Tightening pressure transforms the landscape

The state of asset management

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Michael Patanella, Grant Thornton LLP's Asset Management national sector leader

After years of growth, the asset management industry faces new competitors, changing client needs and expectations, and additional regulatory requirements. With additional scrutiny on fees and more low-fee alternatives, asset managers are under heightened pressure to demonstrate value. Changing demographics and the newly wealthy in emerging markets are changing the profile of the investor: younger, more diverse, more frequently not from the U.S. Investors demand closer alignment to their expectations of transparency and insights related to managing their wealth. At its simplest level, that means having access to their asset manager 24/7. At a deeper level, these diverse investors are looking for asset managers who look and think more like them. Finally, a relentless regulatory burden is increasing at a time when there is pressure to restrict fees.

Technology holds part of the promise to meet investor demands for more transparency, better risk management and new insights for finding alpha. But technology alone is not the answer. After years of robust growth, the industry is at an inflection point, and the landscape will transform. Consolidation will create larger asset management firms with the financial wherewithal to invest in needed technologies, build robust cyberdefense systems and increase their global footprint.[1]

“The entrepreneurial spirit of the industry will always encourage agile newcomers who are willing to rewrite the rules,” explained Michael Patanella, Grant Thornton LLP’s Asset Management national sector leader. “Inflection points mean change, but they also create new opportunities for growth for a new breed of asset manager, one who is more diverse, transparent and savvy at finding ways to help investors manage their wealth and risk.”

Pressure on fees

New competitors are developing creative alternatives to the traditional 2/20 fee model. The new hedge funds are slowly challenging industry norms, generally with incentives only if performance exceeds a certain market hurdle rate. Investors are dissatisfied with fees that do not adjust with substantial increases in assets under management (AUM) — particularly when the investment strategy remains the same and overhead costs associated with the fund have not changed proportionally. New fund managers in need of investors are adding pressure by being more open to hurdle rates.

For private equity (PE), scrutiny over the fees has increased. The SEC has been cracking down on PE firms regarding fee allocation (including transaction, monitoring and broken deal fees) and vague limited partnership agreements that include management fee offsets and ambiguous disclosure practices.

For mutual funds, investors have sharply moved away from higher-fee actively managed funds to lower-cost passive index funds and exchange traded funds (ETFs). Index funds and ETFs now represent 30% of total mutual fund assets, double the ratio from 10 years ago.[2] ETFs built on algorithms that factor in strategies (e.g., value stocks outpace growth stocks) are beginning to gain a foothold with institutional investors.

Technology-enabled robo-advisers are starting to pressure the lower end of the market. While dismissed by some in the industry, others compare the complacent attitude toward new competitors like Betterment LLC (with $5 billion AUM) to U.S. automakers’ reaction when low-cost Japanese cars first entered the American market in the 1960s. Robo-advisers like Betterment appeal to young investors, who are seeking low-cost advice in an era of low-return expectations (not unlike the first buyers of Japanese cars in the 1960s — young baby boomers who became lifelong customers).

[1] Grant Thornton LLP. *Plan Now: Don’t Let Your Books and Records Stall the Sale of Your RIA*.
[2] Thomas, Landon, Jr. “At BlackRock, a Wall Street Rock Star’s $5 Trillion Comeback,” *The New York Times*, Sept. 15, 2016.

Grappling with a heavy regulatory burden

At the same time asset managers are feeling pressures on fees, they see no relief from heavy, steadily increasing regulation. Asset managers looking for growth in emerging markets find themselves for the first time facing global anti-bribery and anti-corruption laws. Recently, a large publicly traded asset manager was charged with paying bribes to government officials in Africa to secure natural resource deals and other investments. As a result, the firm settled charges and agreed to pay penalties. In addition to the firm, a number of individuals from the asset manager were charged, including the CEO, who agreed to pay penalties to settle a record-keeping violation.

But it is not just regulations from entering new markets that concern asset managers; the burden of existing regulations continues to grow as well. SEC regulations about Form ADV will require new levels of disclosure for asset managers. New SEC rules on liquidity risk management will affect open-end mutual funds. Regulators are renewing their focus on cybersecurity. Finally, taxing authorities are posing multiple new challenges on asset managers, not the least of which is the impact on carried interest.

Form ADV revisions add to disclosure requirements

On Aug. 25, 2016, the SEC released new amendments to Form ADV that add to disclosure requirements. The effective date is Oct. 1, 2017, for new advisers initiating their first form or amending an existing form, although most advisers won't be affected until the first quarter of 2018 as part of the annual 90-day Form ADV update. The new requirements focus on disclosures relating to separately managed accounts, many of which are modeled to create a Form PF type of transparency. Other new requirements include disclosing all of the adviser's websites and social media accounts, more information about other offices, and compensation paid for client referrals. In addition, advisers must maintain calculations for performance information communicated to any person. The SEC also updated Form ADV regarding umbrella registration for a group of advisers that operates as a single business, aiming to simplify the process.

