Shifts in the landscape

With investors increasingly looking for assets that are deemed less vulnerable to market volatility, there has been a proliferation of passively managed funds and financial technology platforms. How will the asset management industry respond to these challenges?

BY **THE PERSONAL WEALTH TEAM**

The prolonged volatility in global markets is causing a shift in the asset management industry. Investors are increasingly looking at assets that are deemed less vulnerable to market gyrations to ensure good returns.

As a result, the industry is seeing a proliferation of vehicles that offer passive investing strategies, such as exchange-traded funds (ETFs), or platforms powered by financial technology (fintech) such as robo-advisers.

The popularity of ETFs, which track the performance of a benchmark index, is due to their low fees and the lacklustre performance of actively managed funds in developed countries. By mid-2015, passively managed funds in the US had amassed US$2.97 trillion, surpassing the US$2.96 trillion managed by hedge funds.

Last year, ETFs in the US saw an inflow of US$126 billion — a stark contrast to the outflow of US$228.9 billion seen by mutual funds, according to Thomson Reuters' Lipper Alpha Insight. Professional services firm PwC has projected inflows of US$1.1 trillion and US$2.3 trillion by end-2018 and 2021 respectively.

This indicates that more investors are going into passively managed funds and fund houses are offering more ETFs. This trend is also seen in other countries, where fund houses that provide ETFs are seeing more inflows.

Meanwhile, robo-advisers, which provide automated algorithm-based portfolio management advice, have grabbed 0.5% of the US asset management industry's total assets under management (AUM). This figure is expected to rise to 5.6% by 2020, according to management consulting firm AT Kearney.

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> > *Gan*

PASSIVELY MANAGED FUNDS YET TO GAIN TRACTION LOCALLY

ETFs have not quite taken off in Malaysia despite being made available to investors many years ago. While these funds have taken developed countries by storm, they have not gained much traction in emerging markets, including Malaysia, says Eastspring Investments Bhd chief sales and marketing officer Yap Siok Hoon.

The number of ETFs being offered locally reflects this view. Currently, there are only eight listed on Bursa Malaysia compared with 627 unit trust funds catering for local investors.

"Local ETF offerings have not been as wide as those in developed countries. Thus, for most investors, unit trusts still offer a wider range and variety of funds in which they can invest," says Yap.

There are currently three providers of locally listed ETFs — AmFunds Management Bhd (AmInvest), CIMB-Principal Asset Management Bhd and i-VCAP Management Sdn Bhd, a wholly-owned subsidiary of Valuecap Sdn Bhd. i-VCAP Management is the largest provider with four ETFs while AmInvest and CIMB-Principal offer two each.

Indonesia has 10 ETFs while Thailand has 15 listed on their bourses. These funds mainly track the countries' broader stock market and various sectors in that market.

The Singapore Exchange hosts 72 ETFs — the highest number in the region — but it is still a far cry from the thousands of ETFs in the US. There are more than 1,500 of these funds listed on the New York Stock Exchange alone.

Local fund houses do not feel the need to launch ETFs, says Areca Capital Sdn Bhd CEO Danny Wong. He points out that even with the 3% to 5% sales charge and 1% to 1.5% annual management fee, a number of unit trusts have outperformed ETFs in terms of net returns due to market inefficiencies. "We don't think the underperformance is happening in emerging markets due to market efficiency factors and mismatch between value and prices," he adds.

Bank-backed fund houses such as RHB Asset Management Sdn Bhd are confident that their top-tier funds will outperform the markets they benchmark against due to their bottom-up stock-picking ability and available resources.

"Local fund management outfits like us have the advantage of a network of analysts in different locations carrying out on-the-ground research on companies. This enables fund managers to add value via stock and sector selection," says RHB Asset Management managing director Eliza Ong.

Gan Kong Yik, chief investment officer at KAF Investment Funds Bhd, says the returns from ETFs will continue to exceed the average performance of some unit trusts after taking into consideration the total fees incurred. "However, we do not believe that it spells the end for actively managed funds. The returns of passively managed investments usually reflect the average market return and outperform the average mutual fund return by minimising the expense ratio.

"But mutual funds in the top percentile will likely outperform ETFs, hence our emphasis on the ability to generate alpha for our investors. We believe in a continuous improvement process in formulating our investment strategy and hope to adapt to different market conditions."

Nevertheless, it will only be a matter of time before the demand for ETFs grows as emerging markets get more efficient, making it harder for actively managed funds to outperform the indices, says Phillip Mutual Bhd fund manager Richard Cheong.

