Europe’s Investors Look For Bargains In Managers, Strategies

Low interest rates, local cost disclosure requirements and an increasingly competitive asset management market are pushing European institutional investors to review their investment strategies and look for ways to reduce expenses by either reducing the number of managers they use, negotiating more aggressively on management fees or by implementing cheaper strategies.

Money managers are certainly feeling the pressure from institutional investors and are less confident about maintaining their fee level, revealed a report from **Cerulli Associates** earlier this year, titled “European Institutional Dynamics: Major Themes Reshaping the Investment Landscape Report” (*iiSEARCHES, 30/05*). Whereas more than two-thirds of managers were able to withstand institutional pressure to reduce fees in 2013, the outlook for the next 12 to 24 months looks less promising for them. “[Asset managers] predict [fee] cuts will have to come by 2016, regardless of the kind of institutional end-client,” observed London-based Cerulli Associate Director **David Walker**.

FIERCE COMPETITION

An important reason why investors are able to negotiate fees is the competitiveness of asset management market. Paris-based **Agirc-Arrco** is an example of an investor that is seeking to exploit that competitiveness to secure fee concessions from managers, according to a fund statement. The EUR51 billion second-pillar pension fund spends a whopping EUR140 million annually on management fees, which led it to conduct a strategy review in November 2014 (*iiSEARCHES*, 17/10).

Philippe Goubeault, chief financial officer of Agirc-Arrco, said that even if management expenses amount to 0.20%, an asset review is still worth conducting due to more competitive offers being available on the market. The French asset management market is currently made up of some 600 firms, and around 400,000 investment funds. He did not return further emails or calls by press time to comment on what measures the scheme will take in the future or if it has already started negotiations with managers as an outcome of the review.

In addition, new asset managers are constantly entering the market bringing down prices. “There are new competitors in the market, which want to raise assets. They can be more aggressive regarding the price,” according to an official at **Groupa Asset Management** in Paris. “Competition between managers helps reduce fees or bring fees to a fair level,” said CIO **Salwa Boussoukaya-Nasr** at EUR37 billion **Fonds de Reserve Pour les Retraites** (FRR) in Paris. She declined to comment any further on the investment styles that would be susceptible to fee reductions.

Francois-Xavier Douin

ROOM FOR NEGOTIATION

Larger pension funds in particular are able to negotiate management fees. The larger the institutional investor, or the larger the mandate, the more bargaining power institutions have in negotiating fees, Cerulli’s Walker, Europe Research Director **Barbara Wall** and Senior Analyst **Laura D’Ippolito** declared in a joint statement.

It is this fact that makes FRR’s Boussoukaya-Nasr optimistic about the fund’s current fee arrangement. “Lowering the current fees is not such a worry for us because we believe that we are already getting the best offers possible from the managers [due to] our size and mandate sizes we have for each manager,” she said. “When you are a larger institutional investor you can negotiate fees better because of your size; you have to negotiate less than other customers for the same mandate size.”

“It is commonly held in Europe’s pensions’ community that larger schemes, which can award bigger mandates by virtue of their very size, can and should squeeze managers on asset management fees,” said Cerulli’s Walker. He noted, however, that some larger schemes, for example in the Netherlands, occasionally pay slightly more on average than smaller schemes due to their resources, expertise and “willingness” to invest more in alternative strategies than some of their smaller peers.

Some smaller asset managers are not feeling the pressure yet. Among them is **Métropole Gestion** in Paris, which so far has not been approached by clients with a request to trim fees. “We would probably negotiate with the client to see what we can do,” speculated **Romuald de Lencquesaing**, director of development.

Francois-Xavier Douin, managing director and head of Nordics at **JPMorgan Asset Management** in London, added that the firm rarely charges fees that are in the book. “There is always room for negation if the mandate is of a certain size or if it is very standard.” However, the likelihood is low the firm would reduce fees for very tailored mandates or highly demanded strategies, he noted.

Naturally, not all asset managers are willing to lower fees for their services. Groupama’s official, for example, said the firm would not reduce fees if requested. “On the contrary, the firm is promoting its open-ended funds as much as possible, as well as trying to increase management fees and [revenue],” he noted.

