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Time for Consolidation?

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By Oliver Christopher Gomez

The fund management industry, which has been a key pillar of the Malaysian capital markets, has seen multiple challenges of late. Factors such as globalisation, along with the onset of new technologies and investment platforms, mean that local investors have more options than ever. In addition, regulation and compliance are becoming increasingly costly, with a number of industry players citing cost-efficiency as an on-going issue in the industry. The proliferation of products with almost identical mandates and high upfront fees has put pressure on the industry to evolve to remain attractive to investors.

Against this backdrop, we asked a few fund managers the following questions: Is the industry ripe for consolidation? And is this move necessary for it to stay relevant? Some fund managers are of the view that there should be consolidation in the industry. Affin Hwang Asset Management Bhd managing director Teng Chee Wai says doing so will not only improve cost-efficiency in the industry but also allow the larger players to compete effectively in regional and global markets.

"We should merge so we can scale and build more strategies and use the skills to run bigger businesses. Scale is important in the asset management industry for several reasons. It allows expansion to offset rising costs, especially human and regulatory costs. "Scale also permits investments in technology that lets us build comprehensive data on our clients, build alternative distribution networks and invest in paperless processes. Finally, scale allows the industry to think about going regional.

"We have to be mindful of the global environment where we have seen the consolidation of major asset managers in the industry. Why are they merging despite the scale they have achieved? They understand that the operating environment is changing fast and that will require investments to keep up with productivity and human capital development."

Consolidation has certainly been on the rise in international markets in recent years. Last year saw a number of major mergers and acquisitions in the North American asset management industry. In March last year, Macquarie Investment Management — the investment management division of the Macquarie Group — announced a deal to acquire Luxembourg-based ValueInvest Asset Management SA. The latter's specialist value-investing strategy spans global and Japanese equities and had roughly €4 billion in assets as at December 2017. Last April, BlackRock Inc announced the successful acquisition of Tennenbaum Capital Partners LLC, an alternative investment management firm with roughly US$9 billion in committed client capital as at December 2017. The acquisition gives BlackRock a foothold in the private credit market as a higher-yielding alternative to fixed-income allocations.
Just a month later, US-based asset management firm FIS Group acquired North Carolina-based Piedmont Investment Advisors in an effort to scale both businesses. The combined company is said to manage more

than US$10 billion in assets. According to Institutional Investor, the merger is part of a wider consolidation strategy in the industry, as declining fees and increased competition for institutional mandates squeeze smaller asset managers. In Malaysia, Maybank Asset Management Group Bhd (MAMG) acquired two fund management companies owned by Permodalan Nasional Bhd for RM51 million in May last year. According to a stock exchange filing, Maybank said it was buying Amanah Mutual Bhd for RM16.12 million and Singapore Unit Trusts Ltd for RM34.88 million.

MAMG CEO Badrul Hisyam Abu Bakar said in a press release that in addition to the increased assets under management (AUM), the acquisition paved the way for it to provide more and better opportunities for its retail clients. Teng says, “In Malaysia, the industry has grown well over the past 20 years. But the truth is that even the top five players are sub-scale to the regional and global competitors.”

He tells Personal Wealth that his firm is always open to mergers. “We constantly scout around to see which firm (big or small) would fit into our road map and help us to achieve our five-year goal faster.”

Fund managers believe that in addition to increased cost-efficiencies, consolidation could reduce the large number of duplicate funds in the market. This is particularly rife in the large number of unit trusts that are primarily invested in the local stock market. Kenanga Investors Bhd CEO Ismitz Matthew De Alwis believes consolidation is necessary. “I would say consolidation would definitely help the industry. Taking a straightforward example, there is a disproportionately large number of Malaysian blue-chip funds relative to the number of local blue-chip stocks.”

According to Morningstar data, there are currently 60 blue-chip funds that are invested in mainly local large-cap counters. De Alwis says there also tends to be a lot of so-called “one-hit wonders” in the market. He is referring to the prevalence of smaller funds that heavily outperform over a few years, but then fade away into relative obscurity as they fail to maintain their performance over the longer term.

“Although people say fund size does not matter, it did in 2017. It turns out that the smaller funds — those below RM15 million in net asset value (NAV) — brought in returns of between 50% and 60% that year,” says De Alwis. It had the effect of boosting their average returns over a few years, to the point that these funds were averaging 25% to 30% a year, he points out. However, the added performance in that year would have come at the expense of increased volatility. These outsized peaks and troughs in the smaller funds would inevitably eat into their long-term performance. De Alwis says, “On our side, we tended to be more careful [during the 2017 rally] as we were gunning for consistent performance, as opposed to so-called one-hit-wonder type of returns. As a result, I think our funds benefited from more consistent performance.”

