Flowspring

Bucking the Trend

How the Latest Crop of Investment Products are Reshaping the Fund Landscape

February 2018

Executive Summary

The fund landscape has undergone incredible transformation in the last 10 years, largely due to the divergence of newly launched funds. Over the last 12 months, asset managers launched 3,087 new open end fund and ETF shareclasses. We analyze the characteristics of new funds through time and identify some key trends.

- Passive fund launches are experiencing hockey-stick acceleration, and we see the effects in increasing r-squared values, decreasing net expense ratios, decreasing manager tenure, and the increasing share of new launches that are exchange traded.

- Retirement and institutional shareclasses have grown their share of new launches by 3.4x and 1.7x respectively while A, B, and C shareclasses have declined by 25%, 94%, and 56% respectively.

- Over the last 12 months flows to new funds have significantly diminished. Only 22% of all net flows went to funds that were less than 1 year old. This is below the long-term average of 33% and well below 2016 highs of more than 100%.

- Socially responsible funds account for more than 4% of new launches over the last 3 years – more than double their long-term average.

- We see large shifts in portfolio management team composition, including a strong decline in average manager tenure, and an increase in PhD managers. The percent female managers among new fund launches has remained steady.

New Fund Launches are the Main Agents of Change

There are three ways in which the fund landscape can change: existing funds make changes to their characteristics, funds close, or divergent funds open. The latter is the most significant driver of change.

In the last twelve months, asset managers have launched 3,087 new shareclasses – not quite as high as levels seen between 2012 and 2016, but high relative to long-term averages.

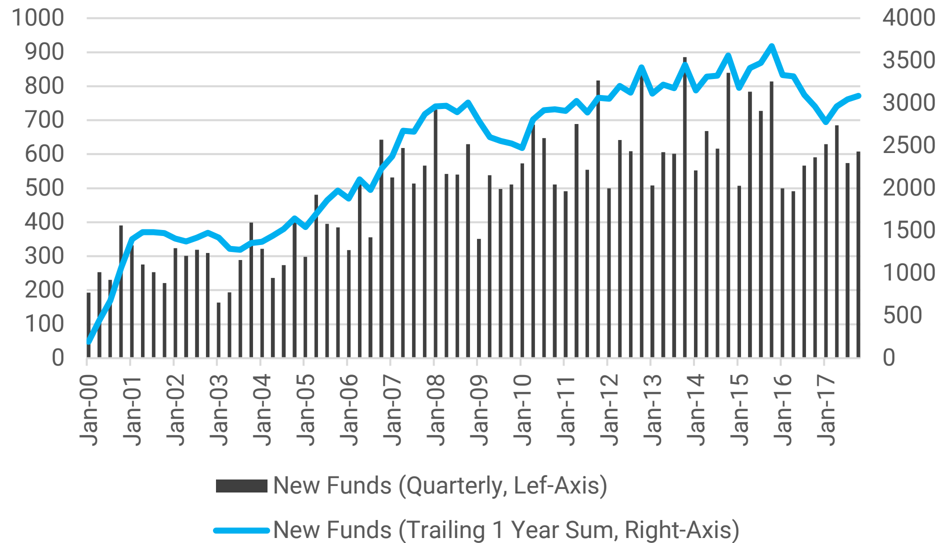

Figure 1. Number of Launches Through Time

In aggregate, new fund launches typically win a disproportionately high share of flows. There are several reasons for this. For example, asset managers heavily market their latest launches to push them to profitable levels of assets. New funds also tend to be more reactive to the latest investor interests – socially responsible funds are a recent example of this phenomenon. Finally, new funds can be an outlet for investors dissatisfied with older funds.