FUND CONSOLIDATION

In addition, Cerulli Associates believes the consolidation of pension schemes in several European countries is also a driver, putting pressure on asset managers to lower fees. “The trend towards fewer, larger pension funds

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could mean that managers that do win business, win larger mandates, but there will be more competition and bargaining power held by institutions and therefore lower fees." Walker added that pension funds are merging for several reasons, including "the burden on costs and resources by regulation, direct and public pressure from some regulators themselves, the need to attract scheme trustees with greater investment expertise; and the need to reduce asset management costs at a time of meagre returns from much of the 'safe' fixed income [investments] at the heart of many schemes' portfolios, among other drivers."

"In the U.K., the number of trust-based defined contribution schemes fell by almost one quarter (22.6%) over the four years to the end of 2013. The greatest proportional depletion (of 38.5%) was seen among smaller schemes with 12 to 99 members. Between 2010 and September 2014 Dutch pension schemes—DC, DB, mixed, capital agreement and others—were depleted in number by 35.6%. The Dutch pensions regulator, **De Nederlandsche Bank,** has actively encouraged small schemes to consider their viability," Walker explained. He emphasised the Danish pension market, which was an exception to the mergers and acquisitions trend. "Some smaller Danish schemes have argued the outcomes they give members, not their size, should be the yardstick determining their viability."

CASS STUDY

A study conducted in November 2014 by London-based **Cass Business School** found that the most prevalent fee structure in the U.K.—a fixed fee in proportion to the assets being managed—is the least favourable one for investors, resulting in an "incentive mismatch." The Heads We Win, Tails You Lose" report revealed that while managers profited most from this fee structure, it is "the worst for the investor," said **Richard Payne**, a lecturer at CASS.

As part of the study, three fee structures—fixed, asymmetric and symmetric—were compared, calculating their financial benefit for investors and asset managers. Results showed that the symmetric fee structure, which allows both parties share the upside and downside of performance, is the fairest option for both managers and investors. "The results in this paper give rise to a natural question: since investors would prefer symmetric, performance-based charges, why don't more fund managers offer such fees?" asked **Nick Motson**, co-author of the report.

The **Gloucestershire County Council Pension Fund** successfully managed to negotiate a more advantageous fee structure with some of its incumbent managers this year. According to its latest financial report, **Standard Life Investments**, **GMO** and **Hermes** have agreed to a partial performance-related fee calculation. Further details on the deal could not be ascertained by press time.

SEEKING ALTERNATIVES, GOING PASSIVE

Contributing to the pressure on managers is the emergence of semi-active strategies, according to **Stephan Skaanes**, a partner at Zurich-based **PPCmetrics**. "Through customised indices, [investors] can partly collect value premiums at a reduced rate compared to traditional mandates," he said. His views are confirmed by **Bob Campion**, head of institutional business at **Charles Stanley Pan Asset** in London, who believes that the proliferation of passive index-tracking products over the last few years has contributed to investors seeking to reduce their management fees. "There was a time a few years ago where you could only invest in quite broad asset classes, using passive funds, but the fact is now that you have a whole generation of exchange traded funds and lots of new index funds, with costs for these products coming down all the time as they are very competitive with each other," he noted.

Stephan Skaanes

Cerulli's Walker, Walls and D'Ippolito noted that some investors are seeking out less costly investment classes, not necessarily due to their "cheapness," but rather their simplicity. "A pension trustee may find it easier to understand and explain to its regulator how a passive index product works than an actively managed fund, and the index product comes without the governance and many monitoring duties that active funds entail," they explained. "Its relative cheapness might only be an additional driver for the investor."

FRR's Boussoukaya-Nasr concurs that the complexity of the asset class is a factor when deciding on an active or passive manager tender; it is not the main driver, however. "Before every RFP that we publish, we conduct market studies to see if there is some alpha on the market that can be captured by a manager and if there are managers that have been able to capture some alpha regularly," she explained. "If we think the market is not broad enough and if we think that there are not enough opportunities to make alpha or if it is too complicated or if there are no managers that can deliver alpha on a regular basis or very cyclically then we chose passive management," she added. "We only want to pay fees for active management when we think that the possibility for them to deliver alpha is likely."

