New City Initiative

M&A in Asset Management

Is it strangling boutiques?

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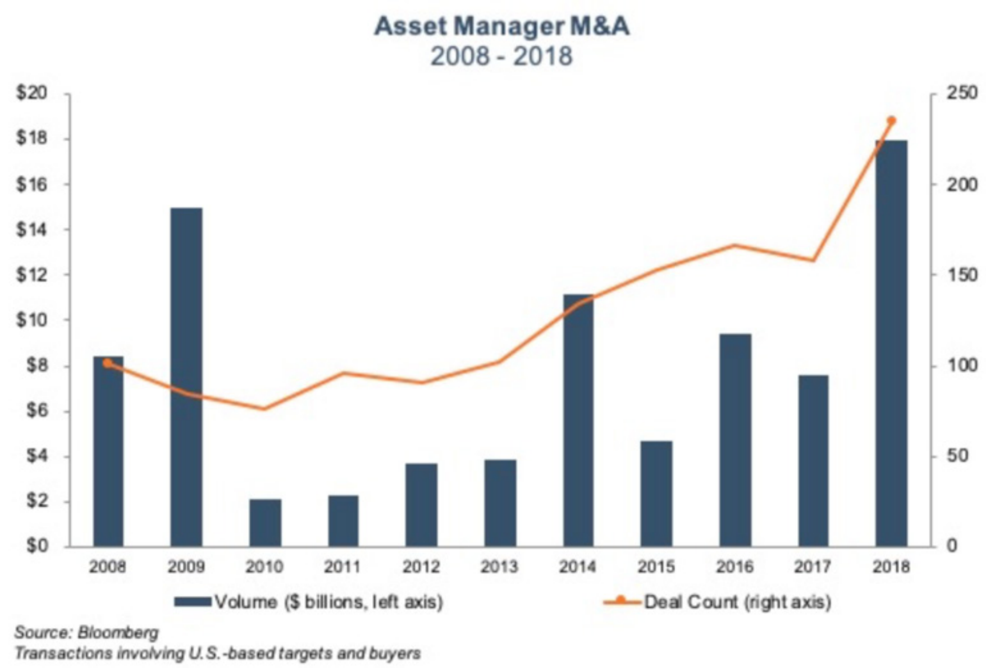
Introduction

In the aftermath of the financial crisis, many asset managers saw M&A (mergers & acquisitions) with their competitors as a means to survival, principally a necessary evil by which to preserve their businesses amid the tumbling markets and as a counterweight to offset the sheer volume of client redemptions. Since then, M&A has only accelerated at major asset managers, as firms look to create economies of scale facilitating investor diversification and wider product distribution footprints. These larger enterprises can also better absorb the increasing operational and regulatory costs that come with running an asset management business in 2019. However, this rush towards consolidation carries risks.

In this paper, NCI looks at some of the implications which M&A is having on the boutique asset manager community. It also questions whether decisive action needs to be taken at a governmental or regulatory level to further scrutinise this M&A activity, especially if there is evidence that these transactions are drowning out competition and undermining investor choice. As part of this analysis into M&A trends within the industry, NCI spoke to a number of its diverse boutique asset manager members about the impact consolidation was having.

M&A Today

Asset management M&A has been riding high over the last few years. According to data from Mercer Capital, both deal volume and deal count in 2018 were at their highest levels since 2009.[1] For instance, total deal count grew by 49% in 2018 in comparison to 2017, whereas deal value was up 140% reaching $18 billion.[2] High-profile transactions last year included Invesco acquiring the Oppenheimer Funds business from Massachusetts Mutual Life Insurance Co for $5.7 billion creating a JV with combined assets of $1.2 trillion.[3]



1 Mercer Capital (January 21, 2019) 2018 was a banner year for asset manager M&A
2 Mercer Capital (January 21, 2019) 2018 was a banner year for asset manager M&A
3 Pensions & Investments (March 18, 2019) All eyes on Invesco as deal raises active management stakes

According to Sandler O'Neill, a US-based investment bank, there were 253 mergers between asset managers in 2018, a rise from 210 in 2017, a sum exceeding the previous record of 243 which has been held since 2007.[4] Furthermore, the bank estimates that the disclosed value of asset management M&A activity grew by 29% to $27.1 billion, the highest since 2007 when that figure stood at an eye-watering $51.6 billion.[5] This flurry of deal-making across active asset managers is being accelerated by several underlying factors.