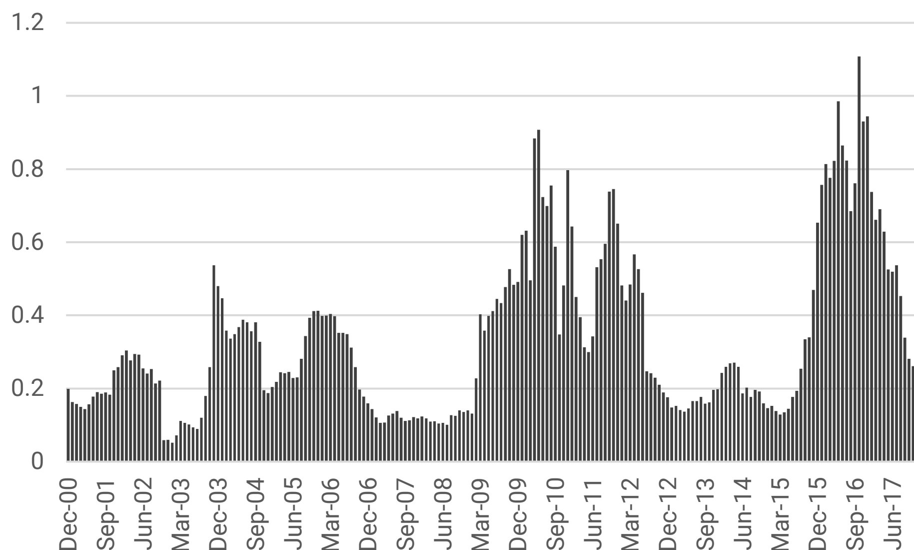

Figure 2: Ratio of flows to new funds (less than 1 year old) to flows to all funds

More recently, interest in new funds has cooled from its euphoric heights in 2016, when new funds won more than 100% of all industry flows in some months. Yet despite their seeming

ability to attract flows in aggregate, most new funds fail to achieve meaningful levels of success.

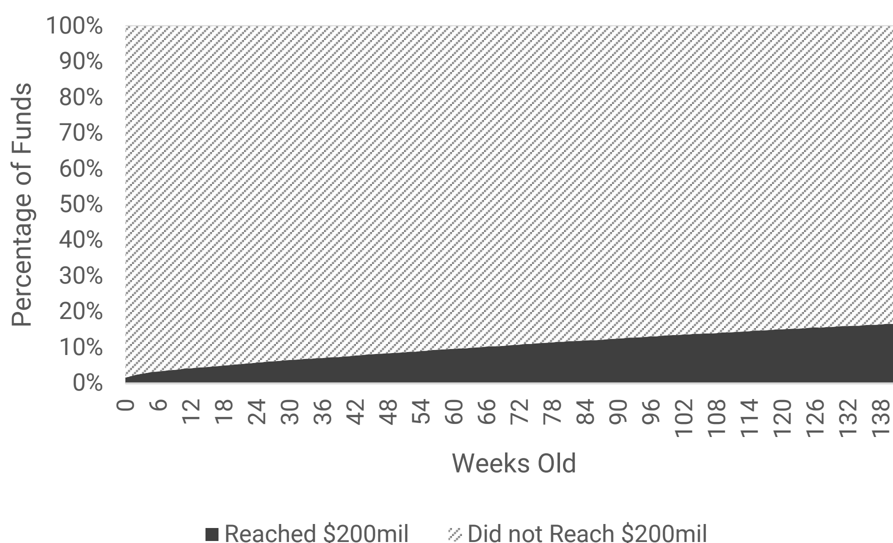

Figure 3: Percent of funds that reach $200 million of assets by a certain age in weeks

After 2 years, only 14% of funds have grown to manage more than $200 million of assets. Clearly, it's not enough to be just a new fund – a new fund must have compelling attributes to find itself at profitable levels of assets within a reasonable time frame.

The Times, They are a Changing

It's no surprise that the fund landscape is changing. What may be surprising is that the rate of change is accelerating. In this section, we examine trends across 5 areas:

- Active vs. passive
- Portfolio composition
- Shareclass types
- Social responsibility
- Management team composition

Active vs. Passive

When separating passive and active funds, it's not always useful to just look at the fund's mandate alone. There are plenty of "closet indexers" out there with active management mandates that still end up with index-hugging performance. For this reason, we use best-fit-index r-squared as our measure of how passive a fund is. The downside of this measure is that it requires a performance track record, and therefore can't give us insights on funds launched too recently.

When we use this measure, it's clear that there's a hockey-stick-like acceleration occurring in the proliferation of passive investment products that began during the financial crisis.

