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U.S. BROKER/DEALER PRODUCT CONSOLIDATION: SHRINKING ASSET MANAGER OPPORTUNITIES

Recent years have been challenging for active asset managers as they attempt to adapt to dropping fees and the steady rise of passive products. Multiple factors have contributed to a significantly more competitive marketplace. Asset managers must take on dispassionate evaluation of their value proposition, strategy, and market positioning.

June 2017 brought partial implementation of the Department of Labor (DOL) Conflict of Interest Rule. The rule expands the definition of fiduciary and extends fiduciary protections to individual retirement accounts (IRAs), whereas only some defined contribution plans had been covered previously. It requires disclosure at the point of sale of the advisor's conflicts of interest and notification to the investor that the advisor must act in the investor's best interest.

While full implementation of the rule was recently delayed until 2019, most industry participants had already made decisions to adapt to the rule, meaning many of the rule's implications are already being felt. While it is certainly impactful, it accelerates many trends that the asset management and wealth management industries were already experiencing. It has led to further fee compression in both the wealth and asset management value chains, as well as further consolidation among broker/dealers (B/Ds).

B/Ds have long struggled with implementing a consistent client service and investment experience. Financial advisors are inherently entrepreneurial. Getting them to adhere to standardized programs and procedures is challenging. Exercising too much control over advisors is challenging in a competitive market as there will always be more flexible alternatives waiting.

Broker/Dealer Product Consolidation

Implementation of the DOL Rule is impacting access at major distribution points for product manufacturers. Most notably, major B/Ds are using the rule as pretext to increase their due diligence resources, carve back their menu of products, and revamp their asset allocations in what is expected to be a stricter regulatory environment. As scrutiny of decisions made in IRAs increases, distributors must be able to justify the process for the recommendations that are made. Litigation in the 401(k) industry provides a guideline—fault is usually found in the lack of a documented

Summary

B/Ds have used the DOL Conflict of Interest Rule as pretext to cut back the number of investment products available in their systems. This compounds the secular trends of fee compression and increased competition for asset managers. Asset managers must dispassionately evaluate their existing product lines to reposition their organizations for future success.

Key Points

- Trimming product lines at major distributors is a competitive challenge for asset managers. Asset managers should invest in key account resources to ensure that they are adequately represented in these key firms. Distributors using external resources to supplement their due diligence efforts only compounds the complexity of covering these systems.
- Asset managers should use shrinking distribution opportunities to reevaluate the breadth of their product lines. Merging or closing subscale products will create streamlined offerings. The resultant reduction of fixed costs from trimming investment personnel and operational expenses may be enough to offset lost fee revenue.
- Large asset managers should evaluate whether their distribution infrastructure carries more value than their ability to manufacture investment products. These firms should consider whether they take on select strategic partnerships with smaller, subscale asset managers.
- Small asset managers that lose a major distribution partner could have an outsized effect on their business. Identifying asset managers with broader distribution capabilities for strategic partnership can help immunize them from some of these risks.

Exhibit 1: Summary of B/D Product Consolidation Activity, 2Q 2017

B/Ds culling products from their systems should cause asset managers to consider doing the same.

Firm	Platform Consolidation Plans
Merrill Lynch	Hired Morningstar to supplement the work of its internal due diligence teams. Cut the number of available mutual funds from 3,500 to 2,200 in May 2016. Announced a second wave in 2017, cutting from 2,200 to 1,800. Culled products represent just 4% of the firm's mutual fund assets.
Morgan Stanley	Restricting 760 funds for new sale, representing about 25% of those available at the firm.
Ameriprise	Dropped 1,500 products from its platform. Limited wholesalers from three firms (AB Global, Franklin Templeton, PIMCO) from proactive contact because these firms do not pay the same level of revenue sharing as other asset managers. Hired Russell and Wilshire to manage its discretionary managed account platforms.
LPL	Cut 29 third-party asset managers (TAMPs) from its platform, keeping just 10 such relationships. Announced a mutual fund brokerage platform for IRA accounts with its 20-largest mutual fund providers. LPL has also telegraphed further cuts to product partners.
UBS	Hired Mercer, a major investment consultant, to supplement its existing manager research teams.
National Planning Holdings	Cutting from 160 different fund families for sale on its platform to between 30-80 firms. Around 20-30 of these firms have already been identified.
Voya	Will cut the number of available mutual funds on its platform from 4,000 to 2,000 by year-end 2017.

