Finding Economies of Scale in Asset Management

A quantitative review of economies of scale and their impact on fund fees in Europe and the UK.

FITZ PARTNERS

Fitz Partners
5th Floor, 211-213 Regent Street
London W1B 4NF
Tel: +44 203 301 0860

Salik Ahmed
Hugues Gillibert
Laura Guthrie

July 2020

Acknowledgements

Fitz Partners gratefully acknowledges the contributions of the following in the preparation of this report: Fergal Banks, Darren Thomas, Zhaomin Chen, Matthew Ponting, Nam Nguyen, Desislava Ivanova, Keegan Fernandes, Pamela Abura, Roxana Mahboubian and each of the fund promoters and service providers who have devoted time and effort in providing us with information.

Table of Contents

Introduction

Pressure on fees has been a prevalent and resurgent topic for the past few years. As the conversation grows, fund fees have come under increased scrutiny. Questions are being asked as to whether the fees charged to investors through funds' assets are always a fair representation of the actual costs incurred by asset managers and reflect any economies of scale which might be delivered by the rise in their assets under management. Following regulatory pressure on fund costs in both the UK and Europe, passing on economies of scale has recently seen more focus in the industry.

Economies of scale are the cost advantages occurring as companies become more efficient and increase their level of output, or size, thereby allowing cost savings. Economies of scale can only be passed on through either a natural recharge of fund costs as they happen, or by engineered fee structures reflecting service providers' and asset managers' own economies of scale. Pressure on fees, increased disclosures and arguments over the type of fee models best suited to investors have been with us for almost three decades - from a simple disclosure of management fees in the 90s to the listing of Fitzrovia's TERs and the quoting by asset managers of ongoing charge figures (OCFs), together with a multitude of regulatory disclosure directives under UCITS and more recently MIFID and PRIIPs, all calling for more "transparency". Following these ongoing disclosures came discussions around "simplicity" and "predictability" which led to further introductions of fixed fee models, in place of the still more common ad valorem or variable fee models. These fixed fee models may by nature be regarded as an extra barrier to delivering economies of scale and although this might be true, we will discuss how tiered "fixed" or contractual management fees could be the best conduit to deliver economies of scale to investors.

In this paper we investigate the current relationship between fee levels and asset size. We look for any signs of economies of scale being passed on to retail and institutional investors across Europe dependant on asset manager, fund or share class size. We will examine how the fund industry is approaching the issue of economies of scale and any specific fee models that have been introduced to pass on their benefits to investors. Finally, we will present quantifiable estimates of where we have found economies of scale in the industry. These fee metrics that are already in place in most funds' share class offerings could be used as a measurable guide when considering the introduction of new fee structures delivering asset size related benefits to both retail and institutional investors.