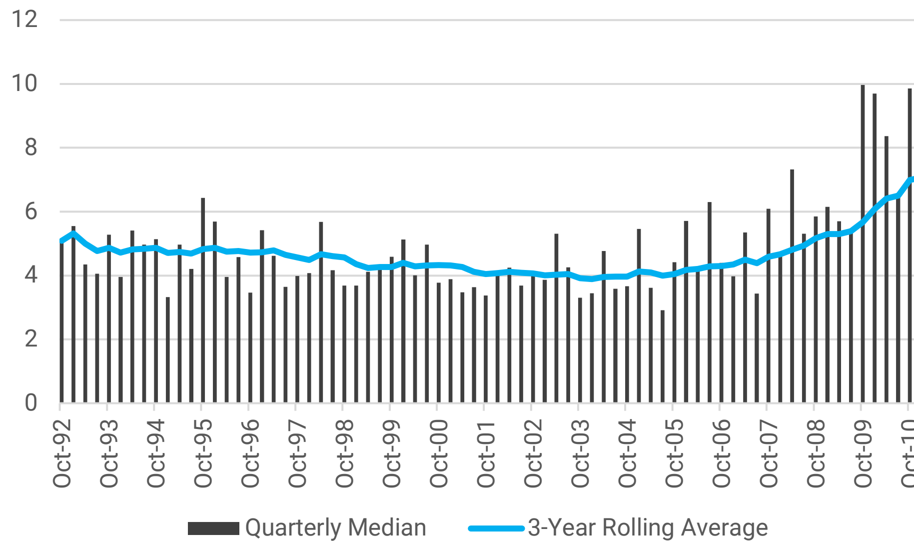

Figure 4: Average Degree of Passiveness (100-Best Fit Index R-Squared) across all new fund launches

This trend is also evident using exchange-traded products as a proxy. Although there are actively managed exchange-traded products available today, the lions share are passive. After the large run-up in passive launches during the crisis and initial recovery, we reached a trough in 2012-2013. Since then, exchange-traded products have been growing their share steadily.

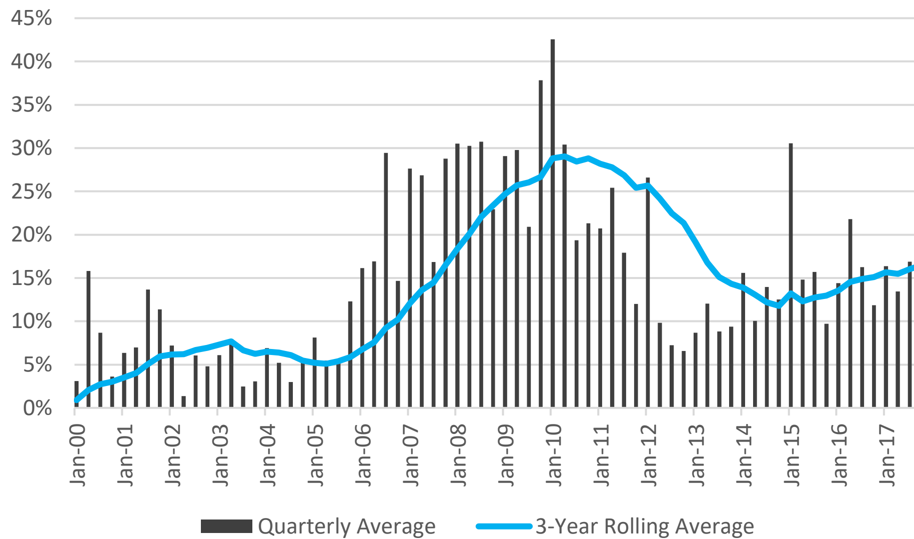

Figure 5: Percent of new funds launched that were exchange traded

For investors, the most exciting development has been the drop in average expense ratios. This drop mirrors the increase in exchange traded products that we see in Figure 5. The current rate of decline in prices is the fastest we've seen in the last 25 years.