The why?

The drive towards consolidation at large asset managers is partly a consequence of the reallocation of funds by investors into cheaper passive products. Morningstar data shows that passive products (index trackers, exchange traded funds [ETFs]) held 48% of all assets in 2018, and this could rise to 50% in 2019 assuming current trends persist.[6] With more institutional investment pivoting towards passive investment strategies, realised fees at active managers are falling, which in turn is encouraging more industry-wide consolidation.

Managers' costs have also increased exponentially which again is prompting greater M&A. Regulations in the EU have been particularly intense for asset managers, with rules such as AIFMD (Alternative Investment Fund Managers Directive), MiFID II (Markets in Financial Instruments Directive II), EMIR (European Market Infrastructure Regulation), UCITS V, GDPR (General Data Protection Regulation); and PRIIPs (Packaged Retail and Insurance-Based Products) all collectively affecting fund manager margins. For many firms struggling under the weight of these complex regulations, consolidation is often seen as the best option.

4 Financial Times (February 16, 2019) M&A activity in fund sector breaks 11 year record
5 Financial Times (February 16, 2019) M&A activity in fund sector breaks 11 year record
6 Bloomberg (December 31, 2018) Shift from active to passive approaches tipping point in 2019

The SEC looks at consolidation

In a recent speech made by Dalia Blass, director, division on investment management at the US Securities and Exchange Commission (SEC), she stated the regulator was creating a new outreach initiative targeting small to mid-sized (SME) asset managers. The initiative will consult with SME asset managers on the matter of regulatory barriers to entry. However, during the same speech it was also acknowledged that industry consolidation and fee compression was potentially depriving ordinary investors from accessing SME managers. Again, this could be a precursor to increased SEC scrutiny of M&A at large investment firms.

The performance case for boutiques

If investors are unable to access as many SME asset managers, they may struggle to obtain portfolio diversification through wider exposures to niche strategies. "As large asset managers get bigger, performance sometimes gets worse as it is not as easy to move in and out of trades. Even if investors are paying lower fees at these large fund managers, they might not be getting the performance they deserve. Boutique asset managers can give investors exposure to niche or specialised products, which is much harder to do at larger fund managers," said an NCI member. Again, this can have a negative impact on returns.

Furthermore, boutique asset managers have a proven track record of outperformance, both against their largest rivals and index trackers. For example, research conducted by the Affiliated Managers Group found boutiques (defined as managers with less than $100 billion) generated returns that were on average 62 bps (basis points) better than their larger peers, and beat indices by 135bps annually between 1998 and 2018.[7] The research also added that investors with boutique only exposures would have generated 16% more wealth than if they allocated into mega managers over the last 20 years.[8]

Averting concentration risk

Analysis by Willis Towers Watson found that the concentration of assets controlled by the top 20 fund managers has grown significantly. According to the data, the largest 20 managers look after 43.3% or $40.6 trillion of the top 500 fund managers' assets under management (AUM).[9] The study also found that there were 12 managers in the top 20 who accounted for 69.8% of that total AUM.[10] For investors, this represents serious concentration risk. It is crucial that investors diversify their portfolios beyond just the largest asset managers, so that they have healthy exposure to boutiques as well.

7 Institutional Investor (October 30, 2018) Boutiques beat larger managers with remarkable consistency
8 Institutional Investor (October 30, 2018) Boutiques beat larger managers with remarkable consistency
9 Investment Week (November 6, 2018) Concentration of assets run by top managers hits record level as firms are warned about shift away from traditional assets
10 Investment Week (November 6, 2018) Concentration of assets run by top managers hits record level as firms are warned about shift away from traditional assets

Should regulators intervene?