Chapter 1: Hunting for Evidence of Economies of Scale in Europe

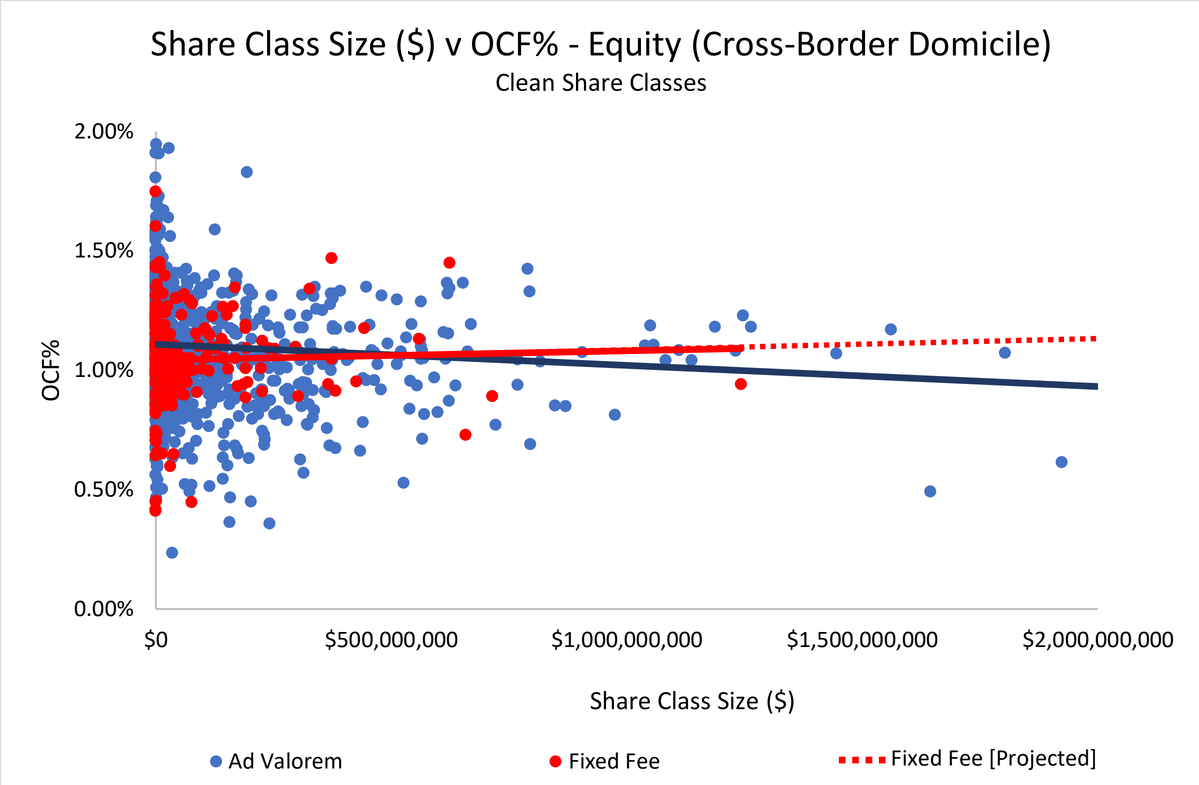
Review of the two most prominent fee structures

Ad valorem fees

Most funds in Europe are still following an "ad valorem" fee model in which managers charge at cost (to the fund) the service providers' expenses, as well as their own costs, as a percentage of a particular share class's net asset value. Ad valorem fees are transparent and the diverse costs of services would be directly charged to the fund's assets; these being a management fee to cover the fund managers' expenses and any other service providers' costs simply "re-charged" to the funds as they occur. This model would allow some of the economies of scale from service providers' costs, if kept under watch by the management company, to be naturally passed on to investors; fixed administration, custody or audit expenses would become relatively "cheaper" as the fund size grows.

Fixed fees

Europe and the UK have also seen the development of "fixed fees" or "all-in fee" models. In essence, these fee models are engineered to last and remain "fixed" for a number of years. Their clear advantage is the certainty they offer to investors with regards to the fees that would be charged over a number of accounting periods. All fund costs will be paid out of one all-in fee or perhaps a couple of fixed fees (often a fixed management fee and a fixed administration or service fee). One must recognise that whilst this fee is definitely simple to understand, it does not provide any visibility on the details of the costs charged to the fund. Past Fitz Partners research comparing fixed fee models to ad valorem fee models have shown that *these engineered fees make these funds more expensive to investors*. The current fee data on our Fund Charges databases still shows a higher level of fees carried by fixed fee models and no sign of any economies of scale, as shown in Figure 1. Fixed fee models by nature are not linked directly to changes in fund or share class asset levels, and therefore do not benefit from any potential saving provided by economies of scale generated by operating expenses outside the management fees unless asset managers choose to revise their fees and proactively force a change, thereby abandoning the fixed and permanent characteristics of this fee model.



[Figure 1 – Share Class Size ($) v OCF% Plots for Cross- Border Domiciled Equity Funds – Separation on Ad Valorem Fee Structures and Fixed Fee structures, Clean Share Classes]

