR in AU).

Note: Contents of the Chart are described in the paragraphs above and below in Section 8.2.4.1.

Source: Deloitte Access Economics (2021) and FE fundinfo (2020).

The finding in Chart 8.7 suggests that even if strong performance is achieved in a particular year, these results are levelled out over time with approximately 20% of funds outperforming benchmarks in the longer term. The ability of even a small number of 'good' funds to consistently outperform the index is analysed in the next section. Whether or not investors have the ability to identify these funds is another question entirely.

#### 8.2.4.2 High performing funds cannot sustain an advantage over time

The above analysis shows that, on average, active (and passive, for that matter) funds tend to underperform the benchmark net of fees. For those that do outperform, or perform better than the average, it is important to understand whether or not these results can be sustained over time or whether good performance is exceptional and performance regresses to the mean after a sufficiently long time horizon. This is particularly important given the results of the regression analysis (see Appendix D) that shows that past performance is a significant driver of flows in Australian managed funds.

Academic literature investigating the persistence of performance in managed funds traces back to the 1960s with many of these studies finding no ability of managers to systematically outperform benchmark indices.<sup>489</sup> Even if fund managers can identify better performing assets, it is expected that these opportunities are quickly competed away by other investors or outperformance in a particular asset is extraordinary rather than the norm (mean reversion).<sup>490</sup> The majority of the literature reviewed in researching this report (both Australian and international), indicated that past performance was a poor, or at best a weak, indicator of future performance.<sup>491</sup>

<sup>489</sup> Some of the more influential of these papers include Treynor (1965), Sharpe (1966) Jensen (1968), Grinblatt and Titman (1989) and Connor and Korajczyk (1991).

<sup>490</sup> Darryll Hendricks, Jayendu Patel and Richard Zeckhauser, *Hot hands in mutual funds: Short-run persistence of relative performance, 1974-1988*, *Journal of Finance*, 48(1), 1993.

<sup>491</sup> Carhart, Mark M., 'On persistence in mutual fund performance' (1997) 52(1) *Journal of Finance*.

Importantly, a number of these studies also suggest that even if certain exceptional funds are able to achieve consistent over performance, retail investors do not possess the tools to identify these funds based on available information.<sup>492</sup>

The pervasiveness of persistent performance certainly creates difficulties for investors attempting to achieve a return on their investment, however, it can also be a strong signal of a well-functioning, competitive industry. Hoberg and Prabhala (2014) showed that the persistence of performance in managed funds usually indicates low levels of competition.<sup>493</sup> By grouping funds based on particular risk characteristics, the authors identified that across every investment horizon, greater levels of competition limited the ability of managers to generate persistent alpha.<sup>494</sup>

In evaluating performance persistence, this chapter compares the ranking of fund managers across time periods. Fund managers were allocated a quintile each year based on the alpha they achieved in the period. Chart 8.8 shows the difficulty in maintaining relatively strong alpha year to year over a three-year horizon. The blue lines show the 20% of funds with the highest alpha in 2017 and charts their movement over 2018 and 2019. Chart 8.8 shows a significant proportion of top performing funds in 2017 moving to lower quintiles in the preceding years. This shows that high performance in one year is not indicative of high performance in the next, with the greatest movement being between the top and the lowest quintile.

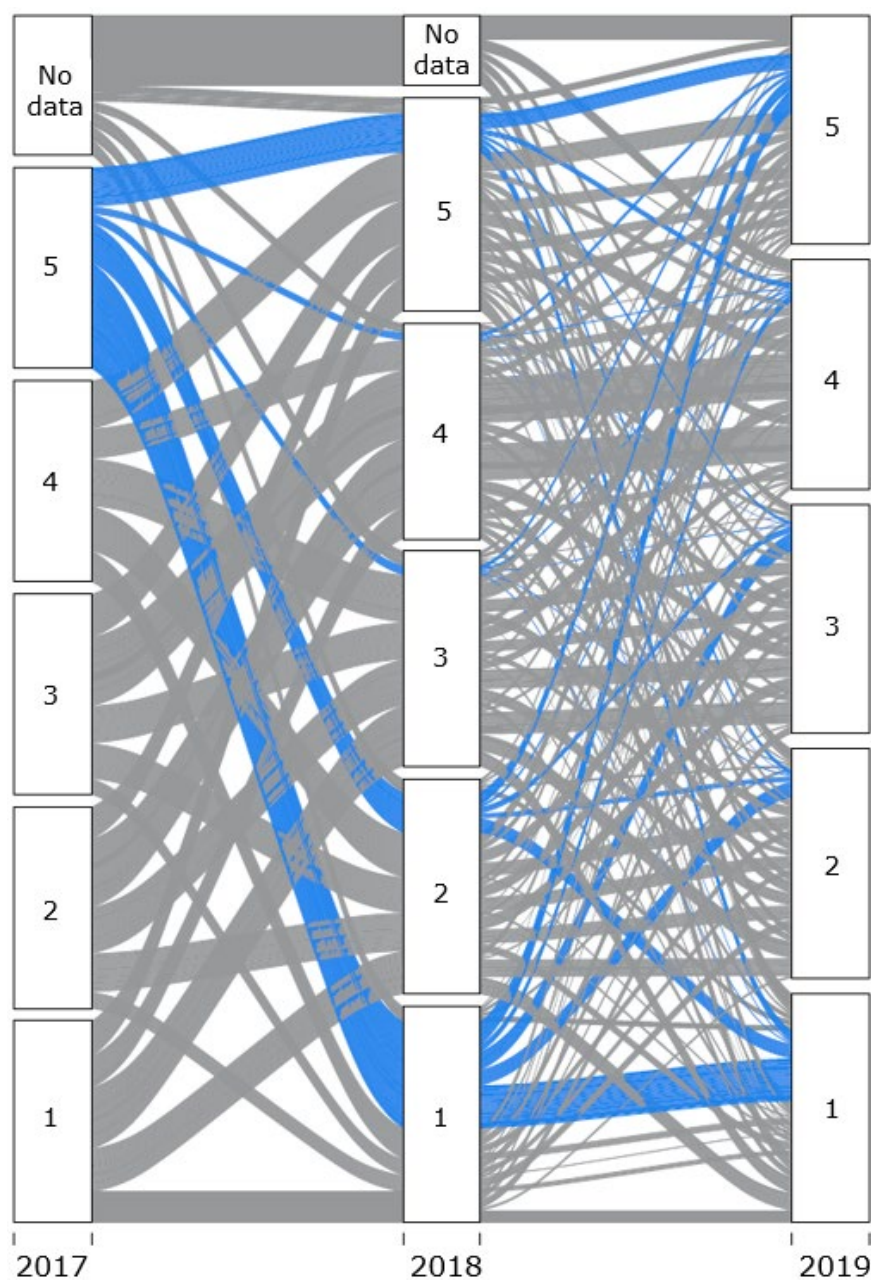
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<sup>492</sup> Lückoff, Peter, 'Mutual fund performance and performance persistence: The impact of funds flows and manager changes' (2011) *Springer*.

<sup>493</sup> Hoberg, Gerard, Kumar, Nitin & Prabhala, Nagpurnanand, 'Mutual fund competition, managerial skill and alpha persistence' (2018) 31(5) *Review of financial studies*.

<sup>494</sup> Ibid.

Chart 8.8: Alpha persistence over time by quintiles



Note: Numbered boxes represent quintiles where 5 represents top 20% and 1 represents bottom 20% of funds.

Note: Contents of the Chart are described in the paragraph above in Section 8.2.4.2 and below in Table 8.2.

Source: Deloitte Access Economics (2021) and FE fundinfo (2020).

The results in Chart 8.8 persist over longer time periods as shown in Table 8.2. The table presents the proportion of funds in the top quintile of funds in one-year intervals. Across all funds in the sample, only 1% of funds managed to stay in the top quintile for five consecutive years. The results were broadly similar by asset class. For equities, no funds were able to sustain top quintile performance across the sample period, while only 2% of fixed income funds were able to do so.

Table 8.2: Proportion of funds remaining in top quintile over consecutive years (2015-2019)

Fund	Count of funds in top quintile	Per cent remaining in top quintile			
	2015	2016	2017	2018	2019
All funds	296	16%	5%	3%	1%
Equity funds	204	12%	1%	0%	0%
Fixed interest	60	15%	7%	2%	2%

Source: Deloitte Access Economics (2021) and FE fundinfo (2020).

Even if a small number of firms can outperform an index over short or medium horizons, research suggests retail investors do not possess the information or skills to identify these funds *ex ante*.<sup>495</sup> As such, retail and wholesale investors, as well as financial advisers, rely heavily on the advice of research houses to predict funds that are likely to perform above the average. Econometric analysis presented in Appendix C finds that, on average, funds with recommendations from a research house do perform better. Moreover, while these ratings may be able to identify better performers, these funds still may not outperform the market index.

### 8.2.5 The relationship between price and performance

The above analysis suggests that managed funds, on average, underperform index benchmarks net of fees and any outperformance cannot be relied upon to continue even in the short term. The inability of past performance to predict future performance also exacerbates the information asymmetry faced by investors, resulting in greater reliance on proxy measures such as brand.

In a competitive market, where consumers are informed and switching is easy, higher prices should be expected to be correlated with higher performance. If the performance of a particular fund was overshadowed by the fees paid, a returns-maximising investor would recognise that the fees are excessive and switch funds. However, in a perfect market, skilled managers that are able to generate higher performance will experience higher demand for their product and adjust fees to extract the highest fee. It could therefore be expected that in a market consisting of rational investors and managers, there would be a flat relationship between fund expenses and returns net of fees, with higher performance being fully offset by higher fees.<sup>496</sup>

Although not definitive, a significant proportion of the literature finds higher-fee funds are associated with lower before-fee performance.<sup>497</sup> This suggests that investors are making uninformed decisions and should avoid high-fee funds to achieve higher after-fee returns.<sup>498</sup> Specific to Australian funds, research by Canstar in 2018 reported that “higher fees do not guarantee better returns” but stopped short of suggesting that investing in these funds was not in investors’ interest.<sup>499</sup>

<sup>495</sup> Cuthbertson, Keith, Nitzsche, Dirk & O’Sullivan, Nial, ‘UK mutual fund performance: Skill or luck?’ (2008) 15 *Journal of empirical finance*.

<sup>496</sup> Sheng, Jinfei, Simutin, Mikhail & Zhang, Terry, ‘Cheaper is not better: on the superior performance of high-fee mutual funds’ (2017) Working Paper No 2912511 *Rotman School of Management*.

<sup>497</sup> Gil-Bazo, Javier & Ruiz-Verdu, Pablo, ‘The relation between price and performance in the mutual fund industry’ (2009) 64(5) *Journal of Finance*.

<sup>498</sup> Haque, Tariq & Ahmed, Abdullahi D., ‘The relationship between Australian mutual fund fees and risk adjusted performance in differing economic conditions’ (2015) 54(1) *Australian Economic Papers*.

<sup>499</sup> Beattie, Dominic ‘Do higher fees charged by managed funds result in higher returns?’ *Canstar* (online), 6 March 2018, <<https://www.canstar.com.au/managed-funds/managed-funds-how-do-fees-compare/>>

Other research has countered this conclusion by finding that high-fee funds perform poorly overall but tend to outperform in adverse economic conditions.<sup>500</sup> Put another way, this suggests that high-fee funds tend to minimise downside risk for investors. However, this report has not tested this hypothesis, since analysis conducted after the release of the Interim Report focused on long-term investment horizons. Research conducted by Morningstar seems to indicate that any such demonstration of superior returns by active managers may have been short-lived.<sup>501</sup>

This section considers the relationship between fees and performance (adjusted and unadjusted for risk) to assess:

- the extent to which prices reflect competition in the market
- the outcomes consumers can expect for a given fee.

It does not seek to provide a view on the relative merits of passive versus active funds.

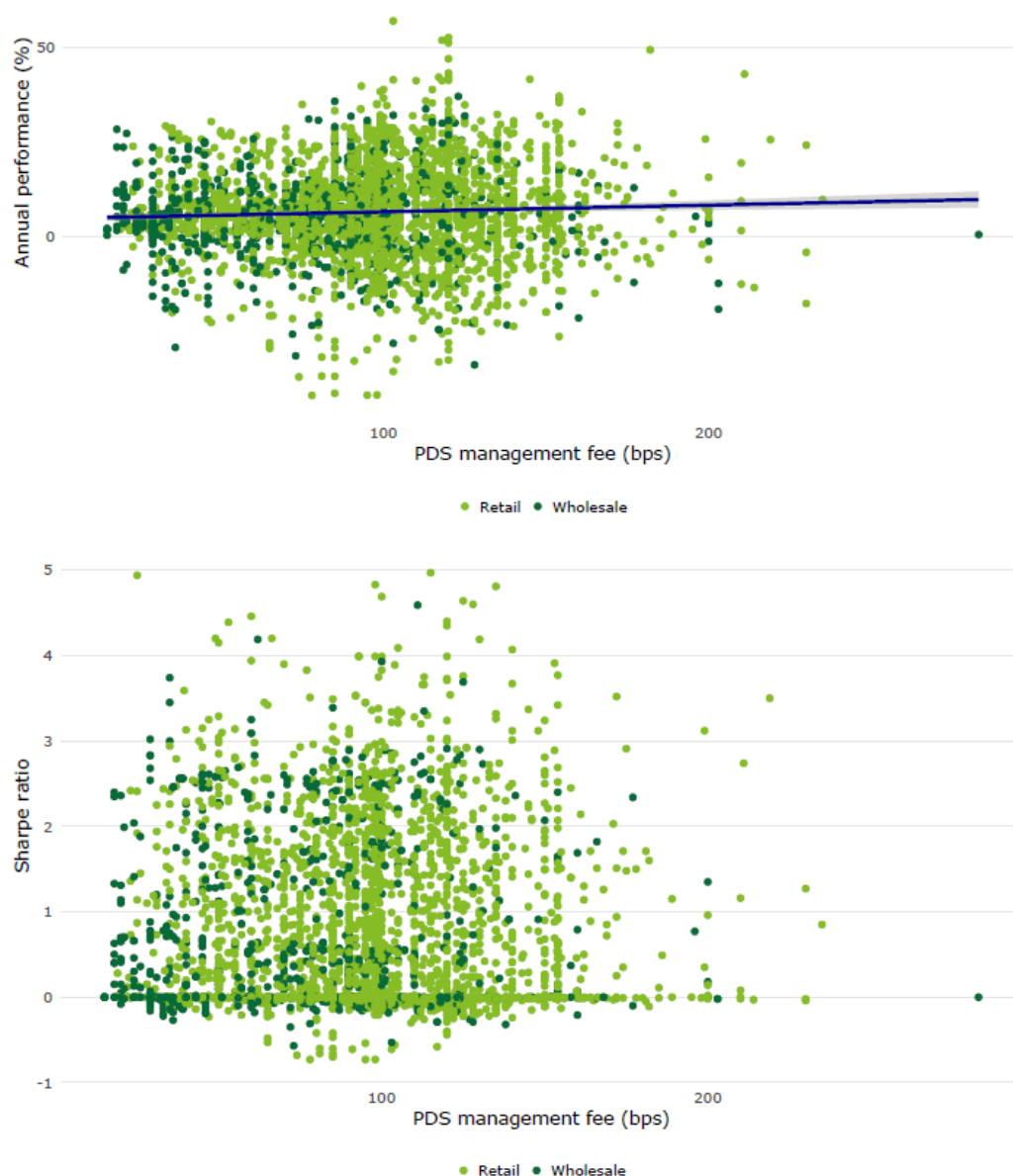
The Interim Report conducted this analysis using simple correlations between fees and performance metrics, both adjusted and unadjusted (See Chart 8.9). Using this approach, the interim findings reported no statistical relationship between risk-adjusted performance and fees but a modest positive correlation between unadjusted performance and fees.

