

# Turning Fund Distribution on Its Head

By Scott Burns and Paul Justice

## ETFs bring managed investment products into the digital age. Goodbye, 1940.

We are often asked why passive investing and exchange-traded funds are gaining so much traction these days. The answer we think most folks are looking for is that the investing world—burned by the market turmoil of 2008—has accepted that active managers have a hard time beating the market.

While that may be true to some extent, we don't believe it is the cause for the dramatic shift in fund flows from active to passive investments. (In June alone, about \$19 billion flowed out of active mutual funds, while passively managed funds had inflows of nearly \$1.1 billion.) After all, the data on active management's ability or inability to deliver alpha on average has been available for decades. Even with that, money has continued to flow to underperforming and mediocre funds and managers. In an efficient market, this kind of behavior is unlikely, but that is the point—the asset-management world is not an efficient market. At least that was the case until a few years ago.

The flows tell the story that asset managers and distribution middlemen themselves don't want to believe. The times they are a-changin', and how these groups sell their wares to institutions, advisors, and individuals is being disrupted by very unlikely sources. The first disruptor is advisors' adoption of fee-based and fiduciary models and standards. The second is the technological advancements

of ETFs and the national stock exchanges they trade on. We are in the early rounds of this sea change, but if you believe in efficient markets, as we do, then how this ultimately plays out is academic at this point.

### Commission's Last Stand

The mutual fund industry is fighting a battle it may be better off surrendering. The SEC is reviewing the structure and transparency of the nefarious 12b-1 fee, and some industry insiders see preserving most of the current elements of this compensation mechanism as critical to their survival. At the heart of all of this regulatory scrutiny is an attack on the primary mechanism for how mutual funds are sold: commissions. Commissions to advisors, wholesalers, platforms, and supermarkets and the value each delivers to the end investor are what this fight is all about.

It may come as a surprise to some, but all of this regulatory wrangling over fees and disclosure is ultimately a lot of energy wasted. Progressive advisors did not wait for regulators to decide that all of these commission shenanigans weren't good for investors. They have adopted fee-based models that don't leave much room for commissions. By aligning their revenue and compensation streams with the fortunes of their clients, advisors have also removed commissions, a source of market inefficiency. It really shouldn't come as

a surprise how advisors allocate their clients' money now that it is their own. They keep costs low, they stay diversified, and they do not churn the portfolio. They buy the best-performing funds, not the best-paying. More and more advisors, especially with new clients, are adopting the fee-based model, and this is what is driving the flows into passive and low-cost vehicles at such astounding rates.

While this has been happening organically in the U.S. market, the regulators have a chance to speed this process up by accelerating their plans to make the fiduciary standard more broadly applicable. While this is debatable, it is our opinion that fiduciary equals fee-based. Anecdotally, major wirehouses and independent advisor platforms have stated that they are planning for a future under the fiduciary standard as if it were a foregone conclusion. One wirehouse reports that as much as 85% of new client money is going into fee-based advisor programs at many of these intermediaries.

### 1940s' Technology in the Digital Age

The arguments over which is the better vehicle, ETFs or mutual funds, usually get bogged down in quarrels about active versus passive (which is a different debate), investor behavior, and product proliferation. All of these diversions miss the point. What we are really debating is technology. Both vehicles are

technologies for gathering a broad group of investors together to combine assets under a single manager. One is Depression-era technology, however, and the other is digital-age technology.

Mutual funds are often referred to as 1940 Act funds, referring to not only the securities act that created them, but also the time period in which they were created. In 1940, the mutual fund was cutting-edge technology. Can you imagine being an asset manager in 1940 and being told that you had to price your fund and clear all trades at the end of the day, each and every day? Remember, this was a paper-trading world where trades were done on the floor of the stock exchange by people flashing funny hand signals at each other. On top of that, you had to communicate your portfolio holdings to all of your investors quarterly in public filings and mail annual reports!

In 1940, these changes were massive and onerous to fund companies, but they allowed for the creation of the \$9 trillion mutual fund industry that we see today. But it isn't 1940 anymore; it is 2011, and technology has made what was probably considered impossible in 1940 laughable today in terms of its capabilities.

Enter the digital age's answer to gathering assets communally: ETFs. Why, in today's computerized environment, do investors need to wait until the end of the day to know what price they purchased their fund at? Would you buy a car that way? Would you go to the dealer at 10 a.m. and say, "I want to buy that station wagon," only to have the salesman tell you that you should give him \$16,000 now, come back at 3 p.m., and then after everyone else has bought their car, he'll tell you how much car you bought? Of course not, but that is how mutual fund technology works.

ETFs are investment vehicles for the digital era. Daily liquidity is possible because the trading technology has made it possible. Tax efficiency

is improved with the injection of a secondary market in addition to a primary one. Daily disclosure is not only required but also feasible with low-cost distribution on the Internet. In 1940, you couldn't have disseminated daily holdings if you wanted to. But most important, the digital technology is cheaper.