For the industry to grow, players will need to look at things like carving out niche segments in the local market or becoming a specialist in only one asset class. "Some fund managers are starting to create niches for themselves. For instance, we are totally focused on being a Malaysian equities leader while someone else may be focused on being a fixed-income leader. "We are seeing the same thing regionally. The Vanguard Group would say it is a leader in index funds, and it is. Some other fund manager, on the other hand, may not bother with traditional distribution networks and is focused on online channels."


CIMB-Principal Asset Management Bhd CEO Munirah Khairuddin & Inter-Pacific Asset Management Sdn Bhd (InterPac) CEO Lim Tze Cheng

It may not be enough, however, because many fund companies — up to 70% of the industry — lack a niche, says De Alwis. "I am not saying we should consolidate into just 5 or 10 players. But do we need 37 companies? Perhaps we could drop this down to between 20 and 25."

His point about duplication is echoed by Inter-Pacific Asset Management Sdn Bhd (InterPac) CEO Lim Tze Cheng, who believes that it would be good for the industry to consolidate, although it is not a necessity at the moment. "I tend to think there is more duplication than diversification. It would be good if the industry consolidates, just to reduce the number of duplicate products in the market. However, I do not believe the industry is at the point where consolidation is a necessity."

That said, he disagrees with the notion that fund sizes, or even larger fund houses, are necessarily more capable of providing more diversified or internationalised products to the investing public. "I do not think the size of the asset management firm is the limiting factor in being able to offer better international products to the investor. I think anybody [regardless of size] can launch an international fund.

"There are two overarching factors to consider: Does the company have the trust of the investing public and does the company have the distribution capabilities? For smaller fund houses like us, our challenge is on the distribution end [rather than investment capabilities]."

CIMB-Principal Asset Management Bhd CEO Munirah Khairuddin has a different view. While she acknowledges that there are key challenges facing the local fund management industry, she believes that by and large, the industry is in control of its own destiny. Thus, it is not under any immediate pressure to consolidate.

An avowed proponent of providing choice to the investor, Munirah does not take the view that there is a "sweet spot" in terms of the number of fund management companies relative to the Malaysian investing population. That said, she does see a couple of early indications that the industry may be in for a squeeze in the coming years. Growing investor protection and securities regulations globally are potential problems for the local fund management industry. "The regulations are not limited to adherence to local laws, but globally accepted ones such as common reporting standards and anti-money-laundering laws, among others. Increasingly, automated systems are required to replace manual procedures and there is a chance the costs involved may be too significant for the smaller fund houses," says Munirah.

Ng Sue Ean, financial services assurance partner & Syarizal Rahim, Islamic financial services assurance partner at EY Malaysia

The issue is whether a boutique fund manager will have a robust compliance and risk management system in place. "The cost of compliance and risk mitigation has risen considerably over the last 5 to 10 years. This could potentially be a challenge for the smaller players in the industry. However, I do know some boutique fund managers who have all their regulatory compliance up to date," she says.

De Alwis says the added scale brought about by consolidation would enable fund houses to improve on technology adoption and distribution networks in addition to improving their overall technical capabilities. However, consolidation is by no means a silver bullet for the industry. "Fund houses are very expensive acquisitions and they are evaluated very differently from other traditional companies. With traditional companies, you simply pay for the assets. With fund houses, the assets [investor money] are not guaranteed to stay with you because investors could just as easily take their money out," says De Alwis.

"However, if you are consolidating because there is a highly effective distribution network or you are a fund house with brilliant IT and technology infrastructure, that would make a lot more sense. But then again, how many fund houses have these kinds of highly desirable value propositions?"

Differentiate, don't consolidate

For all the possible merits of consolidation, Munirah prefers a different strategy altogether. "The investment market has been opening up in recent years and we have been cognisant of the need to keep up with our customers' varying risk appetites, global investment preferences and even levels of investor sophistication."

In this regard, she has resorted to a combination of new investment products outside of unit trusts, as well as finding new ways to invest. In short, CIMB-Principal has added both scale and variety without resorting to consolidation. "The fund management industry can be divided into large fund houses, boutique fund managers and the recent spate of financial technology (fintech) entrants into the market, even if they are not necessarily fund managers," says Munirah.
"CIMB-Principal is in the business of fund management, distribution and retirement planning. So, we have a much broader mandate and selection of products and services than just unit trusts."