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<sup>500</sup> Glode, Vincent, 'Why mutual funds 'underperform'' (2011) 99 *Journal of Financial Economics*.

<sup>501</sup> Aleks Vickovich, "Was Covid-19 the Last Dance for active managers?" (1 October 2020), Australian Financial Review, < <https://www.afr.com/wealth/investing/was-covid-19-the-last-dance-for-active-managers-20200929-p560ca>>

Chart 8.9: Distribution of fees for both unadjusted (1) and risk-adjusted (2) returns net of fees



Note: Trend line included in top chart since the relationship is statistically significant at 5% (p-value=0.002).

Trend line excluded from second chart since no statistically significant relationship found (p-value=0.150).

Note: Contents of the Chart are described in the paragraphs above and below in Section 8.2.5.

Source: Deloitte Access Economics (2021), FE fundinfo (2020) and Lonsec (2020).

Although the Interim Report could not conclude that there was a positive and significant relationship between fees and net risk-adjusted performance, neither could the report establish sufficient evidence to suggest that low-fee funds offer higher returns net of fees to investors.

In response to the analysis presented in the Interim Report, some participants were surprised by this finding, citing research from international markets showing that low fees increased the likelihood of outperformance.<sup>502</sup> Feedback on the analysis undertaken in the Interim Report centred around the use of point-in-time performance data instead

<sup>502</sup> James J. Rowley, David J. Walker and Sarinie Yating Ning, *The case for low-cost index-fund investing* (2018), Vanguard, <<https://www.vanguard.com.au/adviser/en/article/indexing/the-case-for-low-cost-index-fund-investing>>

of cumulative performance over appropriate investment periods. It was also suggested that this analysis should be undertaken at an asset or sector level, since Chart 8.9 compares products that are not similar in fee structure, risk or intended outcomes, despite accounting for risk. As such, the Final Report expands on this analysis below and seeks to address some of these concerns.

#### **8.2.5.1 The relationship between price and performance over longer time horizons**

The analysis shown directly above concluded that, based on simple correlations between fees and performance, there was no statistically significant relationship between the price paid by investors and the risk-adjusted returns earned on these investments. This suggested that active managers could generate value but that this was largely offset by higher fees.

Based on feedback from the Interim Report, the analysis below interrogates the data further by testing whether this relationship holds across three different investment horizons. Using cumulative performance data and average fees over the same investment period, this section considers whether higher-fee, active equity funds have performed better over three-year, five-year and seven-year horizons. The length of investment horizons were limited by data availability (fee data only available from 2013). This section only considers risk-adjusted performance (measured by the Sharpe ratio), although Appendix E considers other performance metrics to test the sensitivity of the results to the choice of performance measure.

Unlike the analysis above, but similar to the analysis the FCA conducted in the United Kingdom, this section considers only equity-class managed funds. This sampling is intentional to ensure that average fees and cumulative performance are comparable and reduce the impact of outliers caused by including multiple asset or investment types. The equity classes were selected based on sample size and include Australian Equities and Global Equities.<sup>503</sup> This analysis excludes passive (index-tracking) funds since these funds are expected to have no relationship with price, given that returns are determined by the characteristics of the underlying index.<sup>504</sup>

The hypothesis tested in this section is unchanged from Section 8.2.5. In conducting similar analysis in the United Kingdom, the FCA states that “a negative relationship would indicate ineffective competition, a positive relationship would indicate effective competition, and absence of a relationship a potential concern”.<sup>505</sup> Since the performance data used in this study are net of fees, this condition is relaxed to allow a positive correlation, or an absence of correlation, to suggest effective competition.<sup>506</sup>

Chart 8.10 shows the relationship between risk-adjusted performance and fees across the two equity classes (horizontal) and three investment horizons (vertical).

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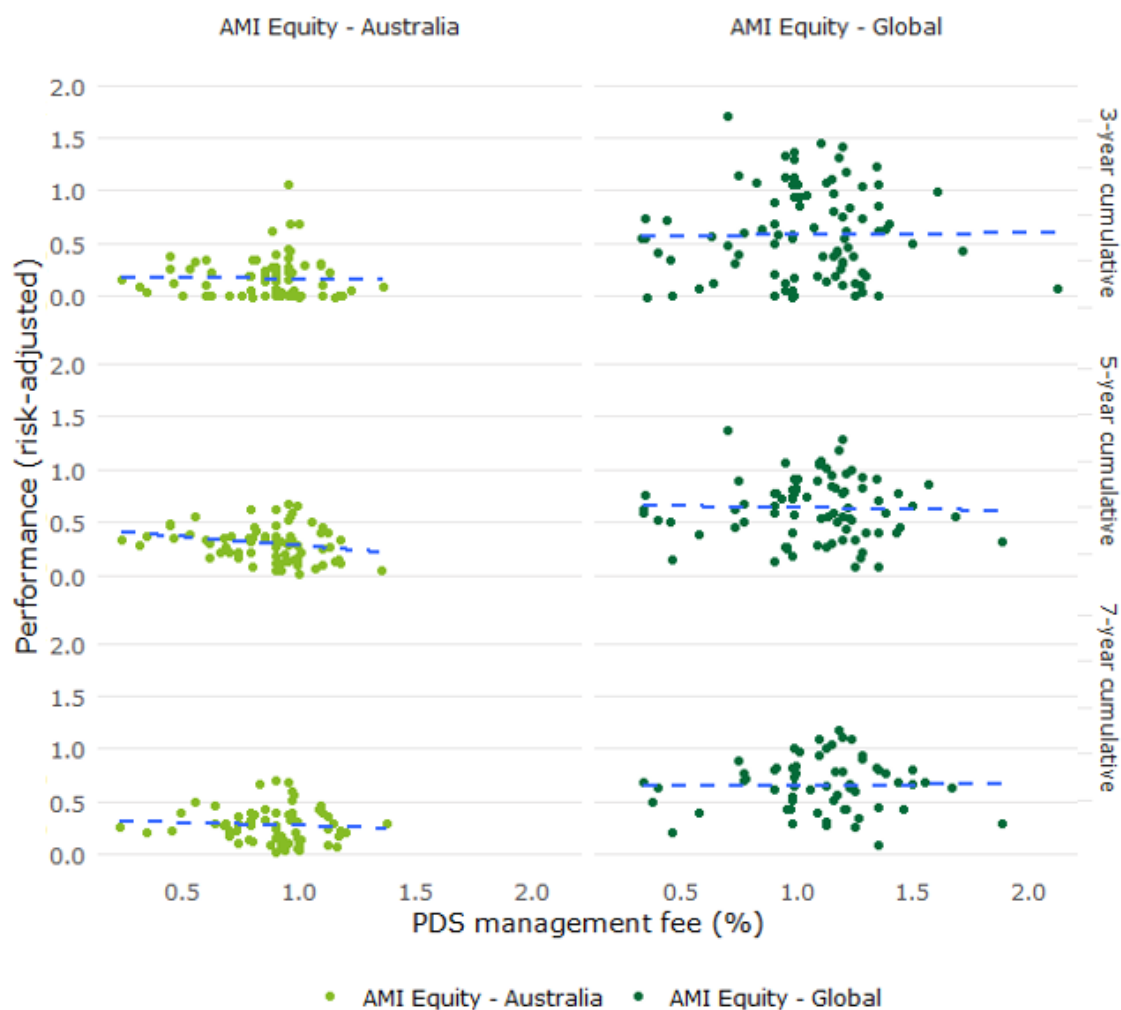
<sup>503</sup> In the FCA analysis, the largest equity classes are UK Equity Large Cap, Global Equity Large Cap and Europe Equity Large Cap.

<sup>504</sup> FCA, *Asset management market study Final Report: Annex 4 – Assessing the relationship between the price and performance of retail equity funds in the UK* (June 2017)

<sup>505</sup> Ibid.

<sup>506</sup> Ibid.

Chart 8.10: Price and performance — active Australian equity funds



Note: This Chart shows only active equity funds although economic results in Appendix E consider other equity classes.

Dashed trend line included to demonstrate the weakness of the relationship and should not be interpreted as statistical significance. The contents of this chart discussed in Section 8.2.5.1 and Table 8.3.

Source: Deloitte Access Economics (2021), FE Database (2020) and Lonsec (2020).

Trend lines have been included in Chart 8.10 (despite statistical insignificance in all but one relationship) to demonstrate the direction and significance of the relationship, which may not always be obvious. The correlation coefficient and p-values for each of these trend lines are shown in Table 8.3



Table 8.3: Correlation between fees and cumulative performance

Sector	3-year	5-year	7-year
Australian equities	-0.016 (0.888)	-0.230** (0.049)	-0.071 (0.563)
Global equities	0.012 (0.910)	-0.031 (0.783)	0.011 (0.934)

\*\*\* Significant at 1% level \*\* significant at a 5% level \* significant at a 10% level

Note: P-values in parenthesis.

Source: Deloitte Access Economics (2021), FE Analytics (2020), Lonsec (2020)

The findings of this additional analysis broadly support the findings presented above in Section 8.2.5; there does not appear to be a significant negative correlation between the risk-adjusted returns (net of fees) and the fees paid on active funds. In only one instance of active Australian Equity funds over a five-year horizon was the relationship statistically significant at the 5% significant level.

At first, this finding appears at odds with the analysis conducted in Section 8.2.4 showing that the majority of funds could not outperform the index. However, the evidence here suggests that funds with higher fees are performing slightly better in gross terms, but that this slight increase in average performance is offset by higher fees so that higher fee funds do not perform significantly differently in terms of risk-adjusted returns (net of fees).

These results, and those outlined in Appendix E, lead to a similar conclusion to that outlined in the Canstar report published in 2018<sup>507</sup>, namely, investors should be aware that higher-fee funds do not necessarily guarantee higher returns net of fees charged. This report cannot conclude definitively, however, that higher-fee funds are more likely to return poor performance (net of fees). Indeed there is some evidence that higher fee funds may have slightly better performance before fees which is consistent with a competitive market.<sup>508</sup>

Further analysis of the relationship between fees and performance using more sophisticated econometric techniques and alternative measures of performance is outlined in Appendix E.

### 8.2.6 Fund managers demonstrate returns to scale

Within the literature, there is evidence to suggest that nonlinear returns to scale exist in funds management.<sup>509</sup> In particular, funds will experience returns to scale as FUM increases until an inflection point is reached where higher FUM is no longer associated with a benefit. This concept was tested with and affirmed in consultation with fund managers who claimed that managers, particularly active managers, will experience decreasing returns to scale after a certain level of FUM.

Reasons for this inflection can be varied. First, large funds are more likely to be subject to liquidity constraints; larger funds sacrifice mobility and agility by taking on greater

<sup>507</sup> Beattie, Dominic 'Do higher fees charged by managed funds result in higher returns?' *Canstar* (online), 6 March 2018, <<https://www.canstar.com.au/managed-funds/managed-funds-how-do-fees-compare/>>

<sup>508</sup> Deloitte notes that this is a different result to similar analysis conducted by the Productivity Commission into superannuation. In this analysis, superannuation fees were determined to be high by global standards and unlike managed funds they found a strong negative relationship between fees and net returns. Productivity Commission, *Superannuation: Assessing Efficiency and Competitiveness* (December 2018), <<https://www.pc.gov.au/inquiries/completed/superannuation/assessment/report/superannuation-assessment.pdf>>

<sup>509</sup> Chen et al., 'Does fund size erode mutual fund performance? The role of liquidity and organization' (2005) 94(5) *American Economic Review*.

FUM and may not be able to exploit opportunities without having a negative impact on market pricing.<sup>510</sup> Similarly, large funds (particularly outperforming funds) may attract more attention from market participants, making it far more difficult to conceal asset selection or particular intellectual property with larger holdings.<sup>511</sup> A lack of liquidity and the ability to quickly take advantage of superior investment opportunities mean that, even if active managers can identify better performing assets, larger funds are more likely to hold more average investments, and therefore achieve nearer to average performance.<sup>512</sup>

Simple correlations presented earlier in Chart 8.4 demonstrated that the best risk adjusted returns were achieved by smaller firms, however the analysis did not suggest that fund size inversely correlated with performance beyond certain thresholds. This does not rule out the possibility that larger funds do experience more difficulty achieving higher performance, just that they are more likely to achieve normal returns as the fund size grows.

Another way that returns to scale could manifest is in the relationship between profits and funds under management. Consultations indicated that the industry is characterised by significant fixed costs (see Section 3.2.3.2), which would suggest that there is likely to be increased returns to scale. If this is the case, it can be argued that it is inefficient to have such a high number of fund managers who all need to engage in the same fixed costs. By consolidating the industry, the initial costs of establishing a funds management business could be socialised across more people.

Using data extracted from fund 388 reporting forms, this report considers the relationship between funds under management and profitability to test existence of returns to scale. Deviating from Section 8.1.1, this section uses operating margin as the measure of profitability due to data availability.<sup>513</sup> Chart 8.11 shows the distribution of operating margins and funds under management for observations within the sample.