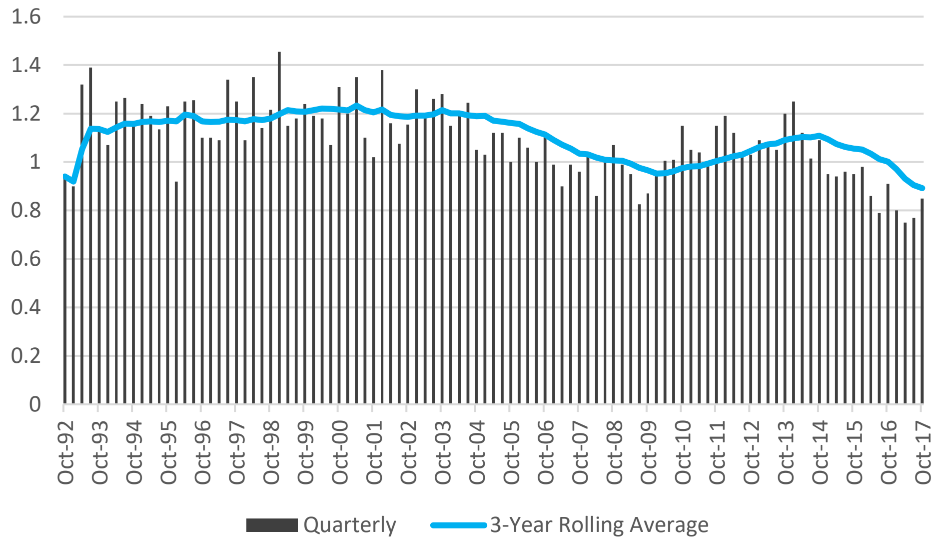

Figure 6. Average expense ratio of newly launched funds

Shareclass Type

The confluence of regulatory agencies pushing for more fiduciary responsibility for advisors, a greater focus on goal-based investing, and asset managers searching for more profitable distribution channels has precipitated a shift in the make-up of shareclass types across newly launched funds.

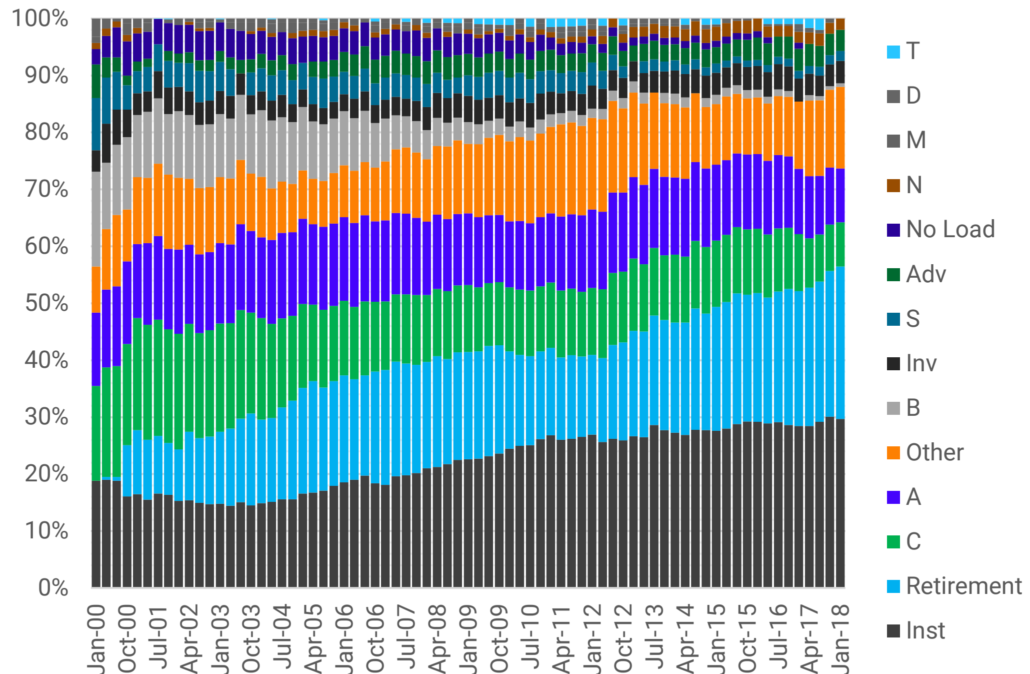

Figure 7. Distribution of new fund launches by shareclass through time

We see in Figure 7 That retirement and institutional shareclasses now make up the majority of fund launches, while 15 years ago, they accounted for less than 30%. A, B, and C shareclasses, which have additional fees associated with sales or purchases have fallen out of favor as investors and have gained better understanding and transparency into how these fees affect performance.

T shares, and clean shares, while still a small portion of all fund launches, are shareclasses that we expect to see rapid growth in as asset managers work to comply with the increasing sense of fiduciary responsibility being placed on advisors.