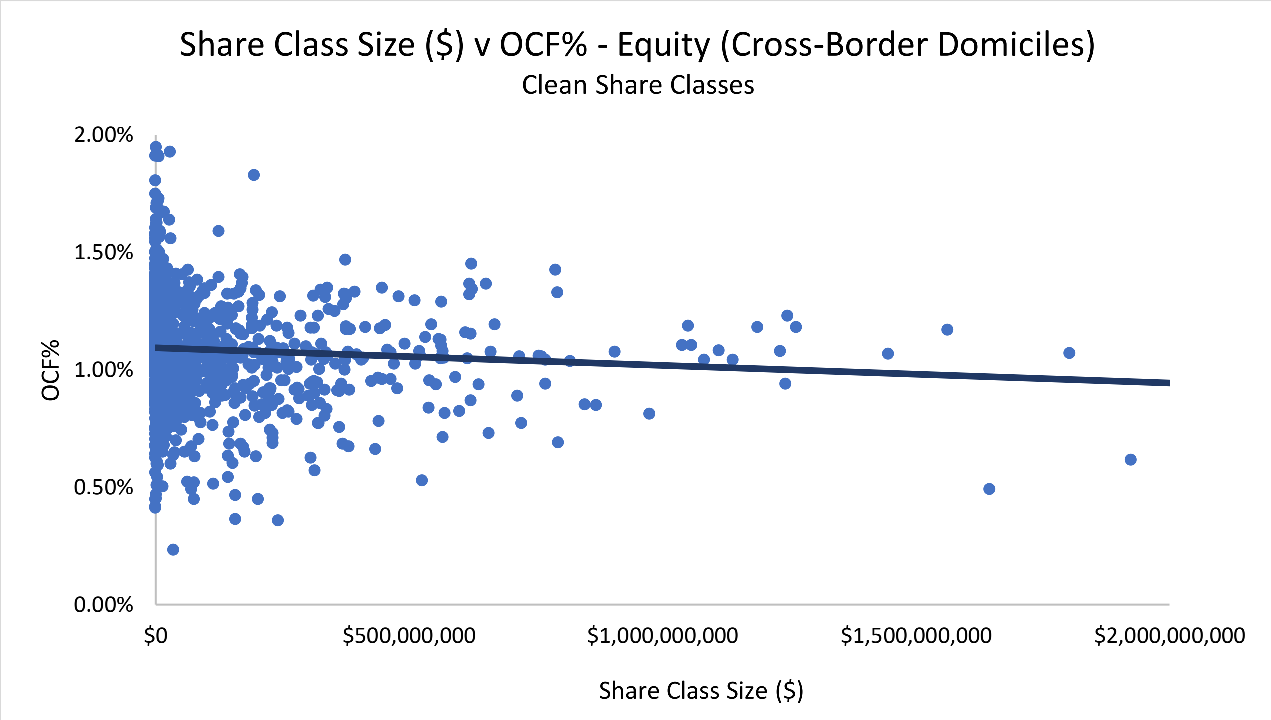
Considering all Dublin and Luxembourg domiciled equity fund fee levels plotted against share class size allows us to observe the difference in trends between ad valorem structures and fixed fee structures. Comparing the two, fees for clean share classes with ad valorem structures gradually fall as share class size rises, whereas clean classes with fixed fee structures show no change as assets grow. Our review of funds with a fixed fee structure show that no significant economies of scale are being passed onto investors as share class size increases. When considering ad valorem fees, we can see a drop in total fees as share classes become larger.

Evidence of economies of scale

In the figures below we use our proprietary Fitz Partners data to consider the potential presence of economies of scale in current fee structures in place in the Dublin and Luxembourg domiciled funds, by considering "clean classes", "institutional classes" and finally "clean-wholesale classes" that are offered through larger distributors.