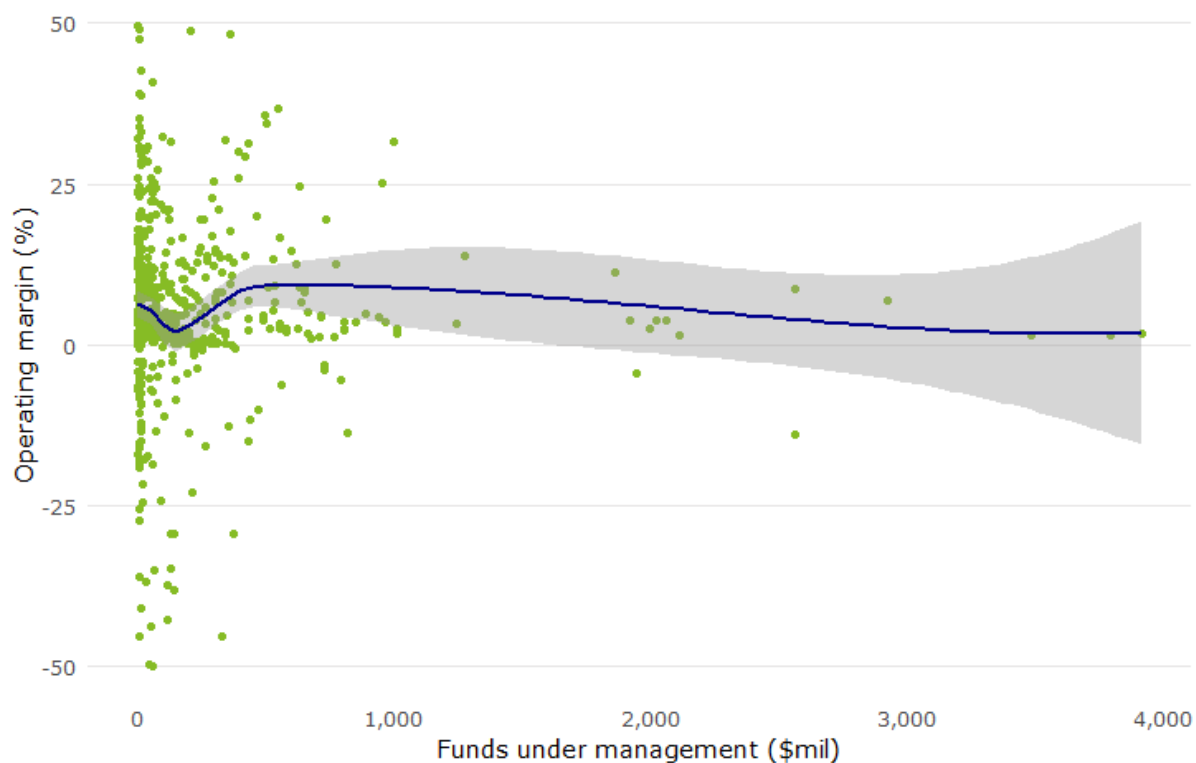
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<sup>510</sup> Financial Conduct Authority 'Asset Management Market Study Interim Report' (Market Study 15/2.2, November 2016) <<https://www.fca.org.uk/publication/market-studies/ms15-2-2-interim-report.pdf>>.

<sup>511</sup> Indro, Daniel C. et al., 'Mutual fund performance: Does fund size matter?' (1999) 55(3) *Financial Analysts Journal*.

<sup>512</sup> Chen et al., 'Does fund size erode mutual fund performance? The role of liquidity and organization' (2005) 94(5) *American Economic Review*.

<sup>513</sup> Operating margin refers to profits made from operations (fees minus operating costs costs) divided by total revenues.

Chart 8.11: Operating margin by funds under management — Fund level ( $N=556$ )

Note: Funds reporting less than 1,000,000 FUM excluded from sample. Operating margin used due to data availability. Operating margin refers to profits made from operations (fees minus operating costs costs) divided by total revenues.

Note: Contents of the chart are described in the paragraph above and below in Section 8.2.6.

Source: Deloitte Access Economics (2021) and Unpublished ASIC 388 forms.

Allowing for a nonlinear relationship shows that the operating margin of fund managers does show various inflection points along the distribution. The shape in Chart 8.11 is broadly consistent with insights observed in consultations. Initially, funds will exist typically with one or few large mandates allowing the fund to remain small (fewer than 10 people) and profitable. In establishing the fund, irrespective of FUM, there are considerable fixed costs including acquiring AFSL, appropriate insurance, legal services and technology. Nonetheless, these costs are known before commencing and with a sufficient mandate or seed funding it is possible to be profitable.

To expand beyond this initial mandate, the fund is required to invest further. Attracting additional capital may include investing in sales teams and more specialised and diverse fund managers as well as acquiring a rating and access to distribution networks. This would explain the initial decline in profits after the \$10–20 million mark. Chart 8.11 shows that there is a space (where a good proportion of observations sit) where returns to scale are present. Fund managers are able to introduce new funds or bring on additional FUM without significant change in their cost base.

At around the \$1 billion mark and beyond, Chart 8.11 shows another steady decline in the operating margin. It is unclear from the data whether this is a result of decreasing returns to scale, such as higher transaction costs, or because larger funds tend to be low cost, low fee funds (such as passive funds). Passive funds represent a relatively small part of the industry in terms of number of funds, but a significant portion of the industry on an asset weighted basis. Since the fees on passive strategies may be lower, larger passive funds may operate at lower profit margins. Nonetheless, the shape of the distribution in Chart 8.11 is consistent with anecdotal evidence obtained from consultation.

### 8.3 Investor satisfaction

In the above sections of this chapter, the analysis has indicated that, on average:

- funds management businesses' profits are above the average of other industries, but are not necessarily excessive and are below some other industries
- active funds are making conscious investment decisions rather than following the market, assessed through their level of activity relative to a benchmark
- risk adjusted returns net of fees are a significant, but not the only feature that investors look for in choosing a fund
- on average active and passive managers achieve returns net of fees that are below the index benchmark although a minority of funds do outperform their benchmark index in a given year
- there is evidence that more expensive funds do receive higher raw returns, however, returns are similar to less expensive funds on a risk adjusted basis net of fees
- fund manager returns above or below the benchmark are not indicators of future performance
- fund managers likely experience some decreasing returns to scale, both in terms of performance and profits, as FUM increases.

Given these findings, the natural extension of the above analysis is to investigate the level of retail satisfaction or confidence in the funds management sector. There is some evidence provided from the Australian Financial Complaints Authority that issues with retail investors do persist despite the level of intermediation and regulation. In the past financial year, the Authority received a total of 2,766 complaints relating to financial investments and advice, of which 409 (2% of all complaints) dealt specifically with managed funds.<sup>514</sup> The issues that these complaints relate to are outlined in Table 8.4.

Table 8.4: Complaints relating to 'investments and financial advice', AFCA (July 2019–June 2020)

Complaint	Count
Misleading product/service information	757
Inappropriate advice	585
Failure to follow instructions/agreement	575
Failure to act in client's best interest	469
Service quality	380
Total	2,766

Source: Breakdown specific to managed investments unavailable. Table refers to all investments and advice complaints. 409 complaints dealt specifically with managed funds in FY2019-20.

Source: AFCA (2020).<sup>515</sup>

A more in-depth assessment of consumer satisfaction is beyond the scope of this research, and as such, this section provides only a qualitative discussion of the findings presented in this section, drawing insights from proceeding chapters as well.

In absence of a retail investor survey, one way this report has attempted to gauge the level of retail satisfaction is by assessing the rate at which investors switch products (see Section 7.3). In a competitive market, the ability to switch, or the threat of switching

<sup>514</sup> Australian Financial Complaints Authority, *Complaints by Product* (July 2020)

<<https://data.afca.org.au/complaints-by-product>>.

<sup>515</sup> Australian Financial Complaints Authority, *AFCA Snapshot – 1 July 2019 to 30 June 2020* (2020)

<<https://www.afca.org.au/media/967/download>>.

prevents firms from exercising market power.<sup>516</sup> This report has found evidence that some transacting does occur in managed funds, although structural impediments such as capital gains tax restrict this to some extent. This was presented in Section 7.3.1 by showing the extent of inflows and outflows at a fund manager group level. Furthermore, econometric analysis in Appendix D indicated that consumers were highly sensitive to changes in ratings of funds, with upgrades and downgrades attracting significant inflows and outflows respectively. However, there is limited evidence on the extent of switching by retail investors.

While retail investors may have the ability to switch fund managers, retail investors do not have the means nor the incentive to actively bypass managed funds providers. Retail investors have the option to manage their own personal assets including superannuation, in fact, retail investors are increasingly opting to manage their own investments as demonstrated by the growth in self-managed superannuation funds (account numbers grew 26% between 2012 and 2017).<sup>517</sup> However, in order for this to be financially beneficial, individuals would need to believe that they could outperform a full-time investment manager to such a degree that would justify the additional time and research it would require to manage personal investments (this was discussed in Section 8.2.3). For the majority of retail investors, this is unlikely to be feasible.

Interim submissions were unable to suggest alternative measures of retail satisfaction, although they did indicate that the incentive structure it aligned to kept satisfaction high. That being said, fund managers indicated that they have little interaction with retail investors as a result of the distribution channels. At best, some respondents challenged the interpretation of switching behaviour, indicating that low levels of switching can be seen as a sign of satisfaction. Fund managers reiterated the importance of considering these outcomes within appropriate investment horizons. These comments are noted but do change our overall findings regarding satisfaction or switching behaviour. This report identifies a retail investor survey as the most likely method of soliciting this understanding.

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<sup>516</sup> Australian Competition & Consumer Commission 'Merger guidelines' (November 2017) <<https://www.accc.gov.au/system/files/Merger%20guidelines%20-%20Final.PDF>>.

<sup>517</sup> Australian Taxation Office, *Growth in SMSF assets* (January 2018) <<https://www.ato.gov.au/about-ato/research-and-statistics/in-detail/super-statistics/smsf/self-managed-superannuation-funds--a-statistical-overview-2015-2016/?page=3>>.

# Appendices

# Appendix A : Terms of reference

ASIC engaged Deloitte Access Economics to research and assess the state of competition in the Australian funds management industry. The assessment is required to include an Interim Report, final report, and recommendations that ASIC may consider in establishing policy settings to promote competition and positive consumer outcomes.

The following sections outline the scope of the report and the broad research objectives as defined by ASIC.

## **A.1. Scope**

The following six key research questions are in the scope of this report:

- how fund managers compete to deliver value
- the features of a fund that make it competitive in its type/class
- how features of funds are promoted or communicated to potential investors and to what extent do potential investors rely on these features when making investment decisions
- how retail investors choose between fund managers and products (e.g. on the basis of quality, service or price)
- the extent of correlation between fees charged and performance achieved
- how the current market structure and regulations impact competition between fund managers.
  - how charges and costs differ along the value chain
  - the extent to which fund managers are willing and able to control costs and quality along the value chain.

Competition between superannuation funds and competition between financial advisers are out of scope.

The following investment products are the primary focus of this report:

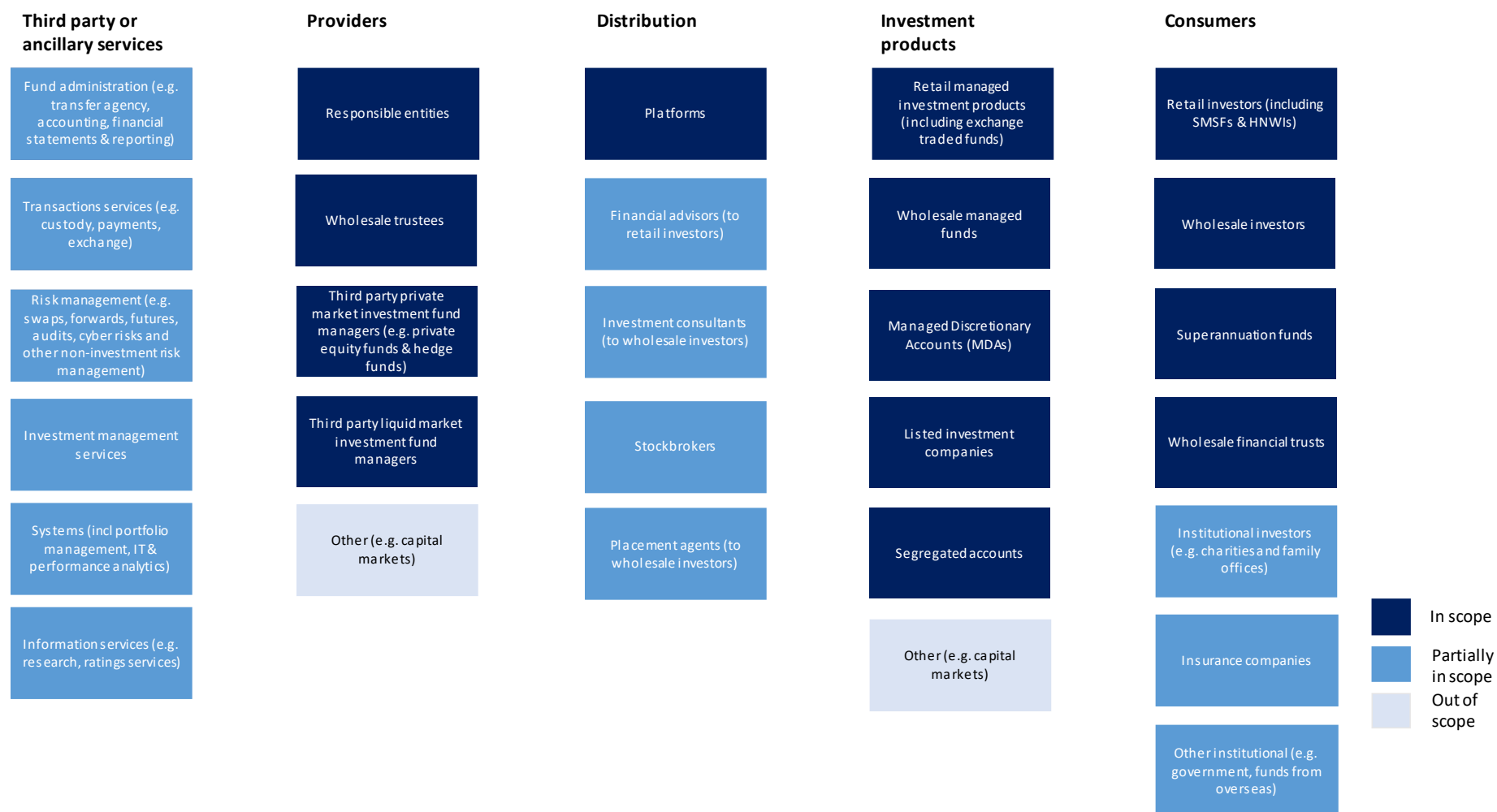
- retail managed investment products (both unlisted and listed, and ETFs)
- platforms (insofar as investments are made by retail non-superannuation investors).