Source: Cerulli Associates

process rather than the actual decision. Regardless, shrinking product shelves and more complex due diligence processes underscore the necessity for manufacturers to revisit their key accounts strategy.

Merrill Lynch, with an employee salesforce and one of the more restrictive cultures of the four wirehouses, has again been a leader in trimming product menus. The process began when it enlisted Morningstar to supplement the work of its internal due diligence teams. Merrill Lynch began to trim product offerings last May, cutting the number of available mutual funds from 3,500 to 2,200. It just announced a second wave, further carving that number to 1,800, essentially halving the number of mutual funds available for sale. However, Merrill Lynch says these products represent just 4% of the firm's mutual fund assets.

Although these products have been restricted for new sales, advisors have not been forced out of these positions. Merrill Lynch's most recent announcement hinted at further turning of the screws—cut funds do not have to sold, but if they are in an advisory account, they need to be moved to a brokerage account. Cerulli believes that ultimately advisors will need to liquidate positions in banned products. What remains unclear, however, is what will happen to these assets if an advisor does not take action.

Morgan Stanley has announced a similar move, restricting 760 funds for new sale, approximately 25% of those available on the platform. One of the reasons cited for elimination from the platform was not complying with new standardized commission schedules at Morgan Stanley.

Similar announcements have come out of Ameriprise, which has both an employee and independent model for its advisors. First, it announced plans to drop 1,500 products from its platform. Next was limiting wholesalers from AB Global, Franklin Templeton, and PIMCO from making proactive contact with its advisors because these firms do not pay the same level of revenue sharing as other asset managers.

Finally, Ameriprise also announced hiring Russell and Wilshire to manage its discretionary managed account platforms. These actions reflect the mixed signals coming out of distributors. On one hand, B/Ds are citing the DOL Rule as a reason for taking control over product decisions, but on the other, one can also see the financial drivers at play.

LPL announced the decision to cut 29 third-party asset management providers (TAMPs) from its platform, keeping just 10 such relationships. Notable cuts included Envestnet and Pershing-owned Lockwood, both of which are major firms in this space. It also announced a mutual fund brokerage platform for IRA accounts. The platform will include only LPL's top-20 mutual fund providers, which represent 80% of its mutual fund assets. While LPL has not yet announced additional cuts to the number of mutual funds on its platform, senior management telegraphed in late 2016 that such a change could be coming. It is difficult to look at the decision to cull TAMP relationships and not see ultimate cuts in other product categories as well.

UBS, another major wirehouse and key distributor for many asset managers, is embarking on a similar plan. UBS hired Mercer, a major investment consultant, to supplement its existing manager research teams. In a slightly different take, UBS uses Mercer's research as an initial screen, allowing UBS' analysts to focus on a smaller group of managers for "high conviction" recommendations.

Asset managers must be acutely aware of the places where B/Ds are supplementing their due diligence efforts with external resources. There will likely need to be increased coordination between retail key account teams and institutional consultant relations teams to ensure that key strategies are being covered by the consultant's manager research teams.

National Planning Holdings (NPH), an independent B/D owned by Jackson National, is also strategically reducing the number of asset managers with which it does business. Currently, NPH estimates that it has close to 160 different fund families for sale on its platform. It has already identified 20–30 firms that have relatively few assets to be cut. Ultimately, NPH plans to whittle the list down to 30–80 mutual fund firms approved to do business in its system. Voya's independent B/D unit was the most recent to make such an announcement. It plans to cull the number of available mutual funds on its platform from 4,000 to 2,000 by year-end 2017.

Wells Fargo, where the majority of advisors operate in the wirehouse model, has not announced any reductions to its platform. However, the multichannel nature of its platform prevents Wells from making similar reductions in products. The firm has advisors operating not just in a classic wirehouse model, but also as independent B/Ds, bank B/Ds, and bank trusts, in addition to being a clearing firm. In general, it has been multi-line firms such as Wells Fargo that have resisted these changes, whereas firms with more straightforward business models have been more aggressive. However, Wells Fargo is also notable in that it brought all the asset manager due diligence professionals for these diverse businesses into a single unit.