"Actively managed funds will have the edge in certain segments of the market, especially in the mid and small-cap space, where the disparity in the valuations of these companies are more significant. Funds that constantly search for undervalued companies will perform better in this area over time. Nonetheless, as the industry grows with more funds competing in the same space, the challenge to outperform will definitely increase," he says.

KAF is one of the fund houses preparing for ETFs to take off in the country. "There are still fewer than 10 ETFs listed on Bursa, and fewer than five of them provide exposure to the local equity market. Also, they are mainly limited to the large-capitalisation companies," says Gan.

"We think that the asset management industry still has a lot to offer [in terms of ETFs] to local retail investors by providing more complex products that are value accretive."

FINTECH STILL AT A NASCENT STAGE

Fintech is already being adopted in the country. But the industry is set to take off with the Securities Commission Malaysia (SC) expected to introduce a framework for robo-advisory services this year.

AmInvest CEO Datin Maznah Mahbob is well aware of the huge impact fintech can have on the asset management industry over the longer term. Those who are not prepared and are slow to adopt it are expected to fall behind when the time comes.

"Fintech firms, including robo-advisers, will pose challenges to fund houses with higher cost distribution models and higher cost of managing funds, which derive from compliance and risk management. New skillsets and approaches need to be developed to address anti-money laundering issues, client sustainability assessments and cybersecurity. Those who are able to navigate this shift in the distribution landscape will be the winners in the long run," she says.

AmInvest, which launched the first local ETF in 2007, is showing strong interest in fintech. "We are a strong proponent of fintech and yes, we will be embarking on fintech initiatives with many strategic partners to capitalise on this market segment, which promotes transparency, ease of access to our suite of investment solutions and lower cost of entry," says Maznah.

Meanwhile, start-ups in the region have begun operating robo-advisory services. One example is Singapore-based Smartly, which has already engaged with the authorities and is planning to launch its platform in Malaysia when the SC's framework is implemented.

RHB Asset Management's Ong says there are three possible scenarios of how local fund houses will respond to the implementation of the framework. "The first is that we will see asset managers continuing to work with distributors while ignoring robo-advisers. The second is partnering with robo-advisory firms and integrating their services with fund houses' existing distribution platform.

"The third is to set up a new distribution platform using robo-advisers to sell products directly to clients. All these scenarios hinge upon where the fund houses' current business is and how sophisticated their distribution channels are."

More importantly, robo-advisers will suit the demands of the younger generation, who have grown up in the mobile and internet age. "Technology is here to stay and will continue to improve. We believe the mass market, youths and millennials, is one of the growth drivers going forward," says CIMB-Principal CEO Munirah Khairuddin.

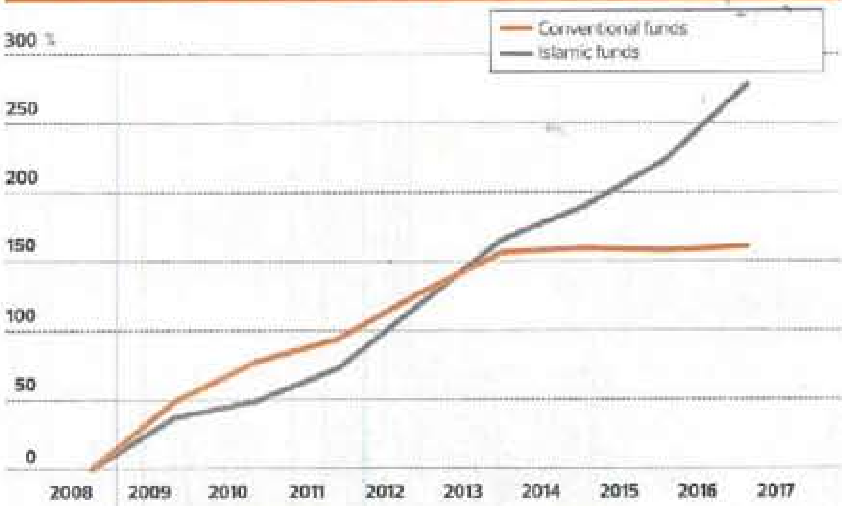
But for fintech to bloom, it will require the necessary infrastructure and demand from investors. "Fintech is still at a nascent stage, with signs of immense potential. However, to flourish, it requires a regulatory framework as well as consumers to reach a level of trust when it comes to placing or transacting monetary assets with start-ups that have short operating track records. They must also be comfortable undertaking financial planning without the human touch," says Public Mutual Bhd CEO Yeoh Kim Hong.