To the extent that they affect competition between fund managers and outcomes for retail investors, the following products are also in scope, however with less focus than the above:

- managed discretionary accounts (MDAs)
- listed investment companies
- wholesale managed funds
- segregated accounts.

The products and participants in the funds management industry covered in the scope of this report are summarised in Figure A.1.

Figure A.1: Elements of the funds management industry supply chain in and out of scope



Source: Deloitte Access Economics (2021).



## **A.2. Research objectives**

ASIC seeks to facilitate understanding of the following:

- the nature, extent and effectiveness of competition in the funds management industry
- the factors that drive competition in the industry to produce positive consumer outcomes
- the impact that increased competition may have at an investor, industry and wider economic level
- the factors that may inform ASIC's exercise of its regulatory function to promote competition in the funds management industry.

The broad research objectives detailed by ASIC include:

- how competition operates for providers of services relevant to the funds management industry in Australia and whether there are any barriers to entry, innovation or changing suppliers
- the incentives that fund managers have to compete to provide value for money
- the proxies used by fund managers and investors to identify future performance and whether these lead to good outcomes for investors
- the extent to which structural features and regulation of the fund management market impacts on the incentives and/or ability of fund managers to compete effectively with each other
- the extent to which fund managers are willing and able to control and scrutinise costs and performance when purchasing services on behalf of the fund, with an emphasis on the performance and costs associated with external investment managers and service providers supporting a fund
- whether there are features of managed funds and fund managers that investors prioritise when making investment decisions
- the aspects of the way the funds management market is structured which affect the way both investors and fund managers behave and how it impacts the way competition works for these services
- the charging structures and underlying costs for providing fund management services to different groups of investors and for different types of funds. These are likely to differ based on the class of investor, the type of product such as active versus passive, and the distribution channel
- the extent to which different types of investors are able to access the right information to make informed choices, assess this information to find the best products for their needs and act on this information to ensure they are getting the best value product for them
- the extent to which switching by investors between funds occurs to better understand the ability of investors to act in response to the information they assess
- the costs of switching between funds and the extent that this may discourage investors from acting in their own best interests. These costs may be real or perceived and can be monetary or non-monetary
- the regulatory requirements and settings that could otherwise be changed to improve consumer outcomes.

ASIC also requested data collection and analysis on long-term trends in:

- fund fees and costs
- fund performance relative to fund objective
- fund manager revenues and expenses (and profitability measures such as cost to income ratios).

# Appendix B : The structure, conduct and performance framework

The structure-conduct-performance (SCP) framework is commonly adopted for assessing competition by regulators and policy agencies in Australia and overseas.

## B.1. Mapping competition regulation to the SCP framework

Table B.1 maps to the SCP framework to the ACCC's merger factors from its Merger Review Guidelines. The Guidelines are the general principles the ACCC applies in its merger analysis (to assess if there is a substantial lessening of competition) under Section 50 of the *Competition and Consumer Act 2010*. Consistent with the description in Chapter 1 regarding using the SCP framework in a complete and holistic manner, the ACCC recognises that any one factor may not be a conclusive indicator of a substantial lessening of competition and it does not look at these indicators in any particular order.

Table B.1: Mapping of the ACCC's merger guidelines to the SCP framework

Merger factor	Relevant element of the SCP framework
Concentration and market shares	Structure
Height of barriers to entry	Structure
Actual and potential import competition	Structure
Availability of substitutes	Structure
Countervailing power	Structure
Dynamic characteristics of the market (such as growth, innovation and product and/or service differentiation)	Conduct
Removal of a vigorous and effective competitor	Conduct
Vertical integration	Structure and conduct
Ability to increase prices or profit margins	Conduct and performance
Other factors (such as efficiencies, effect of export markets and government regulations)	Structure, conduct and performance

Source: Deloitte Access Economics analysis of the ACCC's merger guidelines (2017).<sup>518</sup>

Table B.1 maps to the SCP framework the FCA's Interim Report into the UK asset management market. The FCA's Asset Management Market Study partly motivated this review of funds management in Australia.

<sup>518</sup> Australian Competition and Consumer Commission 'Merger guidelines' (November 2017) <<https://www.accc.gov.au/system/files/Merger%20guidelines%20-%20Final.PDF>>.

Table B.2: Mapping of the FCA's Asset Management Market Study Interim Report to the SCP framework

Analysis undertaken	Relevant element of the SCP framework
Profitability	Performance
Charges along the value chain	Conduct
Drivers of fund flows	Structure and conduct
Ratings and recommendations value added	Performance
Adviser incentives	Conduct
Pricing analysis	Conduct
Investor returns	Performance
Barriers to effective decision-making by oversight committees of pension funds	Structure and conduct

Source: Deloitte Access Economics (2021) and FCA (2016).<sup>519</sup>

### B.1.1 The structure-conduct-performance framework

The analytical approach used in this report to assess competition in the funds management industry, and when considering policy settings to promote competition to achieve positive consumer outcomes, is based on the structure-conduct-performance framework.

The structure-conduct-performance framework is commonly adopted for assessing competition by Australian regulators and policy agencies such as the Australian Competition and Consumer Commission (ACCC), the Australian Energy Market Commission (AEMC) and the Productivity Commission. The framework is used explicitly at times — for example, by the ACCC and AEMC for assessment of the retail energy market. In other instances, while not explicitly referenced, elements have been assessed and the framework has effectively been used. This is evident in the ACCC merger guidelines and the UK FCA's report into asset management industry. Examples of how these different analyses map to the structure-conduct-performance framework can be found in Appendix B.

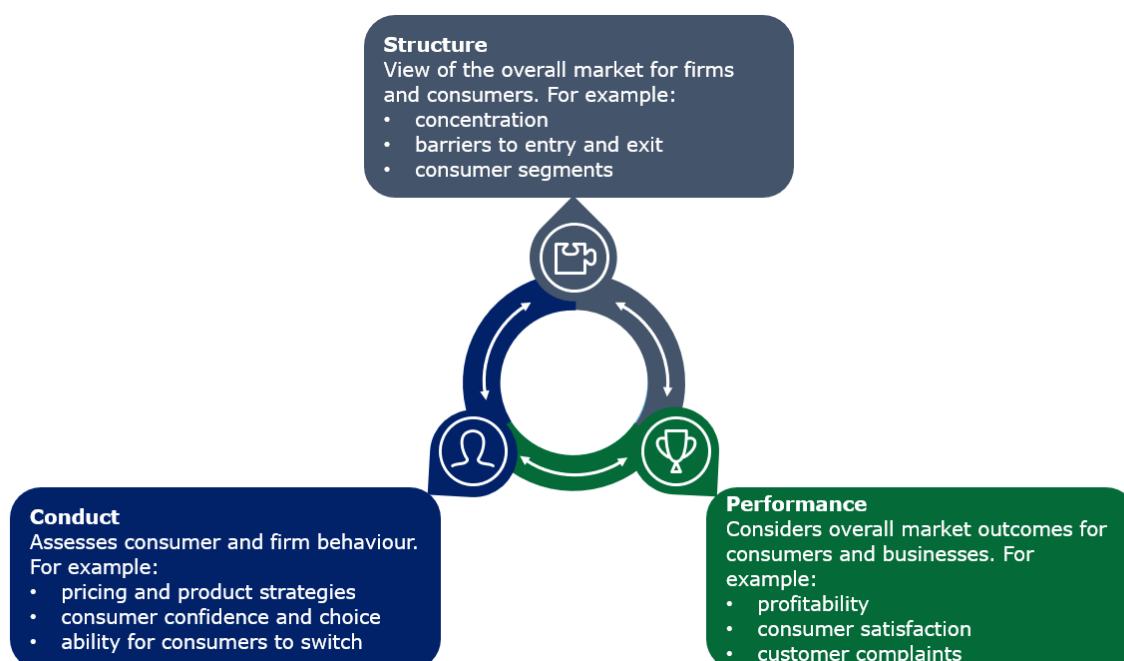
The structure-conduct-performance framework holds that market structure influences the conduct of firms within that market, and the conduct of firms can determine the financial performance of these firms, including the extent to which the market is efficient. More holistic applications of the framework acknowledge two-way relationships between each of the elements. For example, performance can affect structure — a more profitable sector is likely to attract new entrants — and conduct can influence structure — a pricing or product strategy of a firm that is successful can result in it becoming a more dominant player in the market.

This analysis adopts a holistic approach to the structure-conduct-performance framework. It assesses each of the elements over time, exploring how they interact and influence one another. A summary of the type of analysis involved and the key measures of structure, conduct and performance are presented in Figure B.1. This includes concentration and barriers to entry and exit for structure, pricing and product strategies

<sup>519</sup> Financial Conduct Authority 'Asset Management Market Study Interim Report' (Market Study 15/2.2, November 2016) <<https://www.fca.org.uk/publication/market-studies/ms15-2-2-interim-report.pdf>>.

and consumer confidence and choice for conduct, and profitability and consumer satisfaction for performance.

Figure B.1 Structure conduct performance framework



Source: Deloitte Access Economics (2021).

This report recognises that no single measure should be used to draw conclusions about the state of competition. A complete assessment requires that all measures are considered in combination, along with trends over time. For example, market structures with high levels of concentration can still be effectively competitive markets if firms choose to compete vigorously on price, innovation and service quality. That being said, much of the literature and practical applications of structure-conduct-performance have moved towards emphasising the role of conduct. As such, the majority of this report deals with the conduct of participants (see Section 1.4 for outline of report structure).

Acknowledging that a comprehensive competition assessment is multi-faceted, the structure-conduct-performance framework provides a useful approach to methodically and comprehensively test various indicators for evidence that firms are able to exercise exclusionary power. As such, this report is divided into three parts:

- **Structure:** investigates elements of the industry structure that create potential for incumbents to exercise exclusionary power. This includes examining the presence and height of barriers to entry and exit, the degree of market concentration, the extent of vertical integration and the presence of countervailing power.
- **Conduct:** analyses the behaviour of market participants, including buyers and sellers, for indicators of exclusionary power. These indicators include barriers to switching, bundling, predatory pricing, tying or stickiness of products and services, and consumer disengagement.
- **Performance:** assesses the extent of market power by examining the benefit accruing to incumbents and the outcomes delivered to consumers. Market power could be demonstrated by the presence of supernormal profits, funds charging high fees but following a passive investment strategy and low consumer satisfaction.

# Appendix C : Fund Performance

This appendix provides additional information around the metrics and measures used in Chapter 8 as well as analysing the relationship between rated funds and performance.

## C.1. Objective

One of the key objectives of this report has been to understand the features of a fund that drive individual investment decisions. Performance has been identified as one of these key features in the sense that retail investors expect to receive the best value for money given a particular strategy or investment objective. In Chapter 8, the report analysed the components of value for money and how they may differ between investors. The chapter then analysed the performance that is achieved by funds using returns net of fees as the metric to define performance. Although returns net of fees is an incomplete measure of performance, it is a factor that is consistent to all investor's objectives irrespective of other requirements. This appendix expands on the analysis conducted in Chapter 8 by providing additional information on the metrics and derivations used to analyse performance.

The second half of this appendix explores the ability of a retail investor to identify high performing funds ex ante. Whether or not retail investors possess the tools to identify these funds is discussed further in Appendix D as this has important implications on the nature of competition and the ability of retail investors to make informed switching decisions. Throughout this report, the importance of fund ratings on retail flows has been identified as a significant driver of flows (see Appendix D). This appendix explores further the relationship between fund ratings and performance through regression analysis.

Table C.1: Key issues covered in this analysis

Key issue for analysis	Expected outcome
How features of funds are promoted or communicated to potential investors and to what extent do potential investors rely on these features when making investment decisions	This analysis will assess how well research house ratings are able to assess and promote quality in a fund, as measured by risk adjusted returns net of fees.
How retail investors choose between fund managers and products (e.g. based on quality, service or price)	This analysis will demonstrate validity of research house ratings as predictions for future fund performance.

Source: Deloitte Access Economics (2020).

## C.2. Measures of fund performance

Chapter 8 of this report identified and discussed the average performance of funds relative to a prescribed benchmark. This appendix provides additional information on the metrics and calculations used in Chapter 8.

### C.2.1. Alpha

Chapter 8 uses two types of performance measurements. The first measure, alpha, refers to the performance above a specified benchmark. Although there are several methods of calculating alpha, this report uses a simple calculation where:

$$\alpha_p = R_p - R_b$$

Here  $R_p$  refers to the percentage return (net of fees) on the fund and  $R_b$  refers to the return of an appropriate benchmark index. Alpha is used since it has a simple interpretation when comparing the performance investors receive. It is also a metric which most investors will be able to identify themselves, unlike the Sharpe ratio which requires terms that are not readily available to most investors (such as volatility).

This report notes a number of limitations of this method. First, alpha has been calculated only for a select number of broad asset classes (see Table C.2). Second, the actual fund alpha may differ if the fund chooses an alternative index to the one selected or if they use a variation of the index, such as ASX 300 +3%, where the fund seeks to overachieve by a specified amount. Benchmarks were selected based on similar analysis conducted in 2016 by Morningstar and the FSC.<sup>520</sup>

Table C.2: Asset class and benchmark

Asset class	Benchmark
Australian equities	S&P ASX 300 TR in AU
International equities	MSCI World ex Australia ATR in AU
Australian fixed interest	Bloomberg AusBond Composite 0+ Years TR in AU
International fixed interest	Bloomberg Barclays Global Aggregate Hedge AUD ATR in AU
Australian property	S&P ASX 300 AREIT (Sector) TR in AU

Source: Deloitte Access Economics (2021), FSC and Morningstar (2016).