DIY: BUILDING IN-HOUSE TEAMS

Some Nordic institutional investors are cutting asset management costs by building in-house teams, particularly for alternative investments. Some Danish pension schemes make property investments in-house as they consider investing in real estate via funds too costly compared to investing directly, noted Cerulli's expert team.

JPMorgan's Douin noted that apart from property, schemes are also setting up internal teams for infrastructure. He

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observed that management fees are under scrutiny, particularly in Denmark, but also large pension funds in Sweden, such as the **AP Fonden**. "These are closely watched due to their size and importance in the market by the media and the public," he said. "There has been a market preference over the last couple of years, with a couple of large investors going for direct investments that are managed or sourced both internally or in joint ventures [with other peers] with a view to avoid fund costs or invest in infrastructure or real estate funds," he added.

In addition, Douin believes that schemes seek to control their investments. "If you invest in a closed or open-ended real estate or infrastructure fund, you look at the strategy, managers and mandate of the fund, but once you have committed to the fund, you are not in control at all about what is going on in the fund," he explained. "It is the control of what you buy and when you buy it, and at what price you buy it." He emphasized that while investors still invest in domestic real estate, an increasing number of institutional investors are allocating to property outside of their countries, including markets such as Germany, the U.K. and France, by using their in-house expertise.

—Charlene Winkel

Regulatory

Europe Awaits Pension Directive

The European occupational pension market will see some significant changes under the *IORP Directive II*, which is set to be implemented by Dec. 31, 2016. Nothing has yet been set in stone, with five compromise drafts having been drawn up by Italy—the current **European Union** council presidency holder—over the last couple of months proposing or removing requirements presented in earlier drafts. A revised directive is set to be passed by the Latvian government, which will hold the rotating EU council presidency for the first six months of 2015.

The **European Commission** released the Directive II proposal draft in late March 2014. It is the long-awaited revision of the *IORP Directive 2003* that outlines guidelines for the operation and supervision of Institutional Occupational Retirement Pension Fund (IORPs) across EU member states. In light of an aging European population, the directive seeks to strengthen the European pension system to ensure safe and sustainable pensions. Additionally, the directive aims to reinforce the position of IORPs as institutional investors in the European economy and strengthen the capacity of the European economy "to channel long-term savings to growth-enhancing investments," according to the proposal.

The Commission's Proposal

In its proposal, the European Commission defines its four main objectives as follows:

- Ensure the soundness of occupational pensions and better protect pension scheme members and beneficiaries.
- Better inform pension scheme members and beneficiaries; remove obstacles for cross-border provision of services so that occupational pension funds and employers can fully reap the benefits of the single market through the introduction of a pension fund transfer procedure.
- Encourage occupational pension funds to invest long-term in growth-, environment- and employment-enhancing economic activities.
- Remove obstacles for cross-border provision of services so that occupational pension funds and employers can fully reap the benefits of the single market.

The directive seeks to achieve these goals through a two-pillar structure—covering areas such as governance and risk management (pillar one) and disclosure to future and existing pension fund members (pillar two). "The IORP II Directive is roughly comparable with *Solvency II* without the capital requirements, that means without the quantitative requirements of Solvency II's first pillar," explained **Alfred Gohdes**, an actuary at consultancy **Towers Watson** in Wiesbaden. Solvency II requirements were initially introduced in form of a first pillar, but that was removed after EIOPA had carried out a quantitative impact study (QIS), which found that solvency requirements would have a major negative impact on some European pension markets.

Under IORP II, new governance requirements, including risk management, internal audits, as well as actuarial reviews (if necessary) are planned to be introduced, as well as standardised pension benefit statements, providing members with straightforward and concise information about their pension entitlement. Furthermore, a pension fund transfer procedure is set to be introduced. In terms of investments, restrictions are expected to be loosened, in particular for alternative investments, in order to promote financial growth.

FINDING A COMPROMISE, DEFINING IORPS

The initial draft by the European Commission "was very disadvantageous

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