In fact, CIMB-Principal's push into the Private Retirement Schemes (PRS) space is her brainchild and one that she has nurtured for more than five years now. Despite the relatively weak performances when the

PRS funds first came on the market in the early to mid-2000s, the industry has gained prominence over the last two years or so. Former Securities Commission Malaysia (SC) chairman Tan Sri Ranjit Ajit Singh announced early last year that the total AUM of all PRS funds in 2017 had risen by nearly half to RM2.23 billion. This was significantly higher than the RM1.51 billion the previous year.

“Although the market capitalisation of the PRS space is smaller than that of the unit trust fund market, there are millions of Malaysians without sufficient retirement funds. The statistics tell us that the mandatory savings we have will be exhausted very early on in retirement. Lower mortality rates mean that people are living longer on average and will need more security later on in life. That is why I am a big believer in trying to cater to the PRS space,” says Munirah.

In March 2017, CIMB-Principal became the country’s first fund house to be granted the Renminbi Qualified Foreign Institutional Investor (RQFII) licence. It allows investors to have direct access to the China A-Share market.

This was a big win for CIMB-Principal, Munirah tells Personal Wealth, as it gave the fund house a strategic advantage in the market. “Under the RQFII licence, we launched the CIMB-Principal China Direct Opportunities Fund, for which we successfully raised US$100 million in just two months. In our view, a lot of investors are already exposed to the most prominent China counters right now. So, we structured the fund to focus on the up-and-coming companies with the potential to become the next Alibaba Group Holding Ltd. And right now, there are plenty of companies like that in China.”

Another reason?

There remains one other possibility that accounts for both frequent yearly fund launches and the prevalence of duplicate funds in the market. Perhaps ultimately, it all boils down to profitability.

InterPac’s Lim tells Personal Wealth that for many fund houses, launching new funds tends to be the most effective way to attract sales. “New funds excite people and some fund houses would rather sell new funds that entice people to buy at prices associated with the NAV at launch [which would be cheaper than buying into a more established fund].”

The lack of financial literacy among the public means that when people invest in unit trusts, they often do not fully understand the nature of the investment. Lim believes that people invest as and when they are advised to by their unit trust agents. “This is typically the scenario in Malaysia,” he says.

The lack of financial literacy means not enough of the investing public are questioning the cost of these unit trust funds. “Do investors know how much they are actually being charged for returns? Do they know how to measure real performance that has been adjusted for cost, risk and volatility?” says Lim.

“The fact is that a lot of fund management companies are highly profitable. Not all, of course, but a big chunk of them are very profitable. And when you are so profitable, there is no need to consolidate.

“We are one of the few countries where it remains very profitable to run a fund management company. In addition to the annual management fee of 1.5% [for equity funds], there is a sales charge of 3% to 5%.

“Even if you invest in equity unit trusts via your Employees Provident Fund (EPF) Account 2, you are still hit with a sales charge of 3%. If you invest in cash, you would very easily be hit with a sales charge of up to 5%. That is a big chunk of your investment amount, none of which goes to performance. “The sales charge is meant to incentivise the legacy unit trust agent distribution network. There are more than 60,000 registered unit trust agents in the country and more than half of them work for a few fund management companies. If the investing public becomes more vocal and challenges the industry to reduce its sales charges only then do I see a scenario in which the industry would have no choice but to consolidate.”

Distribution still profitable

Ng Sue Ean, financial services assurance partner at EY Malaysia, says some fund managers are actively engaged in the distribution side of the business and not just managing the funds. “Some fund managers may not have a lot of funds, and their funds may not be making a lot of money, but they do brisk business distributing other companies’ funds. So, in that sense, these fund managers are still profitable and doing well.”

Ng believes that for the foreseeable future, there will still be demand for the more traditional distributor networks. As long as these continue to make business sense, fund managers will keep faith with the legacy distributor networks, rather than consolidate.

“The bulk of the investments in unit trusts still come from the retired community or those approaching retirement age. These people typically do not want to worry about where and how to invest. In this regard, the distribution network serves an important purpose,” she says.

Ng believes that a younger generation of investors may force the industry to scale back on its costly sales agency, thus setting the industry on a path to consolidation. “I think the fund management industry will always have positive growth. However, how strong will that growth rate be in the longer term? Will we continue to see the very high growth rates we have witnessed over the last 10 to 20 years?

“Those in their mid-forties and younger are engaged on a number investment platforms. The SC’s recent rules and regulations on crowdfunding and peer-to-peer financing are broadly a response to the interest we have been seeing from younger investors.

“As for the younger investors who rely on unit trusts, they tend to feel more confident in their ability to conduct their own research and invest on their own via online unit trust platforms.”