Asset managers and other product manufacturers must play close attention to these changes at B/Ds. Cerulli believes it is highly likely that B/Ds will eventually force assets out of the products that are no longer for sale. While these products represent a small percentage of the assets at a B/D, they can represent billions of dollars on an absolute basis. If these changes are coming, asset managers must be prepared with solutions not just for advisors, but also for the B/D. Further product cuts could represent a massive "money in motion" event for asset managers.

The rationalization of product menus underscores the importance of the key account role for asset managers. They must recruit and maintain the highest-quality professionals in this position to ensure that large distributors receive adequate attention. Cerulli continues to advocate for shrinking the number of relationships that a key account manager covers to maximize these relationships. Thus, larger asset managers have the advantage of approaching these relationships in a more strategic fashion. Their account managers might have the luxury of covering fewer firms, which allows them more time to penetrate a complex system, such as Merrill Lynch or LPL. Likewise, they have the resources to create and execute an educational campaign. For example, J.P. Morgan is well known and regarded for its quarterly *Guide to the Markets*, a series of charts and talking points that equips advisors to educate their clients on the markets.

Rationalizing Asset Manager Product Lines

The prospect of shrinking product menus at key distributors is cause for asset managers to reevaluate their product and distribution strategies. While well intentioned, cyclical and reactive product development at asset managers has wrought the crowded menus at distributors. Being forced to distribute fewer products should force asset managers to dispassionately review their own product offerings and potentially make some painful cuts.

Making these cuts is not simply about streamlining product offerings, it is about creating an opportunity to reduce fixed costs. As asset managers experience falling revenues, they must evaluate how they can operate as a lower-margin business than they have in the past. While difficult, it is a necessary evil to reset their expectations for their future business model. Investment personnel are highly compensated. Even modest cuts in this staff can result in meaningful savings in fixed costs.

To understand what this process might look like, Cerulli has taken the product line of a mid-sized U.S. mutual fund manager. Currently, the firm offers 30 products and has about $40 billion in assets under management (AUM) in its mutual funds. It is important to understand that this example is illustrative. Product names have been changed to obscure the actual asset manager. In fact, this manager is in an enviable position as it has seen positive net flows through the first half of 2017, a rarity for legacy active managers. In addition, there would be cultural and strategic considerations in which products are selected to be closed or merged.

Exhibit 2 on the following page summarizes the firm's products, Morningstar categories, relative performance, assets, revenue, and number of portfolio managers. There are a handful of situations that Cerulli is seeking to identify. The first is duplicative products, particularly in asset classes that are coming under pressure from passive products. The second is subscale products, particularly those in out-of-favor asset classes or those that have poor performance. Cerulli does recognize the need for continued innovation and product development in the current market, so we do not want to cut all products with low asset bases, but rather give these products room to gather assets.

As we go through this process, we also identify opportunities to cut personnel and realize cost savings. Cerulli makes assumptions about where unique portfolio managers could be cut. In doing so, we also attribute cost savings to carving off some supporting analysts and traders. For each investment professional that we cut, we assume cost savings of $500,000, a figure that may be modest in some cases.

As the first step, we identify three opportunities for fund mergers:

- **Two Large-Cap Blend funds, each with performance in the bottom half of the category.** The "Large Blend" fund is a flagship product for the asset manager, so we maintain that brand. However, the fund has a co-manager who only works on that product. We assume dropping one portfolio manager, one analyst, and one trader.
- **Global Equity and International Equity funds, each with modest asset bases around $150 million.** We merge these funds into a single International Equity fund, as U.S. investors are increasingly allocating to pure international products, rather than global products. The lead manager on these two products is the same, but the co-manager on each are different and they only work on these single products. We again assume dropping one of these two portfolio managers, as well as one analyst and one trader.
- **Finally, there is a U.S. Corporate High Yield fund with just $3 million in assets.** This product is absorbed into the much larger High Yield fund. Again, the manager of the Corporate High Yield product only works on this single product. We once again assume that this merger allows us to drop one portfolio manager, one analyst, and one trader.

As part of the next step, we evaluate additional products with subscale asset bases. In our first pass, we find multiple products with asset bases of less than $300 million. But, we are going to maintain a nontraditional bond, emerging market equity, global multisector income, and real estate product as these products are all ones that could be successful in the current market. Existing low interest rates and the assumption that they could rise creates markets for innovative income solutions such as nontraditional bonds and multisector income. Likewise, multisector income, emerging market equity, and real estate are all satellite, high-skill asset classes that could complement a portfolio with a low-cost passive core. Therefore, we will keep these products open for sale. However, as economic conditions evolve, we will continue to evaluate the market for these products.