### C.2.2. Sharpe ratio

The other measure of performance that this report uses is the risk-adjusted return, as calculated using the Sharpe ratio. The Sharpe ratio considers performance relative to a risk-free asset while also accounting for underlying asset volatility. The higher the Sharpe ratio, the better the fund has performed relative to the risk that the fund is exposed to (measured by the standard deviation).

$$\text{Sharpe ratio}_p = \frac{R_p - R_f}{\sigma_p}$$

Where  $R_p$  refers to the return of the fund,  $R_f$  refers to the risk-free rate and  $\sigma_p$  refers to the standard deviation of the portfolio (fund). The Sharpe ratio is used throughout this report since it is available in FE fundinfo at a fund level. In this report, both alpha and the Sharpe ratio are calculated net of fees.

### C.2.3. Tracking error

The final metric used in Section 8.2 of the report is tracking error. Tracking error provides a measure of how active or passive a fund strategy is by measuring the

<sup>520</sup> FSC and Morningstar, 'Australian Managed Funds Industry' (July 2016), <  
<https://www.fsc.org.au/resources-category/publication/791-2016-fscmorningstar-austnmanagedfundsindustryreport/file>>

standard deviation of a fund relative to a prescribed benchmark. Since it is expected that active managers will deviate from the benchmark based on a particular strategy, active funds should demonstrate a higher standard deviation than a passive fund. This analysis is not concerned whether the deviation from the index is positive or negative, only that active funds show some deviation.

$$\text{Tracking error}_p = \sigma(R_p - R_b) = \sigma(\alpha_p)$$

Where  $R_p$  refers to the performance of the fund and  $R_b$  refers to the performance of the index benchmark. As shown in this equation, tracking error is calculated from the standard deviation in alpha,  $\alpha_p$ . In this report, the standard deviation is calculated on annual performance, rather than monthly performance, as was used in the FCA analysis.<sup>521</sup>

### C.3. Econometric analysis

This section of the appendix examines the relationship between ratings and performance using econometric analysis to understand the efficacy of tools available to retail investors to identify better performing funds.

#### C.3.1. Data

This section discusses FE fundinfo and Lonsec data used in this analysis, including sample size and approaches data cleaning.

##### C.3.1.1. FE fundinfo

The FE fundinfo data has yearly performance data (2014–2020<sup>522</sup>) for **3,179 Australian managed funds**. The dependent variables for the regression models are taken or derived from FE fundinfo (dependent variables described in Section C.4.2).

The analysis uses several other variables obtained from FE fundinfo including FUM, asset class, passive fund indicators, wholesale fund indicators and certain fund manager characteristics including total fund manager FUM and number of funds. These additional controls are described in more detail in C.3.2.

##### C.3.1.2. Lonsec data

Data provided by Lonsec includes **2,109 funds** (including retail, wholesale, active and passive) that have a current rating or have been rated in the past (2010–2020). These ratings are matched against FE fundinfo using unique fund identifiers.

Table C.3 summarises the Lonsec ratings data with accompanying descriptions. The cells have been colour coded to represent where ratings have been grouped together for analysis. In the econometric analysis, rating variables are 'highly recommended', 'recommended' and 'investment grade'. 'Not recommended' variables (coloured blue) were grouped together with 'not rated' due to low sample (fewer than 100 after missing values).

Missing rating variables are assumed to be 'not rated'. The actual number of observations in the regressions will be lower as this does not include missing values for variables and statistical software will automatically exclude funds with missing information on one or more control variables. Actual sample sizes of the individual regressions are included in the regression output tables in Section C.4.

<sup>521</sup> Financial Conduct Authority 'Asset Management Market Study Final Report' (Market Study 15/2.3, June 2017) <<https://www.fca.org.uk/publication/market-studies/ms15-2-3.pdf>>.

<sup>522</sup> 2020 FUM and performance (annualised) data taken as at March 2020. This will not capture the full impact of the COVID-19 pandemic on the fund performance and asset prices.

Table C.3: Lonsec rating system and groupings

Rating	Description
Highly Recommended	Lonsec has a very strong conviction that the product can generate risk adjusted returns in line with objectives.
Recommended	Lonsec has a strong conviction that the product can generate risk adjusted returns in line with objectives.
Investment Grade	Lonsec has a conviction that the product can generate risk adjusted returns in line with objectives.
Approved	Lonsec believes that the financial product can generate risk adjusted returns in line with objectives.
Redeem	Lonsec believes the product is no longer considered worthy of investment for any period of time.
Screened Out	Lonsec does not have any conviction that the product can generate risk adjusted returns in line with objectives.
Not Approved	Lonsec believes the product cannot generate risk adjusted returns in line with objectives.
Fund Watch	Lonsec advises no new investment into this product due to a significant change that has occurred requiring further assessment.
Cease Coverage	Fund manager withdraws from Lonsec research after the research has been completed.
Discontinued Review	Fund manager has agreed to tender a fund for assessment and subsequently elects to discontinue.
Closed/Wind Up	Fund manager advises Lonsec that the product is being wound up and capital returned to investors.
Not Rated	Description unavailable
Hold	Description unavailable
Under Review	Description unavailable
Accept Merger	Description unavailable
Capital Raising Closed	Description unavailable

Note: Colour coding indicates ratings that have been grouped together for the purpose of econometric analysis.  
Source: Deloitte Access Economics (2021) and Lonsec (2020).

### C.3.1.3. Data modifications

After merging the data sets, a number of observations are excluded on the basis of being potential outliers. In particular, there are a number of observations where inflows and outflows of FUM are very large relative to the rest of the sample. Removed from the sample are:

- 70 observations where inflows or outflows for a given year are larger than \$1 billion and represent more than a 25% increase in previous year FUM
- 77 observations where the Sharpe ratio for a given year is greater than 5.

Although these observations may not necessarily be erroneous, they represent a small part of the overall sample and excluding them avoids the risk that coefficient estimates are significantly affected by erroneous or outlier observations.



### C.3.2. Model specifications

This section outlines the model specifications used in the analysis. In the below specifications, the subscripts 'i', 'j' and 't' refer to 'fund', 'asset class' and 'year', respectively.

All models use clustered standard errors at the fund manager level.

#### C.3.2.1. Simple relationship between rating and performance

The first models tested in this analysis are simplified specifications of the primary and secondary models discussed in the following sections. In these simple models, no additional controls are included and rating variables are not lagged.

$$\text{Annualised returns}_{i,t} = \beta_0 + \beta_1 \text{High rec}_{i,t} + \beta_2 \text{Rec}_{i,t} + \beta_3 \text{Invest Grade}_{i,t} + \varepsilon_i$$

$$\text{Sharpe}_{i,t} = \beta_0 + \beta_1 \text{High rec}_{i,t} + \beta_2 \text{Rec}_{i,t} + \beta_3 \text{Invest Grade}_{i,t} + \varepsilon_i$$

Where *Annualised returns*<sub>i,t</sub> refer to returns before accounting for risk and *Sharpe*<sub>i,t</sub> refers to the risk adjusted returns (Sharpe ratio). Rating variables represent indicators equal to one if the fund had a rating of that classification in period *t*. These models test a simplified hypothesis of whether or not investors can expect higher returns if they invest in higher rated funds in a given year.

The primary and secondary models build on this analysis.

#### C.3.2.2. Primary model

This model is the preferred specification given the data and various econometric considerations. Secondary models discussed in the next section serve to provide robustness checks on the results of the primary model.

The primary model uses the deviation from the average Sharpe ratio as the dependent variable.

$$\text{Sharpe Dev}_{i,t} = \beta_0 + \beta_1 \text{High rec}_{i,t-1} + \beta_2 \text{Rec}_{i,t-1} + \beta_3 \text{Invest Grade}_{i,t-1} + \beta \text{Controls} + \varepsilon_i$$

Where the deviation in the Sharpe ratio refers to the difference between the fund's Sharpe ratio and the average Sharpe ratio for the particular asset class in that year:

$$\text{Sharpe Dev}_{i,j,t} = \text{Sharpe}_{i,j,t} - \text{Avg}(\text{Sharpe}_{j,t})$$

Rating variables represent indicators equal to one if the fund had a rating of that classification in period *t-1*. The rating variables are lagged to reduce the potential for reverse causality in the relationship between ratings and performance. For example, a high rating in period *t* is likely to be impacted by strong performance in period *t*. For this reason the analysis uses lagged ratings to address the potential endogenous relationship between contemporary ratings and performance. The use of lag ratings also allows the analysis to focus on the ability of ratings to predict future performance. If ratings are only a good predictor of current performance, this does not assist investors to identify high quality funds ex ante.

Table C.4 provides a description of the controls available for this analysis.

Table C.4: Controls to feature in regression analysis

Control	Description
Annualised Sharpe ratio (lag)	The Sharpe ratio captures the risk-adjusted performance of a fund.
Passive	Passive fund identifier extracted from FE fundinfo.
ETF	Identifier for exchange-traded funds (ETFs). This variable is extracted from FE fundinfo.
Wholesale	Proxy identifier for wholesale fund status. If a fund has a minimum investment amount greater or equal to \$50,000, the fund is considered wholesale.
Year	Only used in secondary models. Accounted for in primary model by the dependent variable (Sharpe deviation).
Asset class	Only used in secondary models. Accounted for in primary model by the dependent variable (Sharpe deviation).
Fund size	Proxy variable for 'brand' estimated using FUM. The size or reputation of the fund may encourage additional flows.
Fund manager size	Proxy variable for 'brand' created by summation of FUM at a fund manager level. The size or reputation of the fund manager may encourage additional flows.
Fund offering	Proxy measure for 'product range' calculated as a count of funds offered at the fund manager level. Some investors will be attracted to fund managers that have a wide range of available products.

Note: Grey rows indicate available controls that are excluded from the analysis.

Source: Deloitte Access Economics (2021).

The grey rows indicate control variables that were considered in the analysis but not used in the preferred specification. Past performance (lagged Sharpe ratio) was excluded for two reasons. First, it was not found to be statistically significant and excluding the variable had no impact on results. This could indicate either that past performance is a poor indicator of future performance or that past performance is already accounted for in the rating variable (fund rating is correlated with past performance). The second reason past performance was excluded is because inclusion of the variable reduces the sample size by around 800 observations. Considering that the variable was highly insignificant, excluding the variable and retaining the sample was considered preferable.

The size variables (fund size, fund manager size and number of funds) were excluded from this regression since there was no relationship between ratings and performance once fund size was controlled. However, given the possible correlation between ratings and fund size, these variables were excluded to assess whether there was a relationship between ratings and performance with fund size excluded. This is a different approach to that shown in Appendix D, where size variables and past performance are included in the models. The reasons for including size and past performance in the flows analysis is discussed in D.2.2.

### C.3.2.3. Secondary model

The secondary model in this analysis acts as a robustness check to test the outcomes of the primary model. In the secondary model, the dependent variable is expressed as the Sharpe ratio rather than the Sharpe deviation. Controls for asset class are included but

the year variable is excluded to test the sensitivity of the results to time controls. From the simple analysis, it appears that higher ratings are more likely to achieve higher performance however, the significance of these ratings is reduced once more control variables are included. This is likely due to the influence of time and asset class.

$$Sharpe_{i,t} = \beta_0 + \beta_1 High\ rec_{i,t-1} + \beta_2 Rec_{i,t-1} + \beta_3 Invest\ Grade_{t-1} + \beta_4 Asset\ class + \beta Controls + \varepsilon_i$$

The independent control variables are identical to Table C.4.

## C.4. Results

This section discusses the econometric output of the models outlined above. The section concludes with a brief discussion of the conclusions and possible implications for competition in the funds management industry, however, most of this discussion is reserved for the body of the report and not included in the appendix.

### C.4.1. Simple relationship

Table C.5 shows that in the simple relationship, both raw and risk adjusted performance are more likely to occur in funds that are rated as investment grade and above by a ratings agency. Furthermore, in raw terms, the increase in annualised returns is proportional to rating — ‘Highly recommend’ has the highest increase, followed by ‘Recommend’. Adjusting for risk however, all ratings have a similar impact on the Sharpe ratio.

Table C.5: Simple relationship — fund rating and performance

Variables	Y = Annualised returns (%) (1)	Y = Sharpe ratio (2)
Highly recommend (t)	3.452*** (0.543)	0.165*** (0.052)
Recommend (t)	3.066*** (0.482)	0.197*** (0.038)
Investment grade (t)	2.674*** (0.403)	0.187*** (0.035)
Constant	3.558*** (0.173)	0.629*** (0.014)
N	17,024	17,024

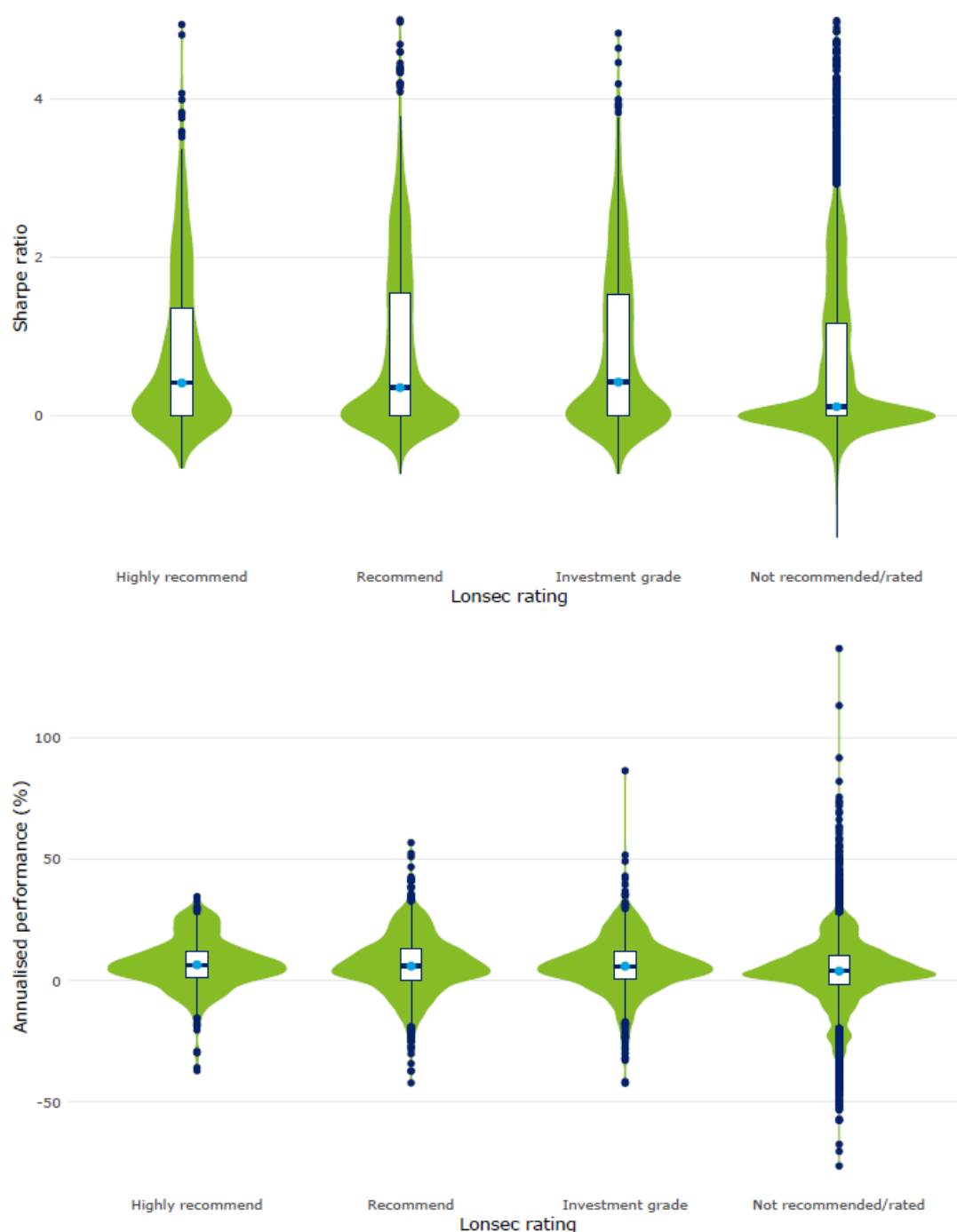
\*\*\* Significant at 1% level \*\* significant at a 5% level \* significant at a 10% level

Note: All models include clustered standard errors at the fund manager level.