Syarizal Rahim, Islamic financial services assurance partner at EY Malaysia, tells Personal Wealth that there is a wider issue of affordability impacting the fund management industry as well. “We have seen how new and innovative products overseas are allowing the younger generation to invest much smaller amounts of money. If micro-investing becomes a more prominent feature of the local investment landscape, I do see younger investors migrating to these vehicles and away from unit trusts.

“If people are struggling with life’s more basic necessities such as home and car loans, how do you entice them to invest in unit trust funds that require them to set aside a few hundred ringgit a month?”

INDUSTRY IS STILL HEALTHY

According to the latest statistics, the fund management industry is still seeing healthy growth, even though the rate has slowed down in recent years. According to Morningstar, 327 unit trusts were launched between January 2014 and December 2018. Specifically, 55 were launched in 2014, 74 in 2015, 61 in 2016, 65 in 2017 and 72 last year.

Meanwhile, 164 unit trusts were shuttered between January 2014 and December last year — 30 funds in 2014, 41 in 2015, 21 in 2016, 30 in 2017 and 42 last year. According to recently released data by the Securities Commission Malaysia, the industry’s total assets under management (AUM) fell 4.2% from RM776.2 billion in 2017 to RM743.6 billion last year.

According to the SC’s Annual Report 2017, the fund management industry’s total AUM had increased 11.5% from RM696.3 billion in December 2016 to RM776.2 billion the following year. Meanwhile, the unit trust industry saw net sales of RM45.2 billion in 2017, reflecting continued investor confidence in the capital markets. Domestic capital market performance was driven by improved investor sentiment and influenced by a variety of internal and external factors.

Last year was a different story, however, with sustained volatility in the local and global markets dragging down performance. CIMB-Principal Asset Management Bhd CEO Munirah Khairuddin acknowledges that the growth rate of the unit trust industry has been slower recently. “Growth has been pretty flat lately, although if you drill down into the more niche segments of unit trust funds, there is probably a lot more potential there. “Even so, AUM in the fund management industry as a whole has been growing. Five-year compound annual growth rates (CAGR) are between 7% and 8%. Taking our wholesale and retail business together, we are probably at those levels. However, our retail CAGR over five years is between 13% and 15%. I think these are good numbers considering that we have a relatively large base [of retail customers].”