Portfolio Composition

Naturally, as we see a shift from passive to active products, we should expect to see a change in the composition of fund portfolios. At the broadest level, we can see that portfolio concentration peaked among launches during the financial crisis. Although it hasn't returned to pre-crisis lows yet, the trend since 2009 seems to be a decline in portfolio concentration. This aligns with the increasing prevalence of passive investment vehicles that often aim to match the performance of broad market indices.

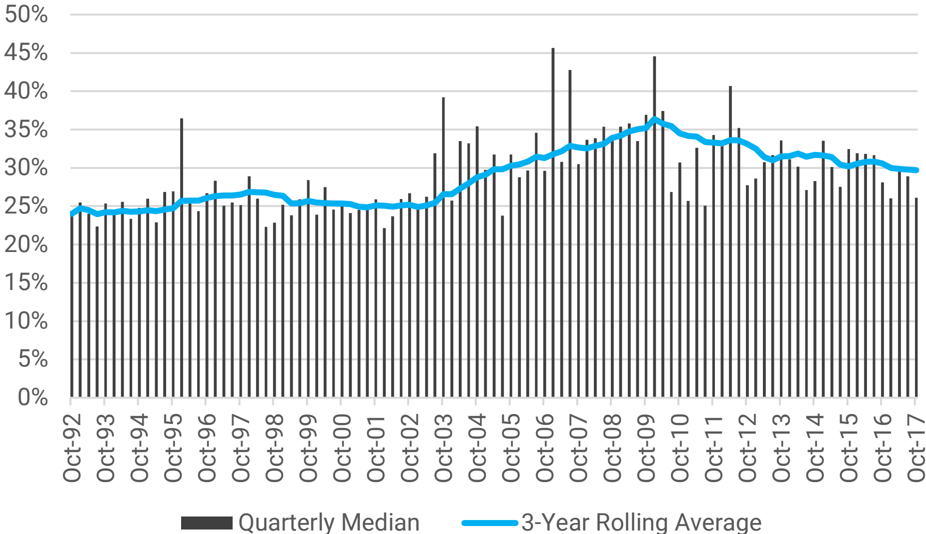

Figure 8: Average weight of top 10 holdings in portfolio of all new fund launches

Another view of portfolio concentration is the number of overall holdings. Figure 9 mirrors the trend in Figure 8 as the number of holdings have recently been increasing while concentration has been decreasing.

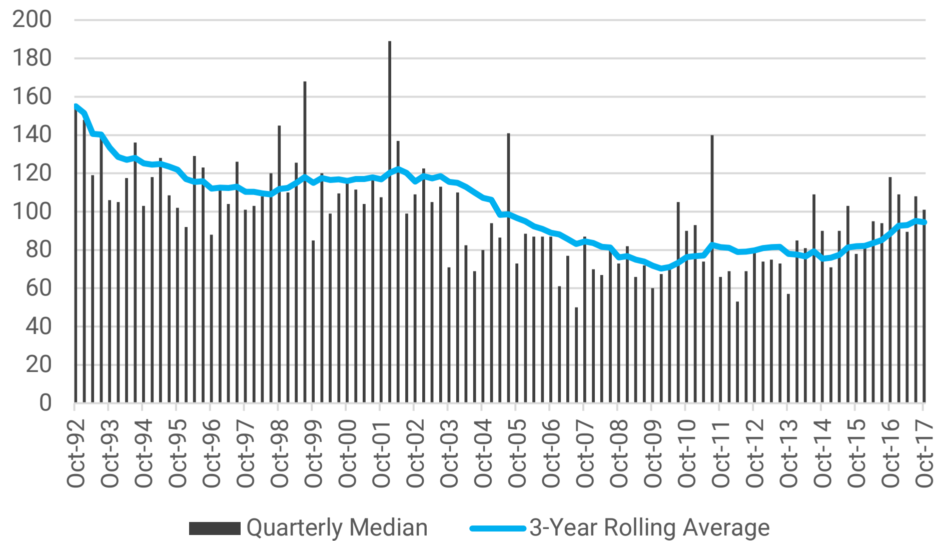

Figure 9: Average number of portfolio holdings across all new fund launches

Beyond simple concentration measures, the economic exposures of newly launched funds have been shifting as well. Figure 9 shows non-US stock peaked in 2009, and have steadily declined since. In contrast, US stock exposure has been increasing since 2011, but is still 10 percentage points below its high of 50% in 2000.