Face-to-face relationships via unit trust agents, also known as consultants, are expected to continue being the fund house's main distribution channel, she says. "We view the development of robo-advisers positively as they will empower financially-savvy investors to conduct and track their investments independently. However, there are many investors who prefer to use the services of unit trust consultants, who can explain, track and provide value-added services to them.

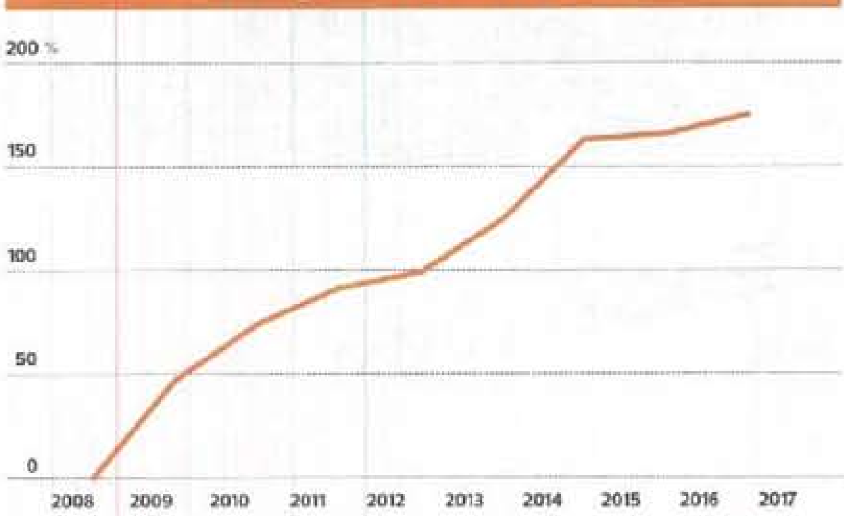
"Our experience shows that investors, especially high-net-worth individuals, still prefer the services of these consultants although they have the capability and access to online investments. Robo-advisers are viewed as complementary to unit trust consultants."

But some issues still need to be sorted out. Hong Leong Asset Management Bhd CEO Hoo See Kheng says he is concerned about the algorithms used by robo-advisers, which are highly dependent on market

Net asset value growth of unit trust funds by category



Total net asset value growth of unit trust funds



SOURCE: THE SECURITIES COMMISSION MALAYSIA

information and not as transparent as developed markets.

"Robo-advisers use software to run their algorithms to automatically allocate, manage and optimise clients' assets. All these rules work well in proper developed markets where information is comprehensive and available in real-time. But for emerging markets in Asia or Southeast Asia, where information is not so comprehensive, it will be a challenge to provide such services on a real-time basis," he says.

SEEKING NEW GROWTH AREAS

Meanwhile, the unit trust industry's growth is slowing and local fund houses are looking at ways to attract investors. "If you look at the market statistics, the unit trust industry has seen flat growth from new money over the past three years. Net sales have been challenging due to a combination of factors, ranging from economic climate to high entry fees," says Hoo.

As at Dec 31 last year, the total net asset value (NAV) of unit trusts had increased only 5.48% over the last three years, according to information provided by the SC. This was largely supported by the growth of shariah-compliant funds. Conventional funds saw a marginal increase of 0.005% during the period while Islamic funds recorded an increase of 44%, albeit starting from a lower base.

According to Pheim Asset Management Sdn Bhd founder and CEO Dr Tan Chong Koay, the new inflows mainly come from the Employees Provident Fund's Members Investment Scheme (EPF-MIS), which allows Malaysian citizens to allocate a part of their retirement savings to unit trust funds.

"We believe the size of the EPF portfolio will grow going forward. The challenge for the unit trust industry is how to expand the pie by attracting more inflows from non-EPF sources," he says.

Industry players have identified ways and growth areas to attract new investments into unit trust funds that could be beneficial to both the public and investment community. One way is to lower the fees charged by unit trusts, says Hoo.

"Given the rising cost of living, investing may be less of a priority for most families in Malaysia. We feel that reducing the cost of investing in unit trusts will provide a more sustainable solution [for the industry]," he says.

The 5% sales charge of local unit trusts is one of the highest in Southeast Asia. While the fee is negotiable and can be lowered to 3%, it is still high compared with the 1% to 2% charged by unit trust funds in Singapore.

It is known that high sales charges are one of the reasons a large number of actively managed unit trust funds underperform their benchmark. This has prompted investors to explore alternatives such as ETFs.

Meanwhile, the SC launched the Islamic Fund and Wealth Management Blueprint early this year, mapping out the road for Malaysia to become a global Islamic finance hub. A key focus of the blueprint is to provide that push for the industry to "offer a full spectrum of shariah-compliant wealth investment products and services".