Source: Deloitte Access Economics (2021).

The results of Table C.5 are presented differently in Figure C.1. From these charts it is clearer to see the distribution of returns for each of the ratings classifications. Looking at the top half that analyses the risk adjusted returns, Figure C.1 shows that the returns of unrated funds are far more compressed around the lower end of the returns spectrum. The average for each of the ratings categories (shown by the horizontal bar in the centre of each distribution) are not dissimilar from one another but higher than for not rated funds in the case of the Sharpe ratio.

Figure C.1: Risk adjusted (Sharpe ratio) and unadjusted performance by Lonsec rating (N=17,024)



Note: Contents of the Chart are described above and below paragraphs in C.4.1.

Source: Deloitte Access Economics (2021), Lonsec (2020) and FE fundinfo (2020).

The bottom half of Figure C.1 shows raw fund returns net of fees. Although it is more difficult in this case to discern a difference in the averages, the distribution of returns shows rated funds clustering at slightly higher returns. Interestingly, the distribution of returns narrows as ratings increase from 'non rated' towards 'highly recommended'. Although 'non rated' funds have more funds achieving higher returns, there are also a larger number achieving poorer returns.

Both econometric results and analysis of the distributions of performance and fund ratings suggest that on average, higher rated funds are associated with higher raw and risk adjusted returns, net of fees.

### **C.4.2. Regression analysis**

Table C.6 shows the regression output for the primary and secondary models.

#### **C.4.2.1. Primary model**

The results of the primary model provide some evidence to suggest that rated funds do perform better than unrated funds. Across both specifications of the model, 'Recommended' and 'Investment grade' return a coefficient that is statistically different from zero. 'Highly recommended' ratings, however, are only significant (at a 10% level) in the second model where there is no time variable (discussed below). Passive ETFs (represented by an interaction term) also indicate a statistically significant increase in performance compared to active unlisted funds. This could be indicative of the relative performance of passive investing, relative to underlying risk, over the time period (2014–2020). It is possible that this is also a function of fees, since passive funds carry a lower charge generally and performance measures are net of fees. This would also explain the coefficient on wholesale funds, all else equal.

Table C.6: Regression output — fund ratings and performance

Variables	Primary model	Secondary
	Y= Sharpe deviation	Y= Sharpe ratio
Highly recommend (t-1)	0.040 (0.032)	0.105* (0.060)
Recommend (t-1)	0.059** (0.023)	0.096*** (0.028)
Investment grade (t-1)	0.084*** (0.025)	0.135*** (0.032)
ETF*Passive	0.074*** (0.027)	0.112*** (0.021)
ETF	0.003 (0.051)	0.080 (0.054)
Passive	-0.012 (0.027)	-0.028 (0.025)
Wholesale	0.063*** (0.023)	0.073*** (0.023)
Equity		0.636*** (0.019)
Fixed interest		0.393*** (0.040)
Property		0.473*** (0.070)
Mixed asset		0.651*** (0.023)
Other asset		0.370*** (0.051)
Constant	-0.021 (0.017)	0.012*** (0.022)
Observations	14,979	14,979

\*\*\* Significant at 1% level \*\* significant at a 5% level \* significant at a 10% level

Note: All models include clustered standard errors at the fund manager level.

Source: Deloitte Access Economics (2021).

The analysis indicates that highly recommended funds do tend to achieve slightly higher returns than non-rated funds, but these differences are not statistically significant or at best only statistically significant at the 10% level. However, it is worth noting that although the sample of highly recommended funds is not small (586), it is smaller than the samples of 'Recommended' (1,775) and 'Investment grade' (989). This difference in sample size could partly explain the larger standard errors for highly recommended. The magnitude of the coefficient on highly recommended is broadly similar to the other ratings which suggests that there is not enough evidence on these results to conclude the relationship between ratings and performance differs between highly recommended funds and recommended or investment grade rated funds.

#### **C.4.2.2. Secondary models**

The final model in Table C.6 excludes any variables relating to time. This is similar to the approach taken in Section C.4.1 except that other control variables, including asset class are included. In Model 'a' the 'highly recommended' variable is significant at a 10% level.

Indeed, the coefficients on all rating variables increase in this model relative to the primary model. This suggests that although rated funds may perform better on average (see Section C.4.1), part of this difference appears to be due to differences in performance of asset classes and the particular year in which performance is assessed. In other words, some of the outperformance of rated funds identified in the simple models is likely to be driven by their prevalence in better performing asset classes and better performing asset classes in a particular year.

#### **C.4.3. Conclusions**

Given the results discussed in Sections C.4.1 and C.4.2, this report finds evidence to suggest that, on average, research houses are able to identify better performing funds. In particular, rated funds are less likely to be found at the extreme lower end of the return distribution (although both rated and unrated funds are able to achieve performance at the upper end of the distribution, indeed some of the best funds in terms of annualised performance are unrated). This suggests that rated funds are less likely to have very adverse outcomes for investors.

This has implications for investor outcomes as discussed throughout the body of the report. It is worth noting again, that these outcomes cannot be attributed only to retail investors and this analysis assumes that retail investors can access fund ratings.

In reality, retail investors may not be able to access fund ratings from research houses either due to cost or restrictions (some research houses do not make information available to individual investors). Nonetheless, for the retail investors operating through an advised channel, the use of ratings either to select or perform due diligence on funds is likely to benefit underlying retail investors.

# Appendix D : Flows

This appendix provides further details on the econometric analysis used to investigate the factors influencing individuals to choose between managed funds.

## **D.1. Objective**

In Chapter 8, the report considered value for money and noted that given differences in individuals' preferences and investment objectives, fund performance needs to encapsulate a range of elements including fees, returns and choice factors (such as risk appetite, asset type, investment horizon).

Chapter 8 also discussed the implications of the (ad valorem) fee structure of managed funds. Under this structure where fees are based on performance, fund managers should be incentivised to focus on performing for investors. If the market is competitive, consistent good performance is the most effective way for fund managers to attract funds under management (FUM) as well as maintaining and compounding existing FUM.

As this would suggest, fund managers primarily compete to attract and retain FUM. The purpose of this econometric analysis is to understand how investors make decisions between funds. FUM flows are expected to be determined by a range of fund features including:

- past performance
- track record and rating
- brand and or investment manager reputation
- advertising
- availability, including distribution channel or listed status.

This appendix discussed the ways in which econometric analysis is used to test the responsiveness of investors to several of these factors. Of particular interest is the sensitivity of flows to ratings produced by research companies. The analysis focuses on ratings for a number of reasons:

- ratings have been shown to be an important source of fund information for retail investors
- ratings are important in order for a fund to be listed on approved product lists APLs and platforms.



In conducting this analysis, the report hopes to provide insight on the below key questions from ASIC.

Table D.1: Key questions covered in this analysis

Key question for analysis	Expected outcome
What features of a fund make it competitive in its type/class	This analysis will demonstrate the sensitivity of flows to various fund characteristics.
How features of funds are promoted or communicated to potential investors and to what extent do potential investors rely on these features when making investment decisions	This analysis will assess the importance of ratings agencies in communicating fund characteristics to investors and the relative importance of these features in determining flows.
How retail investors choose between fund managers and products (e.g. based on quality, service or price)	This analysis will assess the importance of ratings agencies in determining investor assets.

Source: Deloitte Access Economics (2021).

## D.2. Approach

The analysis uses econometric methods to assess the statistical significance of various fund characteristics in determining fund flows in the Australian managed funds industry. The analysis in this section follows a similar approach to the analysis conducted by the FCA in 2016.<sup>523</sup>

It is important to note that this analysis cannot distinguish flows between retail and wholesale investors. Therefore, the analysis is only able to conclude the impact of fund features in determining flows at an industry level. Retail investors represent only 6% of the market for managed funds in Australia and as such, it is possible that this analysis does not fully capture features of particular importance or sensitivity to retail investors as distinct from the market as whole.

### D.2.1. Data

The data set used in this analysis is a combination of two separate data sets provided by FE fundinfo and Lonsec. Both data sets are cross sectional and are described in further detail below.

#### D.2.1.1. FE fundinfo

FE fundinfo has yearly FUM data (2014-2020<sup>524</sup>) for **3,179 Australian managed funds**. The dependent variable measures net flows, captured by FUM (the derivation for which is described in Section D.2.2).

FE fundinfo also provides several other fund features that are included in the analysis, including asset class, past performance, wholesale fund indicator, passive fund indicator and ETF indicator.

#### D.2.1.2. Lonsec data

Lonsec data covers **2,109 funds** (including retail, wholesale, active and passive) that have a current rating or have been rated in the past (2010–2020). The rating in a given year is matched to the appropriate fund in FE fundinfo using a unique identifier.

<sup>523</sup> Financial Conduct Authority 'Asset Management Market Study Final Report' (Market Study 15/2.3, June 2017) <<https://www.fca.org.uk/publication/market-studies/ms15-2-3.pdf>>.

<sup>524</sup> 2020 FUM and performance (annualised) data taken as at March 2020. This will not capture the full impact of the COVID-19 pandemic on the fund performance and asset prices.

Table C.3 summarises the Lonsec ratings data with accompanying descriptions. The cells are colour coded to represent where similar ratings are grouped together. Ratings are grouped together for ease of interpretation as well as sample size. The rating variables used in this analysis are:

- highly recommended
- recommended
- investment grade
- not rated (base case).

The blue cells in Table C.3 reflect funds that are not recommended and were originally classified as 'do not recommend'. However, there were relatively few observations in these categories, which made statistical inferences questionable, so these were reclassified as 'not rated'. Similarly 'Fund Watch' is considered 'not rated' due in part to the small sample.

The merged data set has **22,260 observations** covering the years between **December 2014 and June 2020**. Of the 22,260 observations, **5,121 (23%) matched with a rating**. Missing rating variables are assumed to be 'not rated'. The analysis acknowledges that this approach may incorrectly categorise funds as 'not rated' when the data is missing, or the rating was given by another rating agency. Some of these observations also had missing information for control variables of interest so the sample size used in the regression analysis was smaller.

#### **D.2.1.3. Data modifications**

After merging the data sets, a number of observations are excluded due to large outliers and or potentially erroneous data. Within the data there were several instances where Sharpe ratios appeared considerably higher than average. Taking into consideration the distribution of the Sharpe ratios within the sample and consulting industry professionals regarding a reasonable Sharpe ratio, the analysis determined to exclude observations with a Sharpe ratio greater than 5. This removed a total of 77 observations.

Although these observations may not necessarily be erroneous, the analysis sought to remove these potential outliers as including such outliers can potentially have a large impact on estimated coefficients.

#### **D.2.2. Model specifications and econometric considerations**

This section outlines the model specifications used in the analysis. In the below specifications, the subscripts '*i*', and '*t*' refer to 'fund', and 'year', respectively. In all models, standard errors are clustered at the fund manager level.

##### **D.2.2.1. Primary model**

The primary model tested in this analysis has the following specification:

$$\% \Delta Flows_{i,t} = \beta_0 + \beta_1 Rating_{i,t} + \beta_2 Sharpe_{i,t-1} + \beta_3 Year_t + \beta_4 Controls_{i,t} + \varepsilon_i$$

Where the dependent variable is:

$$\% \Delta Flows_{i,t} = \frac{FUM_{i,t} - (1 + r_t)FUM_{i,t-1}}{FUM_{i,t-1}}$$

This model is our preferred specification, although a range of other secondary models were estimated as part of the robustness analysis and are discussed in the following section.

The dependent variable is adjusted for the returns over the current year ( $r_t$ ) since funds under management can increase or decrease with the value of the underlying assets, irrespective of flows.  $\% \Delta FUM$  (accounting for returns) will therefore capture the net inflows and outflows of a fund in a given year. The hypothesis of this analysis is that these flows are responsive to past performance and endorsement from ratings agencies,

as well as several other variables that guide investor decisions. Indicator variables capturing the year of observation account for seasonality in the data.

Unlike the model described in Section C.4.2, this model does not include lag rating variable — the dependent variable and the rating variables are considered within the same time period  $t$ . This is intentional since, unlike ratings and performance, there is less concern that reverse causality is present; it is less obvious why ratings would be influenced by inflows and outflows (although it is possible that inflows and outflows are a signal of another unobserved feature of the fund).