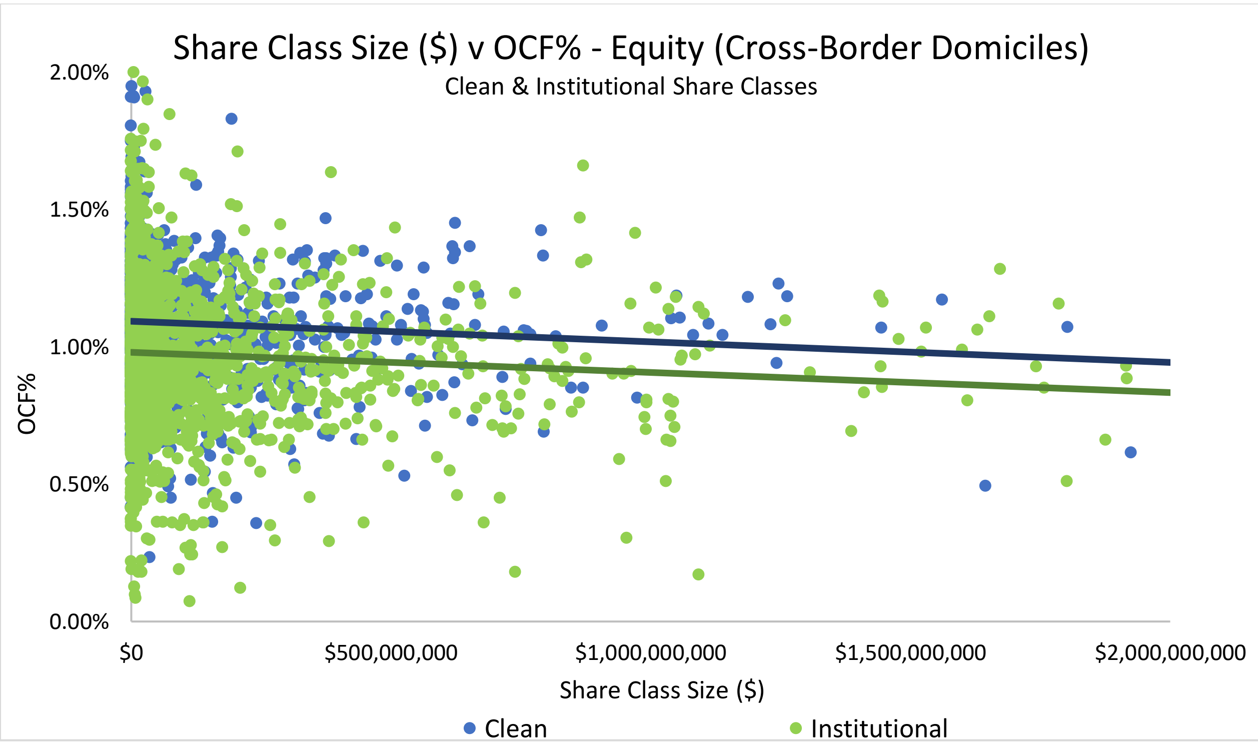
In order to conduct a meaningful comparison we have limited the universe under review to one of the most representative fund sectors: cross-border equity funds

In each figure below, Ongoing Charges (OCF) % are plotted against share class size ($).



[Figure 2 – Share Class Size ($) v OCF% Plots for Cross-Border Domiciled Equity Funds – Only Clean Share Class]

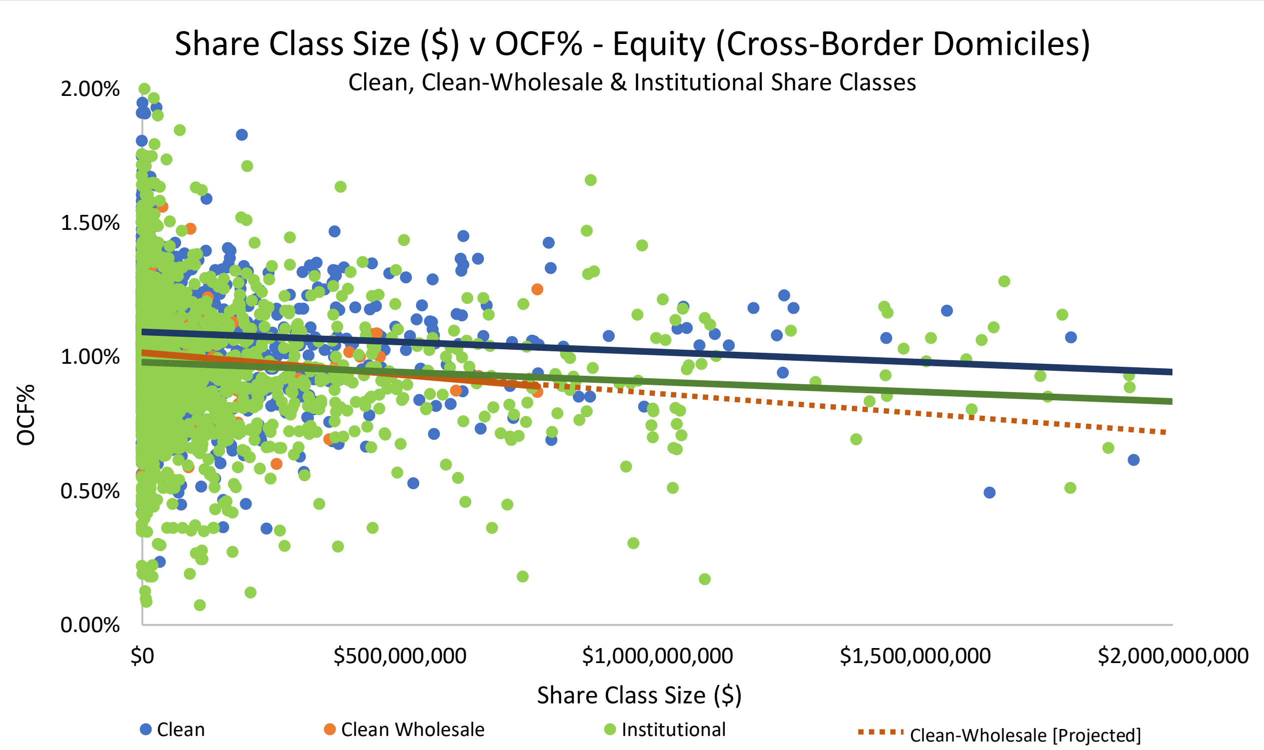
This figure shows clean share classes for cross-border equity funds, plotting the OCF% against share class size. The trendline shows a decrease in OCF% as the share class size increases. Considering the value at the $1 billion share class size with a significant number of observations, the OCF% has reduced on average by 7 basis points.