Finally, we come to the Balanced fund and a suite of three asset allocation products. All four products have asset bases of less than $305 million and rank in the bottom quartile performance-wise. In the case of the Asset Allocation products, they rank in the bottom decile. Thus, we will liquidate these four products. In doing so, we can trim the three-person team managing the Asset Allocation products. While multi-asset-class investing is in demand, the poor investment performance of this team makes it challenging to win new assets. Again, we will assume this allows us to cut an additional analyst and trader.

Closing funds is a painful exercise—it means loss of revenue to an asset manager that is struggling with already-shrinking revenue and margins. Taking the average of management fees across these products' various share classes, we can estimate an annual revenue loss of just greater than $8 million—not an insignificant figure. However, when taking into account our assumptions for personnel savings, we are able to trim 17 investment professionals. Assuming a salary of $500,000 each, there is a savings of $8.5 million in personnel costs. If we were to account for operational savings around tasks such as fund accounting and sending out regulatory documents, it is likely we can, at the very least, offset the lost revenue, if not actually save the organization money. In addition, we have created a smaller, more streamlined product line, with 23 products instead of 30.

Exhibit 2: Hypothetical Rationalization of an Asset Manager Product Line, 2Q 2017 ($ millions)

Duplicative products and subscale performers present the best opportunity for rationalization.

Product/Fund Type	Morningstar Category (US Fund)	Expense Ratio	Percentile Performance 2016	AUM 2Q 2017	Net Flows 2Q 2017 YTD	Revenue	Number of Portfolio Managers	Product Status	PMs to be Cut	Other Investment Personnel to Cut
Municipal Bond	Muni National Long	0.97	80	$1,290	$23.5	$12.6	2			
Bond	Intermediate-Term Bond	0.92	25	$4,700	$267.0	$43.2	2			
Balanced	Allocation—50% to 70% Equity	1.26	71	$290	-$7.3	$3.7	3	Close	1	2
Core Equity	Large Blend	1.11	78	$1,600	-$37.5	$17.8	2	Merge with Large Blend Fund		
Disciplined Growth	Large Growth	1.32	47	$1,150	-$19.0	$15.2	3			
Disciplined Value	Large Value	1.33	57	$435	-$21.8	$5.8	3			
Nontraditional Bond	Nontraditional Bond	1.33	10	$288	$16.0	$3.8	2	Keep - economically in demand		
Emerging Markets	Diversified Emerging Markets	2.19	59	$120	$1.0	$2.6	3	Keep - coexist with passive		
Equity Income	Large Value	1.13	13	$2,100	$8.0	$23.7	2			
Large Blend	Large Blend	1.22	67	$4,800	-$161.0	$58.7	3	Merge with Core Equity Fund	1	2
Tactical Allocation	Tactical Allocation	1.44	73	$625	-$31.0	$9.0	3			
Floating Rate	Bank Loan	1.05	89	$862	$9.5	$9.1	1			
Fundamental Growth	Large Growth	1.14	47	$5,900	$283.0	$67.5	2			
Global Equity	World Large Stock	1.29	66	$170	-$0.5	$2.2	2	Merge with International Equity		
Global High Yield	High Yield Bond	1.33	55	$625	-$23.0	$8.3	2			
Global Multisector Income	World Bond	1.22	38	$49	-$2.2	$0.6	4	Keep - coexist with passive		
High Income Municipal	High Yield Muni	1.07	32	$600	$9.5	$6.4	2			
High Yield	High Yield Bond	1.35	43	$1,000	-$42.5	$13.5	2	Absorb Corporate High Yield		
International Equity	Foreign Large Blend	1.63	72	$170	-$1.3	$2.8	2	Merge with Global Equity	1	2
Mid Cap Value	Mid-Cap Value	1.20	65	$958	-$29.0	$11.5	1			
Multi-Asset Income	Allocation—30% to 50% Equity	1.03	4	$832	$45.5	$8.6	4			
Multi-Asset Ultrashort Income	Ultrashort Bond	0.69	19	$3,500	$287.0	$24.1	3			
Real Estate	Real Estate	1.57	55	$129	$6.0	$2.0	3	Keep - coexist with passive		
Mid Cap Growth	Mid-Cap Growth	1.17	67	$1,400	-$6.0	$16.4	3			
Short Term Income	Short-Term Bond	0.79	51	$589	$21.0	$4.7	2			
Moderate Allocation	Allocation—50% to 70% Equity	0.84	96	$164	-$7.0	$1.4	3	Close	3	2
Conservative Allocation	Allocation—15% to 30% Equity	0.93	91	$57	-$1.5	$0.5	3	Close		
Aggressive Allocation	Allocation—70% to 85% Equity	0.82	96	$306	-$8.5	$2.5	3	Close		
Strategic Income	Multisector Bond	1.09	49	$6,000	$75.0	$65.5	3			
US Corporate High Yield	High Yield Bond	1.35		$3.00	$0.03	$0.04	1	Merge into High Yield Fund	1	2
Totals				**$40,712**	**$653.0**	**$443.7**	**-**	**-**	**7**	**10**