"It is estimated that more than 80% of Muslim individuals are currently investing in non-Islamic products. Thus, this is a huge potential market for fund houses to tap," says KAF's Gan.

Those seeking shariah-compliant investments, which are more conservative and less volatile, will have more choices in terms of asset classes and strategies going forward.

Besides that, new asset classes and investment strategies, such as private equity unit trust funds, are expected to be offered more widely by fund houses to cater for investors with different risk appetites, says Eastspring's Yap. "Essentially, products that can fill the gaps in the market will attract more AUM." ■

Awards methodology and guidelines

GENERAL METHODOLOGY

Criteria (cumulative)

- Funds registered for sale in the respective country as at the end of the calendar year of the respective evaluation year.
- At least 36 months of performance history as at the end of the calendar year of the respective evaluation year.
- Lipper Global classifications with at least 10 distinct portfolios based on the primary share class definition, excluding residual classifications, institutional and other non-retail funds, private, closed-end, exchange-traded, insurance and linked funds.
- Asset classes: equity, bond, mixed-asset, commodity and alternatives. Absolute return funds screened over all asset types except real estate.

Fund classification awards

The currency for the calculation corresponds to the currency of the country for which the awards are calculated and relies on monthly data. Classification averages are calculated with all eligible share classes for each eligible classification. The calculation periods extend over 36, 60 and 120 months. The highest Lipper Leader for Consistent Return (effective return) value within each eligible classification determines the fund classification winner over three, five or 10 years.

Fund classification awards are given to the company that has the day-to-day responsibility of investing and monitoring the assets under management within the fund's portfolio in order to achieve the investment objectives of the fund. This company is also referred to as a portfolio management company or investment adviser. The award goes to the fund management company in cases where no company has been appointed or several companies shared the task.

Asset class group awards

Fund groups with at least five equity, five bond or three mixed-asset portfolios in the respective asset classes are eligible for a group award. The lowest average decile[1] rank of the three years' Consistent Return measure of the eligible funds per asset class and group will determine the asset class group award winner over the three-year period. In cases of identical results, the lower average percentile rank will determine the winner.

Asset class group awards will be given to the best large and small groups separately. Small groups will need to have at least three distinct portfolios in one of the asset classes — equity, bond or mixed-asset.

Overall group award

Fund groups with at least five equity, five bond and three mixed-asset funds are eligible for an overall group award.

An overall group award will be given to the group with the lowest weighted[2] average decile[1] ranking of its respective asset class results based on the methodology described above. In cases of identical results, the lower average percentile rank will determine the winner.

An overall group award will be given to the best large and small group separately. Small groups will need to have at least three equity, three bond and three mixed-asset funds.

No asset class and/or overall group awards are handed out if there are fewer than three competing companies. Asset class and overall group awards are given to the company that is responsible for establishing the fund by appointing the fund management company, promoting and/or distributing the fund, the brand of the fund and the product range. This company is also referred to as promoter or sponsor.

SPECIFIC METHODOLOGY ISSUES

Asia

- Because of the small market size, Asian countries will not make a distinction between large and small groups for the single asset class and overall group awards.
- To be eligible for an asset class group award, the groups will need to have at least three distinct portfolios in one of the asset classes: equity, bond or mixed-asset.
- To be eligible for an overall group award, the groups will need to have at least three equity, three bond and three mixed-asset funds.
- Classification awards will be handed out to classifications with at least five distinct portfolios.
- Malaysia: The regular universe excludes Islamic funds and the Employees Provident Fund (EPF). Separate classification and group awards will be handed out to funds in the Islamic and EPF categories within classifications meeting the aforementioned criteria.

Global Islamic

- All Islamic-flagged shariah-compliant mutual funds globally within Lipper Global Classifications with at least five distinct mutual funds over the respective time frames.
- Calculation currency is the US dollar.
- No distinction between large and small groups for the single asset class and overall group awards.
- To be eligible for an asset class group award, the groups will need to have at least three distinct portfolios in one of the asset classes: equity, bond or mixed-asset.
- To be eligible for an overall group award, the groups will need to have at least three equity, three bond and three mixed-asset funds.
- Currently, only the equity asset class groups are eligible for a group award.

For a detailed explanation, please read the Lipper Leaders methodology document at lipperalpha.financial.thomsonreuters.com/lipper/our-methodology/

Footnote: [1]The decile ranking is obtained by the percentile ranking according to the formula: INT((((Percentile Rank - 1) * (1 - 0.01))/10) +1) in order to eliminate the percentile ranking bias within very small and very large sectors by number of funds.

[2]Weighted by number of funds