#### **Fund Distribution, Meet Your Wal-Mart**

Traditional mutual fund platforms are often called supermarkets. The name is very fitting to their role in the history of the asset-management world. Like real grocery stores, they stock a lot of products on their shelves and charge a tidy little markup for doing so. Like a grocery store, there are lots of distributors and middlemen who take their cuts along the way, ultimately raising the costs for consumers. That is until Wal-Mart WMT (or a big-box retailer of your choice) came along and ruined it for everyone who had their hand in the cookie jar.

Wal-Mart cut out the middleman, cleared the shelves of marginal products, and introduced a very competitive generic substitute. This is happening in the fund world today, and what is asset management's Wal-Mart? The national exchanges.

The exchanges are the real disruption to the traditional asset-management distribution world; ETFs are just the technology that they are exploiting to do so. The exchanges mean open architecture and flat rates for transactions. The fact that they are leveraging billions of dollars of transactions allows them to transact funds at \$6 for retail investors or pennies a share for larger investors. That is opposed to the 40-basis-point trailers or the \$45 transaction fees charged by a mutual fund supermarket, not to mention the loads and trailers that commission-based advisors charge. Most discount brokerage platforms allow investors to buy certain ETFs without paying any transaction costs. Now that is progress!

Like what happened with grocery stores and Wal-Mart, not everyone will make it to the

other side in the asset-management world. Wal-Mart destroyed the old grocery store model, its distributors, and the marginal products that paid for shelf space in the old days. Under this model, the best products thrive—with *best* meaning those that deliver premium results (perceived or real) and those that charge low prices. The same will be true in asset management. Low-cost passive funds are the proxy for generic. Managers and shops with premium brand names and, more important, premium results will still get to charge premium prices.

#### **Does This Mean Active Is Dead?**

A simple conclusion for many is that if and when this all comes to be, active management is dead. That is not what we're advocating by any means. Marginal active managers are going to have a tough time surviving, for sure, but there are solid managers who will still be able to draw assets to their funds.

The real test is coming. PIMCO intends to launch an actively managed ETF version of its Total Return strategy, and our disruption theories and the future of asset management are riding on the success or failure of this launch. If we're correct, then this ETF should have no trouble attracting a massive amount of assets. Priced at 0.55%, it is slightly more expensive than the mutual fund version's institutional share class (0.46%), costs the same as the transaction-fee Harbor Fund version, and is significantly cheaper than the A shares (0.85%). By the way, that fee difference between the institutional and A share classes costs the A shares a star in their Morningstar Rating for funds. Retail investors get a 4-star option, but institutional investors get a 5-star fund—for the exact same fund strategy.

If you are a doubter of active ETFs, ask yourself this: In a fee-based, fiduciary world, how could an advisor ever recommend a marginal 3-star fixed-income fund with a load or a trailer when an ETF such as PIMCO Total Return is available on the exchange for all investors, with no minimum investment, at 0.55%? The answer is



## Spotlight

that he or she cannot. The whole fund industry must be on pins and needles watching what happens with the launch of this fund.

In the end, if ETF technology is good for passive investing, it will be even better for active investors and managers. Those distribution fees cost managers their stars and eat into investors' returns. Passive investing is pretty tax-efficient in the first place, but active strategies will most likely benefit to an even greater extent. In the end, it is impossible to argue that more liquidity, transparency, tax efficiency, and lower costs are somehow bad things for investors, whether they are active or passive.

### Global Sea Change

The impact of the national exchanges, ETFs, and fee-based advising won't just affect the United States—it will have global implications. One of the side effects of the '40 Act and similar legislation around the world is that they created geographic investing silos. That is, U.S. investors could buy only U.S. offerings, U.K. investors U.K. funds, and smaller markets like Dubai and Singapore have squat.

But the network of exchanges tears down all of those borders. If investors have access to the New York Stock Exchange, they have access to all of the securities listed on the exchange, regardless of where they reside in the world. Additionally, they could cross-list the fund on any number of exchanges in local markets.

This has already happened with passive ETFs. According to filings, it is not uncommon for a passive ETF to have international ownership ranging anywhere from 30% to 60% of total assets. It will not be any different for active managers. Why more star managers aren't following Bill Gross' lead and launching active products on the exchange to gain more access to international investors is mind-boggling. In terms of regulation, the United States is actually playing catch-up to a few countries. The United Kingdom and Australia already have plans to mandate fee-only advising starting in 2013. Both countries are much further behind in natural adoption of fee-based advising, so the abrupt change should be far more disruptive to their advisor markets, though the outcome will ultimately be the same.

### Revolution or Evolution?

The forces dictating the sweeping changes that are affecting how funds are sold are already in motion. If you want to know why these things are happening, don't look to the symptoms, namely passive investing and ETFs. Instead, look to the root of the cause in fee-based advising and technology revolution that is clearly under way and only gaining more speed. In the end, the investor is the winner and the "fee eaters" and "commission addicts" are the losers. Investments will be "bought" and not "sold" as would happen in any efficient capital market. At least, that's our theory. ■■

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Scott Burns is Morningstar's director of ETF, closed-end, and alternative fund research. Paul Justice is director of North America ETF research.