[Figure 3 – Share Class Size ($) v OCF% Plots for Cross-Border Domiciled Equity Funds – Clean and Institutional Share Classes]

Considering these values for institutional share classes we observe parallel trends in OCF% values as we did whilst considering the clean share classes with rising net asset size. The difference in average fee levels between the two shares classes remain unchanged as share class size increases, with institutional fees always being on lower.

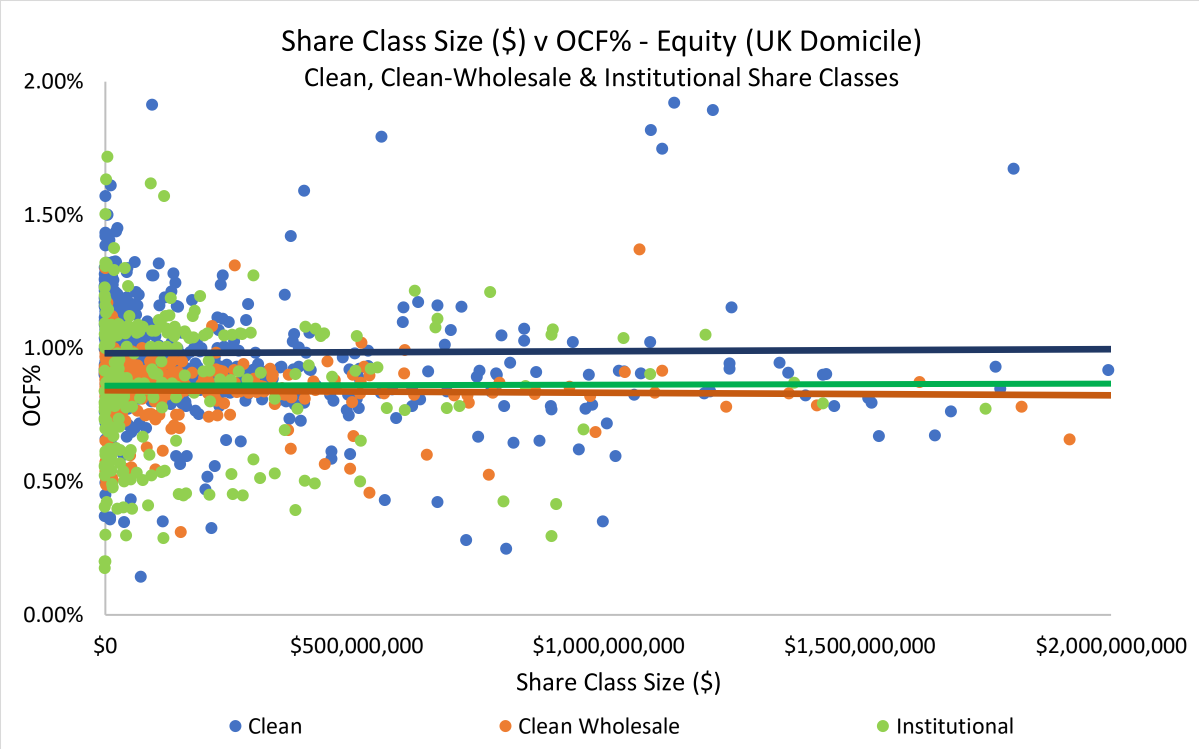
Still using our Fitz Fund Charges data, we additionally consider the further discounted clean share classes, clean-*wholesale* classes, sometimes called “Super Clean” share classes.