NCI members are divided about the merits of either SEC, FCA (Financial Conduct Authority) or CMA (Competition and Markets Authority) intervention into asset management M&A, at least among some of the larger providers. "M&A is stifling competition. If you look at any industry where there is consolidation, you get less competition and asset management is no different. I definitely believe this is something which regulators should be keeping an eye on, or even consulting the industry about," said one fund manager member of NCI.

Others believe a more sensible, proportionate approach towards regulation could help competition. "The barriers to entry are very high and this is something regulators need to be aware of. It makes it harder for boutiques to enter the market and reinforces a bifurcation between the hegemons and smaller providers," said another NCI member firm.

It has also been noted that there are "second order" barriers. Within the UK discretionary wealth management and IFA (Independent Financial Advisor) sector, there has been huge consolidation as firms deal with regulatory complexity and look to achieve economies of scale. As a result, they advise much larger pools of capital which must be allocated to managers who can accept sizeable investments, namely those with higher capacity. The biggest managers are typically the ones who can onboard the larger flows, but smaller funds - or those that are disciplined about capacity and the liquidity they offer - cannot accept these outsized allocations. Again, this is widening the gulf between big and small.

Failure to find a solution to these issues will ultimately deprive investors of choice and potentially even returns, forcing them to allocate into only but the largest, dominant asset managers. If the UK is to have a competitive asset management industry, NCI strongly recommends that a more proportionate approach to regulation would be a good starting point in what will allow boutiques managers to flourish alongside their larger peers.

New City Initiative Members

UK Members

Alvarium Investments	Bentley Reid & Co.	Brown Advisory	Cape Ann Asset Management
Columbus Point LLP	Dalton Strategic Partnership LLP	Edgbaston Investment Partners	Findlay Park Partners LLP
Floreat Group	Guinness Asset Management	Highclere International Investors	Independent Franchise Partners LLP
Kennox Asset Management Limited	Kiltearn Partners	Latitude Investment Management	LGT Vestra LLP
Longview Partners LLP	Majedie Asset Management Ltd	Marathon Asset Management	Mayfair Capital Investment Management Ltd
Morant Wright Management	Neptune Investment Management	Northill Capital LLP	NS Partners Ltd.
Ocean Dial Asset Management Limited	Oldfield Partners LLP	Orbis Investments	Phoenix Asset Management Partners Ltd
Polar Capital	Record Currency Management	Revera Asset Management	RWC Partners Ltd.
Sanderson Asset Management	Sanlam Four Investments Ltd	Silchester International Investors	Somerset Capital Management LLP
Stanhope Capital LLP	Stonehage Fleming Family & Partners	S. W. Mitchell Capital LLP	Tellsons Investors LLP
Troy Asset Management Limited	Waverton Investment Management		

Continental Members

Comgest S.A.	Quero Capital	Skagen Funds

About the New City Initiative

NCI is a think tank that offers an independent, expert voice in the debate over the future of asset management.

Founded in 2010, NCI counts amongst its members some of the leading independent asset management firms in the City and the continent. The NCI gives a voice to independent, owner-managed firms that are entirely focused on and aligned with the interests of their clients and investors.

Over the last decade, a traditional “client-centric” approach has enabled entrepreneurial, owner-managed firms to emerge as an important force in a financial industry dominated by global financial giants. Now, more so than ever, these firms play a key role in preserving the stability and long-term focus of the financial sector, which is of benefit to society at large.

About the Author

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Charles Gubert is a consultant to the NCI. He is founder of GTL Associates, a research, copy-writing and marketing consultancy to financial services institutions, and a contributing editor at Global Custodian Magazine. Prior to this, he was a research manager at Thomas Murray IDS, a consultancy and editor at COOConnect, an online title aimed at chief operating officers at alternative and long-only fund managers. He started his career as a reporter at Risk Magazine and Hedge Funds Review.

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