Revenue Loss from Closed Funds	$8,063,800
Expense Savings from Investment Personnel Reduction	$8,500,000

■ Close ■ Merge ■ Keep

Sources: Morningstar Direct, Cerulli Associates

Once again, this is an illustration, and Cerulli acknowledges that these actual decisions are much more difficult to make when taking into account human and cultural issues. Our assumptions in trimming investment support staff may be too aggressive. Analysts and traders might be supporting multiple products, meaning we may not be able to achieve the full cost savings. However, some of these decisions are necessary as asset managers are faced with fewer places to sell their products. But, these decisions must be guided in part by asset managers considering those places where they can truly differentiate.

Rethinking Distribution Value Propositions

The consideration of differentiation must again be guided by the prospect of limited distribution opportunities. While large asset managers might see a portion of their products restricted from future sale, the prospect of being dropped from a major distributor could be disastrous for smaller asset managers. As a function of their size, smaller asset managers cannot invest heavily in large salesforces and innovative educational materials.

On the other hand, for large asset managers, a dispassionate evaluation of their capabilities may reveal that their distribution infrastructure and relationships at major distributors carry as much weight as their ability to manufacture differentiated investment products. Cerulli believes that larger managers could essentially play the role of a third-party distributor, renting their distribution infrastructure to smaller managers. A version of this strategy occurred when Schroders, a European-based asset manager, shut down its U.S. retail intermediary business, transferring the assets to subadvisory products distributed by The Hartford. The Hartford already distributed mutual fund products through a long-running subadvisory partnership with Wellington.

If we consider the scenario outlined in Exhibit 2, this would mean identifying two or three key smaller asset managers where strategic partnerships could be developed. In seeking potential strategic partners, large asset managers must accept that they will continue to face steep competition from passive products. Broadly speaking, there are two potential situations. In the first, it is a small manager with a long-standing track record of success, but a limited asset base. More attractively, in the second, it would be a manager that offers an innovative strategy that can coexist in an investor portfolio with passive products. Examples could include alternative capabilities, multi-asset-class solutions, or asset classes, such as emerging markets, in which a strong argument can be made for active management.

There is no shortage of potential partners in this space. A quick Morningstar screen of asset managers with less than five products, less than $1 billion in mutual fund assets, and an average Morningstar rating of at least 4 stars reveals 76 potential partners. Interestingly, among this group are multiple asset managers with non-U.S.-based parents. These strategic partnerships could go both ways, allowing the U.S.-based manager to leverage distribution capabilities elsewhere in the world.

Recent years have been challenging for active asset managers. However, many of the secular trends discussed in this document—fee compression, increasing regulation, distributor consolidation—are not going away. Thus, it may require extreme adaptation from asset managers to reset their legacy businesses for future success. ◆

About Cerulli's Intermediary Research

Cerulli's intermediary practice focuses on retail-focused financial advisors in the United States. Areas of coverage include market sizing and segmentation, practice structures and attributes, distribution of retail asset management products and services, product decisions, broker/dealers, clearing and custody agents, advisor recruiting and transitions, RIA aggregators, growth drivers, and practice management challenges.

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Cerulli's strategic consulting and custom research combines our excellence in research, industry-focused thought leadership, and 25 years of experience to provide clients with guidance on the most important strategic issues facing their firms.

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