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Liquidity risk management

On Oct. 13, 2016, the SEC voted to adopt changes to modernize and enhance the reporting and disclosure of information provided by registered investment companies, as well as to improve the liquidity risk management by open-end funds, such as mutual funds and ETFs. “The SEC believes that the former will improve the quality of information available to investors, and will allow the SEC to more closely and effectively monitor, collect and use data reported by the funds,” explained John Stomper, Grant Thornton’s Mutual Funds national sector leader.

“Improving the liquidity risk management by open-end funds will provide more transparent and relevant disclosures regarding fund liquidity and redemption practices,” explained Jon Mayer, Mutual Funds national sector deputy. In addition, the new rules will permit mutual funds to use swing pricing, allowing funds to ensure that shareholders who remain invested in a fund do not shoulder the costs triggered by other investors who have redeemed out of the fund.

More scrutiny on cybersecurity

The SEC is issuing proposals on cybersecurity (including cybersecurity regarding third parties). Given their access to information about deals and investors, asset managers are already being targeted by cyberthreats. Breaches at the fund level can shake investor confidence and compromise the firm’s ability to raise funds. Asset management firms are expected to incorporate cybersecurity into their business strategy and risk management policies, even weaving it into the diligence process. For PE, cybersecurity considerations extend from the fund to the portfolio companies. The complexity increases when third parties for both the fund and the portfolio companies are added to the mix.

A common form of third-party cybersecurity risk review are Service Organization Controls (SOC 1, SOC 2 or SOC 3) Reports, which help vendors demonstrate the strength of their internal controls to current and prospective customers.

“Having access to a SOC report can be extremely helpful when evaluating potential vendors and monitoring third-party risk on an ongoing basis,” explained Kristina Vieni, Grant Thornton Special Attestation Reporting leader for Metro New York and New England. “However, the mere existence of a SOC report may not address all of the asset manager’s specific concerns, and it is important to understand the scope of the SOC report.”

New tax rules and implications

From a tax regulatory standpoint, the new rules dealing with partnerships, disguised sales, debt sharing and tax audits require rethinking traditional structures and positions. In addition, new rules dealing with tax reform (potentially affecting the taxation of carried interest) are expected, and will also call for rethinking traditional structures and positions.

While it is possible to understand and plan within the new rules, the uncertainty regarding fallout from IRS audits of partnerships will remain unknown and complicate planning. For PE firms, tax complexity for their portfolio companies will increase as new IRS regulations (including Section 385 treatment of intercompany lending, and European Union base erosion and profit-shifting actions) gain traction.

Technology holds the promise, but not the single answer

Today, asset managers tend to operate many different technology platforms that do not interact. Connecting disparate data systems, particularly across the finance, risk and treasury functions, could provide the intelligence and insights on the correlations between lagging and leading indicators of risk and performance. This would benefit investors, regulators and the asset managers themselves.

Asset management firms are looking to artificial intelligence solutions to help respond to the need to perform a growing number of compliance tasks. In the financial services sectors, these solutions are often called regulatory technology or RegTech — technologies designed to manage data and meet their particular regulatory challenges. A rush to embrace RegTech has been escalating since the financial crisis. SEC rules to amend Form ADV to modernize disclosure and reporting are a further impetus to make these critical technology investments.

Regulations aren't going away, but asset management firms of all sizes have ample opportunity to comply with them more efficiently and effectively. Even more opportunity lies in changing the way asset managers think about the underlying data in their risk, treasury and finance functions, transforming what's usually viewed as an overhead function into a genuine competitive advantage.

Asset managers know that connecting with the emotional needs of today's investor is as important as meeting traditional measures of success. Greater transparency is one factor in building trust. There are new technology platforms that are changing the rules in delivering accessible and transparent information and insight that today's investors demand — consider the impact BlackRock Inc.'s Aladdin risk mitigation platform has had on the ETF market. Asset managers are considering how other asset classes could be integrated into new platforms to allow multistrategy platforms.

A changing landscape

Asset management is becoming essentially a zero-sum game — certain sectors will benefit to the detriment of others. We've seen passively managed index and ETFs grow at the expense of actively managed funds. PE has also managed to grow, as larger PE firms move downstream for deals and PE managers become more comfortable with add-on acquisition strategies. After decades of dramatic growth, hedge funds face the challenges of a persistent low interest rate environment and a bull market for equities that has raged since 2009. For the time being, it does not pay to be the contrarian.

Consolidation is creating a bifurcated market. Large funds have the financial resources to invest in the technologies needed to address regulatory and risk concerns. Small funds can carve out a strategic niche to serve specific investor needs. This creates a squeeze on midsized funds, which are looking at their business models and assessing if they can make it on their own.

Managers of the best-run firms will understand the changing landscape and strategically position their firms to deliver value based on their unique strengths. They will use this period of consolidation to create the transparency, insights and fee value that connect with global investors in innovative ways. They will understand all asset classes and demonstrate the agility to guide investors with effective technology platforms that cross multiple asset classes. In some cases, that will mean finding new efficiencies to profitably drive down costs and fees. In other cases, that will mean partnering with entrepreneurial competitors who have found niche investment strategies that can be integrated into their platforms. Most importantly, they will have the courage to follow through with promising innovations that will provide reliable results for clients and, perhaps, in the process, disrupt and redefine their industry.

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