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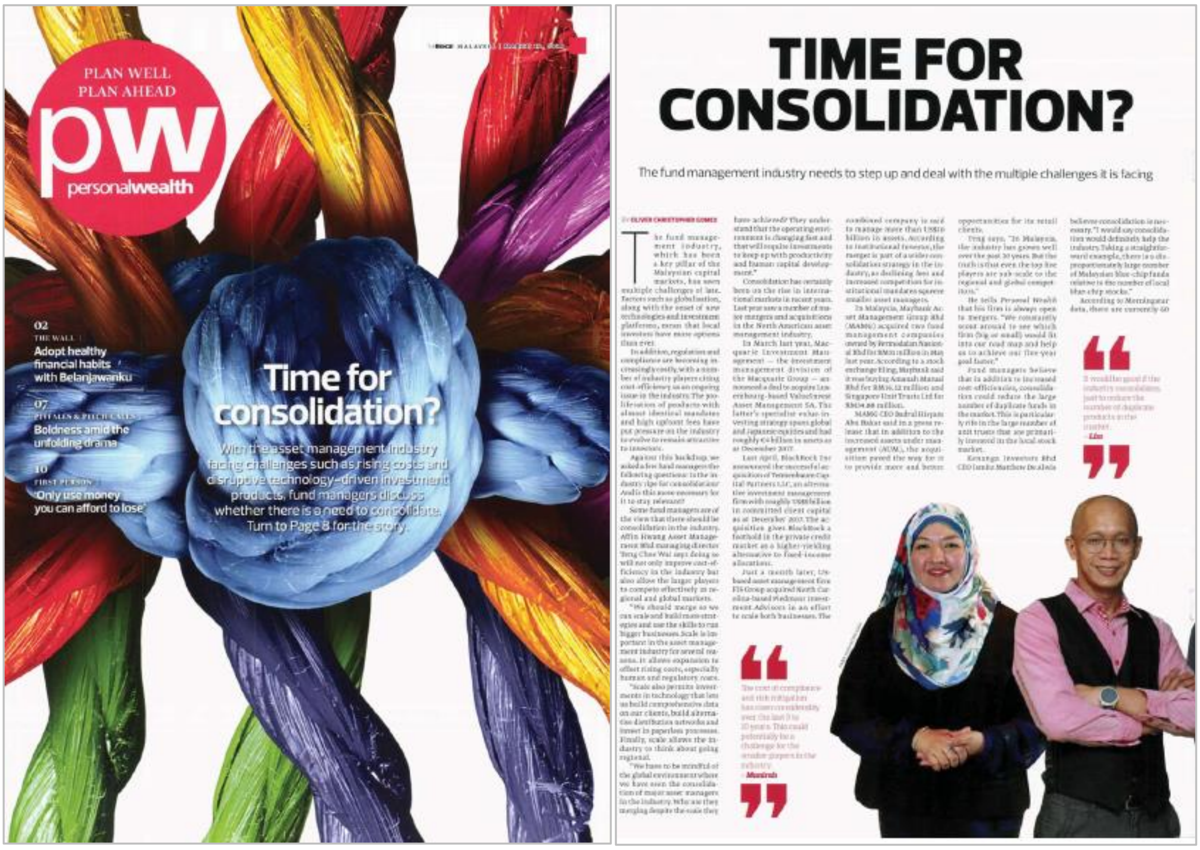
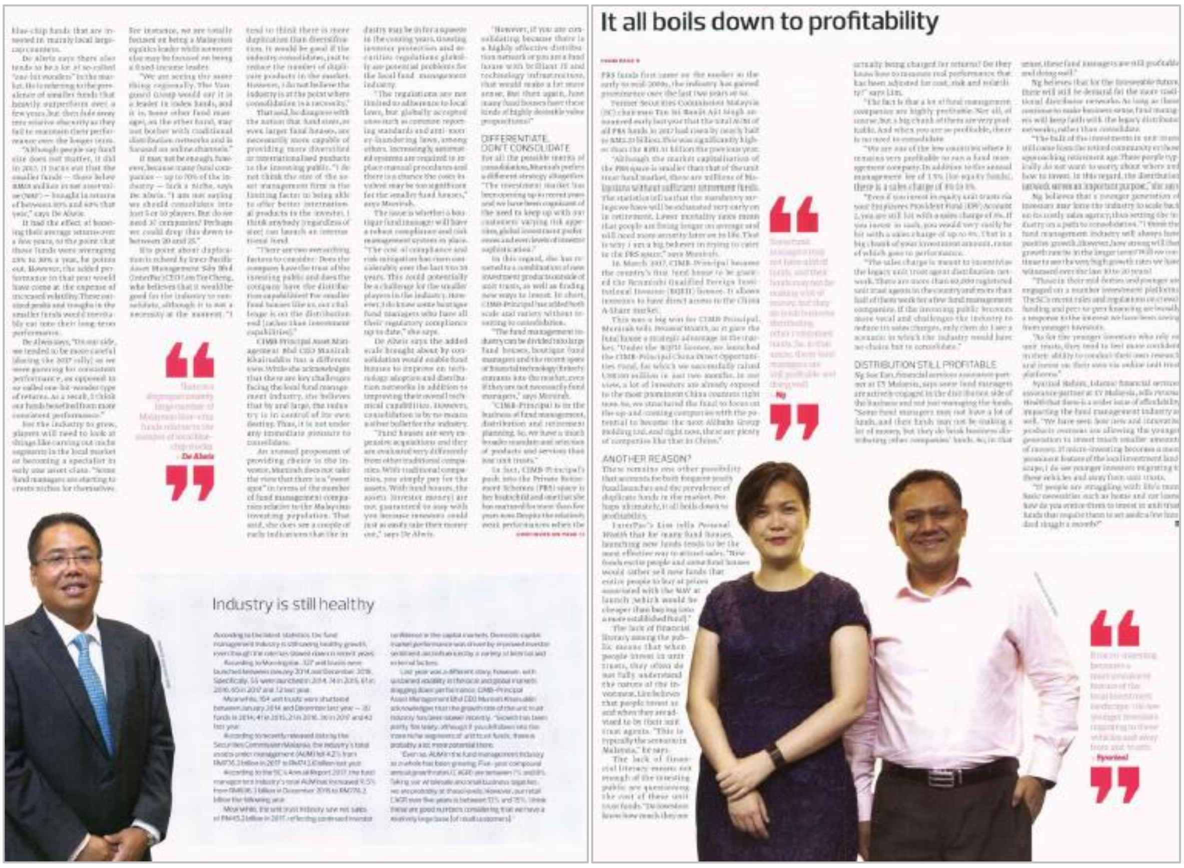


TIME FOR CONSOLIDATION?

The fund management industry needs to step up and deal with the multiple challenges it is facing

Kenanga Investors


It all boils down to profitability

Industry is still healthy