Another reason for considering the variables in the same period is due to the responsiveness of flows to ratings changes. Since the periods in the data are yearly observations and it is reasonable to suspect that flows adjust reasonably quickly to a change in rating, using a lagged rating variable may remove some or all of the explanatory power. Similarly, Section C.4.2 is particularly concerned with the ability of ratings to predict future performance whereas there is no requirement for prediction in this model. Nonetheless, the sensitivity of the model to lagged rating variables is considered and discussed in the Results section.

#### **D.2.2.2. Secondary models**

To further examine the robustness of the results of the primary model, two additional models are tested. The first considers the raw change in flows.

$$\Delta Flows_{i,t} = \beta_0 + \beta_1 Rating_{i,t} + \beta_2 Sharpe_{i,t-1} + \beta_3 Year_t + \beta_4 Controls_{i,t} + \varepsilon_i$$

Where the dependent variable is:

$$\Delta Flows_{i,t} = FUM_{i,t} - (1 + r_t)FUM_{i,t-1}$$

An important limitation of this model is that because funds are captured in levels little weight is placed on large flows to or from smaller funds. Of course, if flows were solely driven by past net performance then fund size would not affect the magnitude of flows.

The final specification considers the impact on flows of a change in rating. Whereas the previous two models have considered static ratings, this model tests the responsiveness of flows to a change in the fund's rating. Since this model relates only to funds with a rating, the sample is reduced to 1,797. The model has the following form:

$$\% \Delta Flows_{i,t} = \beta_0 + \beta_1 Rating\ Change_{i,t} + \beta_2 Sharpe_{i,t-1} + \beta_3 Year_t + \beta_4 Controls_{i,t} + \varepsilon_i$$

Where the  $Rating\ Change_i$  is a categorical variable signalling 'upgrade', 'downgrade' or 'no change'. The coefficients in this model are interpreted relative to 'no change' (base case). Each of these models is also tested with a lag rating variable to test the longevity of a rating change as well as to test the sensitivity of the independent rating variables to the dependent variable.

The independent variables in these regressions are outlined in Table D.3.

Table D.2: Controls to feature in regression analysis

Control	Explanation
Ratings	The primary independent variable(s) of interest. It will comprise a series of indicator variables in period T-1 (potentially more [T-2 & T-3]) that indicate the ratings level (See Table C.3.)
Annualised Sharpe ratio (lag)	The Sharpe ratio captures the risk-adjusted performance of a fund (unlike the raw performance term used in specifying the dependent variable).
Average flows (%) by asset class and year	This term is calculated by averaging the percentage change in flows in a given year by asset class. Average flows are included so that any additional flows reflect abnormal flows. This term controls both time and asset class.
Passive	Passive fund identifier extracted from FE fundinfo.
ETF	Dummy indicator for exchange-traded funds (ETFs). This variable is extracted from FE fundinfo.
Wholesale	Proxy measure for wholesale fund status. If a fund has a minimum investment amount greater or equal to \$50,000, the fund is considered wholesale.
Funds under management (FUM)	Proxy variable for 'brand'. The size or reputation of the fund may encourage additional flows.
FUM (manager level)	Proxy variable for 'brand'. The size or reputation of the fund manager may encourage additional flows.
Count of funds	Proxy measure for 'product range' i.e. some investors will be attracted to fund managers that have a wide range of available products.

Source: Deloitte Access Economics (2021).

### D.3. Results

This section discusses the econometric output of the models outlined above. The section concludes with a brief discussion of the conclusions and possible implications for competition in the funds management industry, however, most of this discussion is covered in the body of the report.

#### D.3.1. Regression results

##### D.3.1.1. Primary model

The results of the primary regression model indicate that ratings are a significant driver of flows after controlling for several other variables, including performance, fund size and year. Relative to the base case 'non rated' fund, a 'highly recommended' fund and a 'recommended' fund can expect an additional 16% and 10% inflow of funds. Past performance, represented by the lagged Sharpe ratio, is weakly significant and suggests that a one unit increase in the Sharpe ratio is expected to increase flows by 1.4%, all else being equal. This effect size and statistical significance of the performance variable is weaker than might be expected, however, some of the explanatory power is likely captured by the inclusion of other variables, in particular the rating variables.

Inflows are strong across the interaction term of ETF and passive funds, supporting the overall trend towards passive investing, and ETFs in particular, that has been seen over recent years.

In relation to the size variables (fund size, fund manager size and number of funds), only fund size was significant at the 10% level. The sign on the coefficient is also unexpected, indicating that as funds grow, they receive less inflows relative to their size. This could indicate that investors or fund managers acknowledge that funds experience some decreasing returns to scale after a certain level of FUM. The other two size variables are insignificant. Interestingly the sign on both these coefficients are also negative. As discussed in Section C.3.2.2, it is possible that part of the impact may be captured by the rating variables.

As the dependent variable is the relative change in funds the results do not imply necessarily that larger funds do not receive more flows but only that larger funds do not receive disproportionately more flows. Overall, the hypothesis that brand plays an important role in an investor's decision, independently from ratings, is not evident from these results.

Average asset flows by class capture the effects of year and asset class and are highly significant in the primary model. This variable is included to capture the effect of inflows that arise naturally over time and across asset classes and allows the interpretation of the other variables to consider 'abnormal' flows for that asset class and year arising from a high recommendation, for example. The coefficient indicates that a 1% increase in fund flows in that class for a given year lead to a 0.83% increase in fund flows for the fund, all else equal.

Table D.3: Determinants of flows

Variable	Primary model Y= %ΔFlows	Secondary (a) Y= ΔFlows	Secondary (b) Y= %ΔFlows
Highly recommend	0.155*** (0.038)	17.629 (19875)	
Recommend	0.102*** (0.027)	-17.234 (13.004)	
Investment grade	0.000 (0.026)	-13.342 (8.637)	
Rating upgrade			0.126*** (0.047)
Rating downgrade			-0.092*** (0.029)
Sharpe (t-1)	0.010* (0.026)	1.716 (1.163)	0.002 (0.011)
ETF*Passive	0.311*** (0.047)	123.114** (58.146)	-
ETF	0.251** (0.107)	33.163*** (11.320)	-
Passive	0.089** (0.039)	35.319 (23.819)	0.106** (0.045)
Wholesale	0.001 (0.263)	-7.358 (21.131)	-0.066 (0.043)
FUM (\$billions)	-0.004* (0.002)	-	-0.013 (0.012)
Fund manager FUM (\$ billions)	-0.000 (0.000)	-	-0.000 (0.000)
FUM (log)	-	12.339 (9.311)	
Fund manager FUM (log)	-	2.661 (4.961)	
Number of funds (fund manager)	-0.000 (0.000)	0.080 (0.060)	-0.000 (0.000)
Average flows for asset class (\$millions)	-	0.853** (0.385)	-
Average flows for asset class (%)	0.835*** (0.000)	-	0.937*** (0.000)
Constant	0.005** (0.025)	18.987 (20.598)	0.061*** (0.037)
N	9,652	9,652	2,051

Note: \*\*\* Significant at 1% level \*\* significant at a 5% level \* significant at a 10% level. Standard errors are clustered at the fund manager level and shown in parentheses.

Source: Deloitte Access Economics (2021).

**D.3.1.2. Secondary models and sensitivity analysis**

The first of the secondary models (Secondary 'a') further examines the relationship between size and flows. In this specification, the dependent variable of flows is no longer proportional to the size of the fund but the dependent variable is defined as the level of flows. When the dependent variable is expressed in level terms, the amount of funds under management and number of funds becomes highly significant. The coefficients on the rating variables switch to negative and the coefficient on the recommended rating is highly significant. These results seem to be driven by some very large funds. When fund size and fund manager size are transformed into logs (as shown in Secondary 'a'), this removes any significant negative relationship between fund flows and ratings. Nonetheless, the results suggest that fund manager size is a more material driver of aggregate flows than ratings — although ratings are significant drivers of relative changes in flows of funds.

The final model in Table D.3 (Model 'c') tests the responsiveness of flows to a change in the rating variables. The coefficients on rating upgrade and rating downgrade are both as expected; an upgrade results in a positive 13% increase in flows and a downgrade results in outflows of 9%. This model supports the findings of the primary model on the impact of ratings on relative flows of funds. This also supports conclusions drawn throughout the report that investors are sensitive to fund outcomes and perceptions and not only have the ability to, but demonstrate a degree of preparedness to switch funds. Nonetheless fund size remains a significant determinant of total fund flows.

As discussed in Section C.3.2.2 regression estimates will be biased if there is reverse causality between the independent and the dependent variables. In this case, this could occur if changes in flows cause a ratings change as opposed to ratings changes impacting flows.

As a test of robustness, both the primary model and the Model 'b' were tested using the lagged rating variables. The output of these regressions is not included in this appendix for brevity, however the results of both models reaffirmed the positive relationship between ratings and relative flows. However, the size and statistical significance of the coefficients declined — primary model drops to a 5% significance level and coefficients approximately halve — which is consistent with the idea that investors are likely to be more driven by current ratings than ratings in a previous year.

**D.3.2. Conclusions**

This analysis seeks to identify key variables that affect an investor's decision making as well as test the sensitivity of investor's flows to these variables. In particular, the analysis has shown the importance of research houses informing investors and guiding investment decisions. Considering the findings of Appendix C, this appears sensible. In addition, past performance continues to drive flows, despite evidence in Chapter 8 that showed past performance was a poor indicator of future performance.

While the analysis found limited evidence of the effect of brand or advertising, these variables are difficult to tease out in econometric analysis. Fund size was shown to be a significant driver of aggregate flows, however, relative to fund size this effect was weak. To register the true impact of these measures, data from investor surveys would provide a more accurate reflection of importance.

**D.4. Limitations of the analysis**

The report acknowledges several limitations on the approach taken in this appendix. First, results are highly dependent on the datasets. FE fundinfo is comprehensive, however, missing values were common and funds under management data was only available from 2014 onwards whereas performance data extended back further. The extension of several key data fields would improve the analysis by increasing the sample as well as covering more years of analysis.

The report also acknowledges that Lonsec is only one research house and results may be sensitive to the choice in research house. The funds covered by research houses may also differ between supply and demand side models (see Section 6.4.4).

The results are also likely sensitive to the choice of controls and model specification. As discussed in Section D.3.1, some of the coefficients are sensitive to functional form and choice of dependent variable specification. The appendix has already acknowledged a number of variables that would ideally be controlled (including advertising, brand and fund manager). This analysis has attempted to use proxy variables where possible, however, interpretation of these results has been difficult.



# Appendix E : Performance and prices

This appendix provides further details on the econometric analysis used to assess the relationship between fees and performance.

## E.1. Objective

In Chapter 8, the report considered competition through an assessment of the value for money investors receive on Australian managed funds. Value for money, in the context of managed funds, is typically considered to be the return a fund achieves (over a suitable horizon) for a given fee. This appendix builds on the analysis conducted in Section 8.2.5 that explored the relationship between the performance of a fund and the price paid for the fund. Despite the importance of returns to a fund's value for money, this report acknowledges that value for money needs to be considered in the context of a range of other factors, such as diversification, risk appetite, asset type, investment horizon.

This analysis seeks to provide additional insight to the below key questions:

Table E.1: Key questions covered in this analysis

Key question for analysis	Expected outcome
What features of a fund make it competitive in its type/class	This analysis will identify if better performing funds can charge higher fees
How features of funds are promoted or communicated to potential investors and to what extent do potential investors rely on these features when making investment decisions	This analysis will determine if price is a suitable indicator of performance.
How retail investors choose between fund managers and products (e.g. based on quality, service or price)	This analysis will determine if price is a suitable indicator of performance.

Source: Deloitte Access Economics (2021).

## E.2. Approach

In Section 8.2.5, the report analysed the simple correlation between the price (total fee paid on a fund, excluding intermediation) and the risk-adjusted returns (captured by the Sharpe ratio) for a sample of Australian equity funds. This appendix builds on this analysis by introducing econometric analysis to test the relationship after including additional controls.

### E.2.1. Data

The data set used in this analysis is a combination of two separate data sets provided by FE fundinfo and Lonsec. Both data sets are cross sectional and are described in further detail below.

#### E.2.1.1. FE fundinfo

FE fundinfo has yearly FUM data (2014–2020) for **3,179 Australian managed funds**. The dependent variable (performance after fees) is extracted directly from this data set

calculated cumulatively over three separate investment horizons. All performance metrics reported in FE fundinfo are calculated net of fees.

FE fundinfo also provides funds under management which is included in this analysis to account for the size of the fund. For each performance period, FUM is averaged accordingly over the same period. The analysis also uses the information provided in FE fundinfo to filter the data set by active status and asset class.

#### **E.2.1.2. Lonsec data**

Lonsec fee data covers **1,447 funds** (for which a unique fund identifier is provided) over an 8-year period (2013–2020). These funds include a range of fund types (active and passive, wholesale and retail) and incorporate both rated and unrated funds.

Similar to funds under management, fees are averaged over the relevant investment horizon.

### **E.2.2. Model specifications and econometric considerations**

This section outlines the model specifications used in the analysis. In the below specifications, the subscript '*i*' refers to fund. Unlike other Appendices, the subscript '*t*' in this analysis refers instead to an 'investment horizon'. The analysis considers three investment horizons; three years, five years and seven years.

In all models, standard errors are clustered at the fund manager level.

#### **E.2.2.1. Primary model**

The primary model tests the relationship between fees and the risk-adjusted returns, as represented by the Sharpe ratio. As described in Appendix C.2, the Sharpe ratio captures risk by calculating returns relative to the standard deviation. This report considers risk-adjusted returns (net of fees) to be the most appropriate measure of performance in this analysis. As such, the primary model takes the form:

$$Sharpe_{i,t} = \beta_0 + \beta_1 Fees_{i,t} + \beta_2 \log(FUM)_{i,t} + \beta_3 H_t + \beta_4 Class_i + \varepsilon_i$$

Where *H* is a binary indicator variable for the investment horizon under consideration.

The primary model is estimated over all Australian funds and in three subsets of Australian-domiciled equity funds: all equities, Australian equities and global equities.