[Figure 4 – Share Class Size ($) v OCF% Plots for Cross-Border Domiciled Equity Funds – Clean, Clean- Wholesale and Institutional Share Classes]

Overlaying the data for clean-wholesale share classes for cross-border equity funds to the figure, we can observe a more pronounced downward slope than that of the standard clean and institutional share classes as size increases. However this may not only be a reflection of economies of scale. The introduction of clean-wholesale share classes in cross-border funds are *much more recent* when compared to the clean and institutional share classes, and their lower fees as they launch would be a reflection of external factors such as further fee pressures from platforms insisting on ever lower levels of fund fees.

So far we have considered cross-border funds only but when considering UK domicile funds the picture is slightly different and surpisingly consistent across the three share class types, as shown in the figure below.

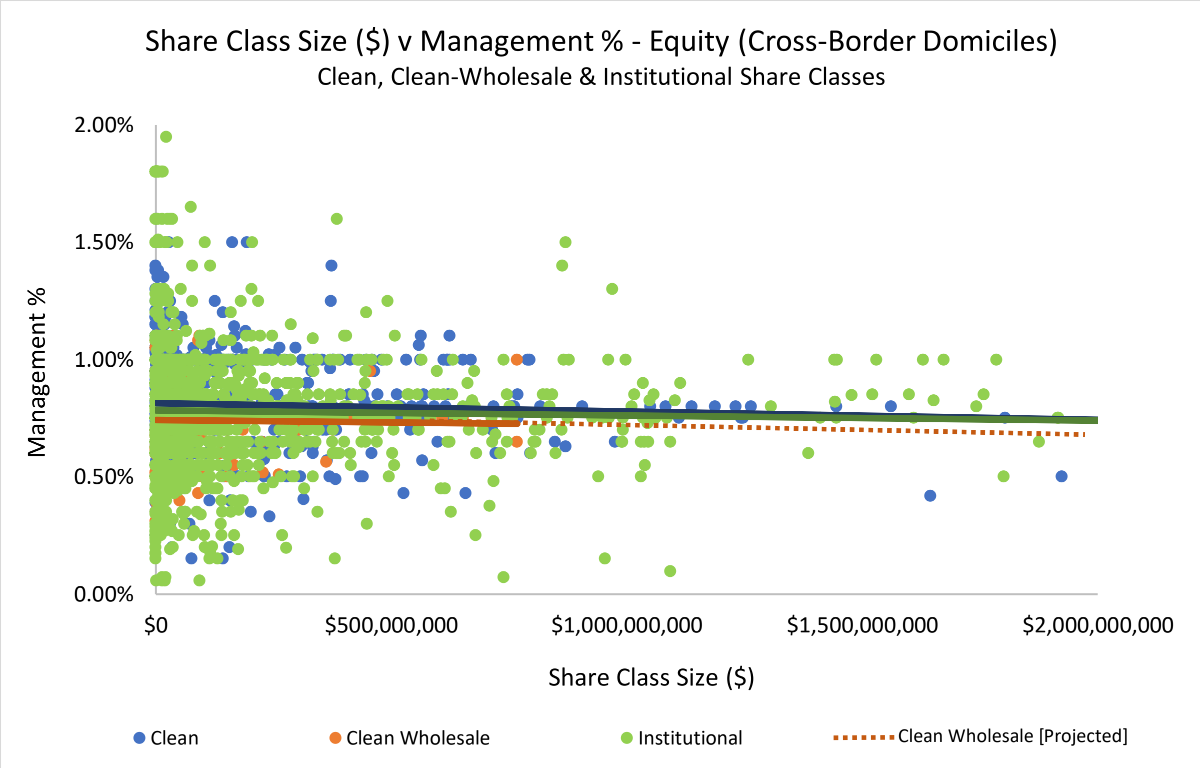


[Figure 5 – Share Class Size ($) v OCF% Plots for UK Domicile Equity Funds – Clean, Clean-Wholesale & Institutional Share Classes]