#### **E.2.2.2. Secondary models and sensitivity**

This analysis considers the relationship between fees and two other performance metrics. These secondary models serve as a sensitivity analysis, to assess whether the results significantly differ under alternative measures of performance. The report considers two other metrics commonly referenced in managed funds, (risk-unadjusted) performance and excess returns (also known as alpha). These measures are described in Section 8.2.3. The secondary models differ only in terms of the dependent variable, as below:

$$Performance_{i,t} = \beta_0 + \beta_1 Fees_{i,t} + \beta_2 \log(FUM)_{i,t} + \beta_3 H_t + \beta_4 Class_i + \varepsilon_i$$

$$Alpha_{i,t} = \beta_0 + \beta_1 Fees_{i,t} + \beta_2 \log(FUM)_{i,t} + \beta_3 H_t + \beta_4 Class_i + \varepsilon_i$$

### **E.3. Results**

The results of the regression support the simple analysis conducted in Section 8.2.5.1. Overall, this report cannot establish a significant positive or negative correlation between fees and performance across different samples of asset types as well as different performance metrics.

#### **E.3.1. Regression results**

Table E.2 shows the regression outputs for the primary model across four different samples of funds. Consistently across the samples, there is no strong coefficient on the

fee variable, suggesting no significant relationship between fees and net performance (noting small samples for Australian and Global Equity). As in the simple analysis shown in Section 8.2.5.1, while statistically insignificant, three out of the four samples show a negative sign on the coefficient.

Table E.2: Relationship between fees and performance – Sharpe ratio

Variable	All funds	All equity funds	Australian equity	AU global equity
Fees	-0.035 (0.033)	-0.010 (0.048)	-0.072 (0.051)	-0.039 (0.098)
FUM (log)	0.000 (0.006)	0.004 (0.009)	0.007 (0.010)	0.002 (0.022)
Timeframe (Base = 3 years)				
5 year	0.104*** (0.098)	0.120*** (0.012)	0.131*** (0.014)	0.021 (0.026)
7 year	0.131*** (0.010)	0.128*** (0.013)	0.105*** (0.018)	0.066*** (0.033)
Asset class	Yes	Yes	No	No
Constant	0.156 (0.128)	0.327* (0.192)	0.085 (0.192)	0.587 (0.440)
N	1,616	830	212	237

Note: \*\*\* Significant at 1% level \*\* significant at a 5% level \* significant at a 10% level. Standard errors are clustered at the fund manager level and shown in parentheses.

Source: Deloitte Access Economics (2021).

While this data shows the five- and seven-year returns as higher than the base case (three-year returns), this is not necessarily expected with the Sharpe ratio, as it might be for unadjusted performance. Cumulative fund performance may increase over the period, however, this may be negated by increases in returns on the risk free rate or increases in volatility. To reduce the impact of cumulating returns, this report considers a measure of outperformance (alpha), which is more easily interpreted over time periods.

The FUM variable included to account for size is insignificant in all models and excluding this variable entirely does not significantly alter the coefficients of other variables.

### E.3.1.2. Secondary models and sensitivity

The secondary models support the findings of the primary model, despite using different performance metrics. Table E.3 shows raw performance (unadjusted for risk) is also not statistically significantly impacted by the level of fees. The table also shows a reversal in direction on all but one of the coefficients, now indicating a positive, but not statistically significant, relationship.

Table E.3: Relationship between fees and performance — Unadjusted performance

Variable	All funds	All equity funds	Australian Equity	AU Global equity
Fees	0.080 (0.368)	0.116 (0.628)	-1.246 (0.831)	0.001 (1.291)
FUM (log)	0.022 (0.080)	-0.039 (0.139)	0.203 (0.162)	0.133 (0.280)
Time frame (Base = 3 years)				
5 year	1.311*** (0.122)	1.658*** (0.207)	2.113*** (0.334)	0.054 (0.377)
7 year	1.499*** (0.157)	1.553*** (0.249)	1.507*** (0.406)	0.460 (0.433)
Asset class	Yes	Yes	No	No
Constant	3.902** (1.669)	7.473* (2.719)	3.167 (3.128)	7.811 (5.744)
N	1,616	830	212	237

Note: \*\*\* Significant at 1% level \*\* significant at a 5% level \* significant at a 10% level. Standard errors are clustered at the fund manager level and shown in parentheses.

Source: Deloitte Access Economics (2021).

Table E.4 shows that fees have no statistically significant relationship with alpha. The coefficients on the investment periods in Table E.4 show that within this sample, funds appear to attract a higher alpha over long-term horizons (7 year), however, this could be a feature of the data; the report does not necessarily anticipate higher alpha over longer investment horizons. Even if this is the case, an increase on alpha relative to the base year may still represent overall underperformance.

Table E.4: Relationship between fees and performance — Excess returns (alpha)

Variable	All funds	All equity funds	Australian Equity	AU Global equity
Fees	-0.448 (0.595)	0.105 (0.929)	-1.130 (0.938)	-0.427 (1.974)
FUM (log)	0.072 (0.091)	0.006 (0.145)	0.182 (0.170)	0.196 (0.300)
Time frame (Base = 3 years)				
5 year	0.119 (0.109)	0.099 (0.191)	0.378 (0.813)	-0.360 (0.349)
7 year	0.386** (0.144)	0.472* (0.247)	0.813** (0.395)	-0.197 (0.433)
Asset class	Yes	Yes	No	No
Constant	-1.15 (2.011)	-0.898 (2.950)	-2.293 (3.167)	-2.375 (6.298)
N	1,616	830	212	237

Note: \*\*\* Significant at 1% level \*\* significant at a 5% level \* significant at a 10% level. Standard errors are clustered at the fund manager level and shown in parentheses.

Source: Deloitte Access Economics (2021).

### E.3.2. Conclusions

This analysis supports the conclusions drawn in the body of the text. On average, performance earned in active funds is offset by the fees charged. Investors should be aware that higher fee funds do not necessarily guarantee higher returns, however, this analysis cannot conclude that higher fee funds are not in an investor's best interest.

### E.4. Limitations of the analysis

The major limitation of this analysis relates to sample size. The Lonsec data and the FE data use different naming conventions that are not easily matched, and unique identifiers are missing for some funds (particularly in Lonsec data). As a result, the sample is lower than optimal, given the broader coverage of both datasets. That being said, this report has no reason to believe that missing data creates sampling biases, as the absence of fields appears random. Nonetheless, future analysis could seek to examine whether these results continue to hold with a larger sample.

The other limitation of this analysis is the unavailability of data for fees before 2013, as discussed in Section E.2.1.2. While the periods considered in this section are sensible given typical investment horizons, it is possible that certain funds and strategies are intended to be held in excess of seven years.

# Appendix F : Accessibility tables

This appendix includes summary tables describing the underlying data of key charts.

## F.1. Chapter 2

This section presents charts from Chapter 2.

Table F.1: Asset allocation – self-managed super (March 2020) — Chart 2.2

Asset class	Share of total assets
Listed shares	26%
Cash and term deposits	19%
Unlisted trusts	13%
Non-residential real property	11%
Limited recourse borrowing arrangements	8%
Other managed investments	6%
Residential real property	6%
Listed trusts	5%
Other assets	3%
Debt securities	2%
Unlisted shares	1%
Loans	1%
Collectables and personal use assets	0%
Crypto currency	0%
Insurance policy	0%

Source: ATO (2021).<sup>525</sup>

## F.2. Chapter 4

This section presents charts from Chapter 4.

<sup>525</sup> Australian Taxation Office, *Self-managed super fund quarterly statistical report - March 2020* (May 2020) <<https://www.ato.gov.au/About-ATO/Research-and-statistics/In-detail/Super-statistics/SMSF/Self-managed-super-fund-quarterly-statistical-report---March-2021/>>.

Table F.2: Most common methods of fund promotion (% of respondents) – Chart 4.1

Method	1	2	3	4	5
Fund philosophy/objective	35%	6%	0%	6%	0%
How quickly investors can withdraw/redeem money from their investments	0%	0%	0%	6%	6%
Inclusion of fund on platform lists	6%	0%	0%	12%	29%
Inclusion of fund on approved product lists for advisory groups	0%	0%	0%	29%	18%
Ratings by research houses	0%	0%	24%	12%	24%
What the fund invests in	35%	0%	18%	6%	0%
Ethical investment	6%	0%	0%	0%	6%
Reputation of fund manager	12%	24%	6%	12%	0%
Reputation of firm	0%	6%	6%	6%	6%
Brand of firm	0%	0%	6%	0%	0%
Marketing	6%	0%	0%	0%	0%
Management fee	0%	0%	12%	12%	0%
Past performance	0%	47%	24%	0%	6%

Note: Respondents were asked to select the features of a fund that make it most competitive and rank from one to five.

Source: Deloitte Access Economics (2020).

Table F.3: Mean management fees by asset class (%), 2014–2020 (N=5,966) – Chart 4.6

Year	Multi-asset	Property and infrastructure	Australian equities	Global equities	Fixed interest
2014	0.78	0.72	0.86	1.25	0.62
2015	0.77	0.88	0.87	1.00	0.56
2016	0.81	0.84	0.85	0.90	0.56
2017	0.80	0.89	0.87	1.05	0.57
2018	0.88	0.94	0.95	0.95	0.58
2019	0.86	0.89	0.87	0.93	0.57
2020	0.80	0.95	0.87	1.03	0.35

Source: Deloitte Access Economics (2020) and Lonsec (2020).

### F.3. Chapter 5

This section presents charts from Chapter 5.

Table F.4: Most important factors in selecting third-party service providers (% of respondents)  
- Chart 5.3

Factor	1	2	3	4	5
Capabilities of provider	56%	22%	11%	11%	0%
Breadth of services available e.g. ability to bundle	11%	33%	11%	22%	0%
Price	11%	0%	56%	0%	11%
Size of provider	0%	11%	11%	11%	11%
Brand or reputation	0%	33%	0%	22%	0%
The providers knowledge of my business	11%	0%	11%	11%	22%
Financial stability	11%	0%	0%	0%	0%

Note: Participants were asked what the most important factors are in selecting one third-party provider over another. Participants selected at least one and could rank up to five.  
Source: Deloitte Access Economics survey (2020).

Table F.5: Barriers to changing suppliers of third-party services (% of respondents) — Chart 5.5

Barrier	1	2	3	4	5
Low number of alternative suppliers	11%	0%	11%	11%	11%
Complexity of switching	67%	11%	0%	11%	0%
Cost involved with switching or changing suppliers	0%	44%	33%	0%	0%
It is time consuming to switch	11%	22%	33%	0%	0%
It is difficult to unbundle services	0%	11%	0%	33%	11%
Risk to investors in switching	0%	0%	0%	0%	11%

Note: Participants were asked whether any of the following represented barriers. Participants selected at least one and could rank up to five.  
Source: Deloitte Access Economics survey (2020).

## F.4. Chapter 6

This section presents charts from Chapter 6.



Table F.6: Proportion of customers and funds invested in in-house or external products — Chart 6.1

Asset class	In-house products	External products
Number of products open to new customers	23%	77%
Number of products on approved product lists	21%	79%
Values funds invested by new customers	75%	25%
Values funds invested by all customers	68%	32%
Number of new customers invested in products	64%	36%
Number of customers invested in products	78%	22%

Source: ASIC (2018).<sup>526</sup>

## F.5. Chapter 7

This section presents charts from Chapter 7.

Table F.7: Most common methods of fund promotion (% of respondents) — Chart 7.1

Method	1	2	3	4	5
Through financial advisers	29%	35%	0%	0%	6%
Through platforms	18%	0%	18%	0%	0%
Newspapers/articles	0%	0%	0%	6%	35%
Through research houses and ratings agencies	12%	6%	18%	24%	6%
Disclosure statements such as PDSs	12%	0%	0%	0%	6%
Firm website/online	12%	6%	24%	18%	0%
Fact sheet	0%	6%	6%	6%	0%
Videos and webinars	6%	29%	6%	0%	6%
Social media	12%	6%	6%	6%	0%

Note: Respondents were asked to select at least one method for promoting funds to retail investors and rank them one through five.

Source: Deloitte Access Economics survey (2020)

## F.6. Chapter 8

This section includes charts from Chapter 8.

<sup>526</sup> Australian Securities & Investments Commission 'Financial advice: Vertically integrated institutions and conflicts of interest' (Report No 562, January 2018) <<https://download.asic.gov.au/media/4632718/rep-562-published-24-january-2018.pdf>>.

Table F.8: Profit margins by industry (2019) — Chart 8.2

Industry	Profit margin (%)	Industry	Profit margin (%)
Forestry and logging	18.2	Superannuation funds management services	36.5
Iron ore mining	45.2	Professional services	22.4
Meat processing	4.8	Legal services	31.9
Beer manufacturing	17.7	Travel agency and tour arrangement services	13.5
Wine production	4.3	Online recruitment services	41.8
Footwear manufacturing	9.2	Car sharing providers	41.4
Industrial gas manufacturing	14.8	Air freight services	1.3
Pharmaceutical product manufacturing	12.4	Carpentry and joinery timber manufacturing	5.9
Gaming and vending machines manufacturing	17.8	Ridesharing services	0.5
Electricity transmission	30.5	University and other higher education	5.7
Bricklaying services	21.3	General practice medical services	7.3
Toll road operators	33.8	Aged care residential services	2.7
Music publishing and sound recording	10.7	Casinos	12.4
Internet service providers	17.1	Funeral directors, crematoria and cemeteries	19.3
General insurance	12.7	Private equity	30.4
Mortgage brokers	22.1	Non-weighted average	9.5
Financial planning and investment advice	32.6	Funds management services	24.4
Custody, trustee and stock exchange services	26.9		

Source: IBISWorld (2020).

Table F.9: Proportion of all funds (%) outperforming the index — 1 year (non-weighted) – Chart 8.5

Year	Australian fixed interest	Australian property	Australian shares	International fixed interest	International shares
2010	47%	48%	23%	50%	66%
2011	15%	36%	41%	6%	29%
2012	44%	32%	39%	51%	61%
2013	44%	42%	73%	69%	19%
2014	17%	8%	35%	16%	22%
2015	18%	17%	52%	11%	23%
2016	25%	24%	23%	41%	34%
2017	26%	53%	41%	53%	73%
2018	10%	33%	17%	28%	23%
2019	24%	17%	35%	30%	23%

Note: Performance calculated net of fees. Benchmarks: Australian fixed interest (Bloomberg AusBond Composite 0+ Years TR in AU), Australian property (S&P ASX 300 AREIT (Sector) TR in AU), Australian shares (S&P ASX 300 TR in AU), International fixed interest (Bloomberg Barclays Global Aggregate Hedge AUD ATR in AU), International shares (MSCI World ex Australia ATR in AU). Sample = 14,674.

Source: Deloitte Access Economics (2020) and FE fundinfo (2020).

# Limitation of our work

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