Figure 5 above shows the average OCF% of UK domiciled equity funds for clean, institutional and clean-wholesale share classes. The three levels of fees in the UK remain the same as share classes size increases. Their trendlines run almost perfectly parrallel to each other and show no evidence of economies of scale being passed on to investors.

As demonstrated above, we have seen some signs of economies of scale when considering the total operating costs, or OCFs, of share classes in cross-border funds. In the figure below we will consider solely share class *management fees* and examine if the total fee reductions, as shown above, come from service providers' charges only, or if any reduction in total costs might also come from lower levels of management fees.

It is worth noting that on average, the management fee accounts for 73% of the overall costs charged for clean share classes of equity funds domiciled in Luxembourg and Dublin. Any sign of economies of scale coming through a reduction in management fee would be very significant, and would have a large impact on the level of total operating costs or OCFs.



[Figure 6 – Share Class Size ($) v Management% Plot for Cross-Border Domiciled Equity Funds – Clean, Clean- Wholesale and Institutional Classes]

Looking at the figure above, it is clear that there is no evidence of economies of scale being passed on to investors when considering management fees. Across the cross-border clean, clean-wholesale and institutional share classes, the average management % stays *relatively static* as share class size increases.

As briefly discussed above, any meaningful impact on investors total costs would have to come from the management fee. Some asset managers have tried to move away from fee structures solely based on the charge of a set management fee and have introduced more innovative structures with a view to differentiate themselves while further aligning investors interests to their own.

In the following chapters we will examine in depth the current fee structures in place passing on economies of scales to investors, how these structures have developed in Europe since 2012, what level of discount they offer and which level of fund or share class size would have been chosen as the point at which to offer a reduction in fees. We will also consider in separate chapters if the size of an asset manager could influence the sliding scale structures they choose to offer and if any current components of pricing models in the market could be used as a guide when setting up breakpoints and management fee discount levels.

FITZ Research Order Form

Company Legal Name:	______________________________
First Name	______________________________
Surname	______________________________
Position in the company	______________________________
Address	______________________________
	______________________________
	______________________________
Email	______________________________
Telephone	______________________________
VAT number	______________

✓ One-off Order, Research Report: **"Finding Economies of Scale in Asset Management: A Quantitative Review of Economies of Scale and their Impacts on Fund Fees in Europe and the UK."** £3,000.

Terms & Conditions:

1. Invoice and Payment
The Client will be invoiced at the delivery of the report. VAT will be added to invoices issued to UK-based companies. Invoices are payable within 30 days of issue. Late payment are subject to an additional charge of 5% for each month or part month overdue.

2. Liability
Fitz Partners Ltd shall not be liable to Client for loss of profit, revenue, contracts, anticipated savings or any other indirect or consequential loss. In any event, Fitz Partners Ltd shall not be liable to Client for more than the value of the Client's subscription. This Contract is governed by English Law.

3. Copyright
All content provided in FITZ Partners products is owned by Fitz Partners Ltd and protected by United Kingdom and international copyright laws. FITZ Partners content may not be reproduced, transmitted or redistributed without the prior written consent of Fitz Partners Ltd.

Signature	______________	Date	______________
Print Name	______________	Title	______________

If you wish to receive our research report, please send a scanned copy of order form to:
Roxana: Roxana.mahboubian@fitzpartners.com ***or Hugues:*** hugues.gillibert@fitzpartners.com

If you wish to discuss the research report further, please contact:
Laura: laura.guthrie@fitzpartners.com ***or Salik:*** salik.ahmed@fitzpartners.com

Fitz Partners Ltd, 5th floor, 211-213 Regent Street, London W1B 4NF
Telephone: +44 203 301 0860. Email: info@fitzpartners.com. www.fitzpartners.com