US Bond exposure and non-US bond exposure are also diverging, with the split occurring around 2013 when expectations of rate hikes by the US Federal Reserve began taking hold. Considering consensus expectations are that rate hikes will continue in the near to medium term, we expect this trend to continue as well.

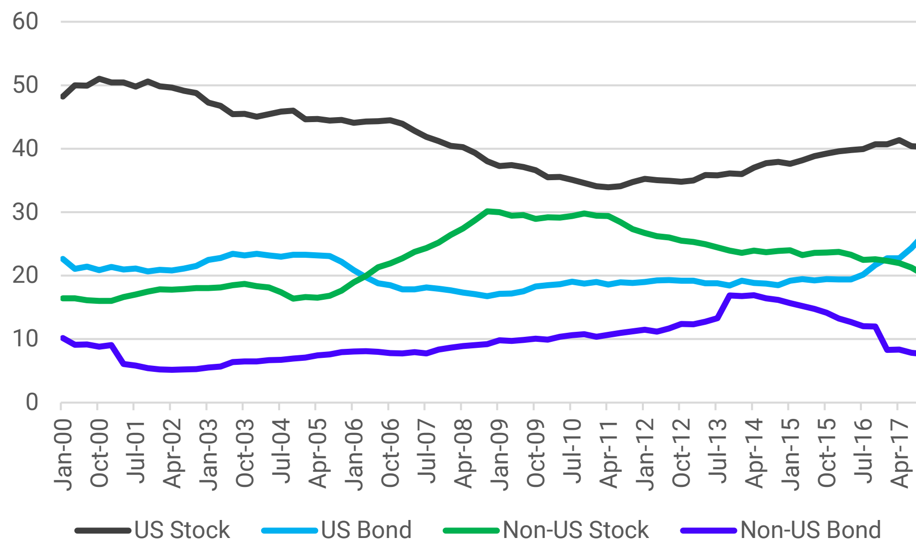

Figure 10: New funds' 3-year moving average allocation to asset classes

Socially Responsibility

Socially responsible investing has become increasingly popula. Nearly 4% of all funds launched in the last 12 months have a social responsibility mandate, up from a long-term average of about 2%.

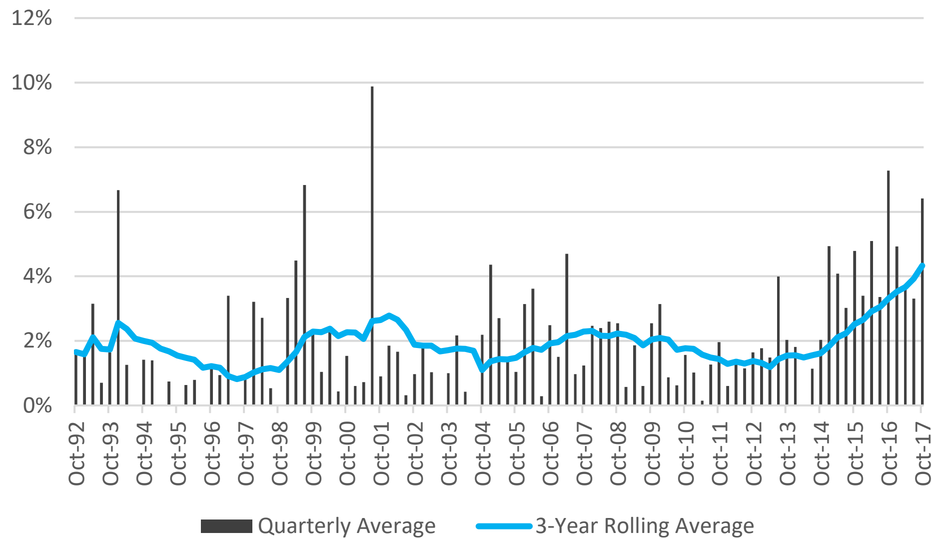

Figure 11: Percent of new funds launched that had a social responsibility mandate

Fueling this trend, are the increasing financial capital of millennial investors who care more about social issues when allocating capital, as well as increasing transparency into the adherence to these mandates by fund managers. Since these causes should only get stronger, we expect socially responsible investing will continue to be a larger and larger share of new fund launches.

Management Team

Changing investment products often necessitate new breeds of portfolio manager. The most striking trend we see on management teams is the plummeting maximum tenure of managers of new funds. Investors simply don't demand or respond to manager tenure as much for passive investment vehicles.

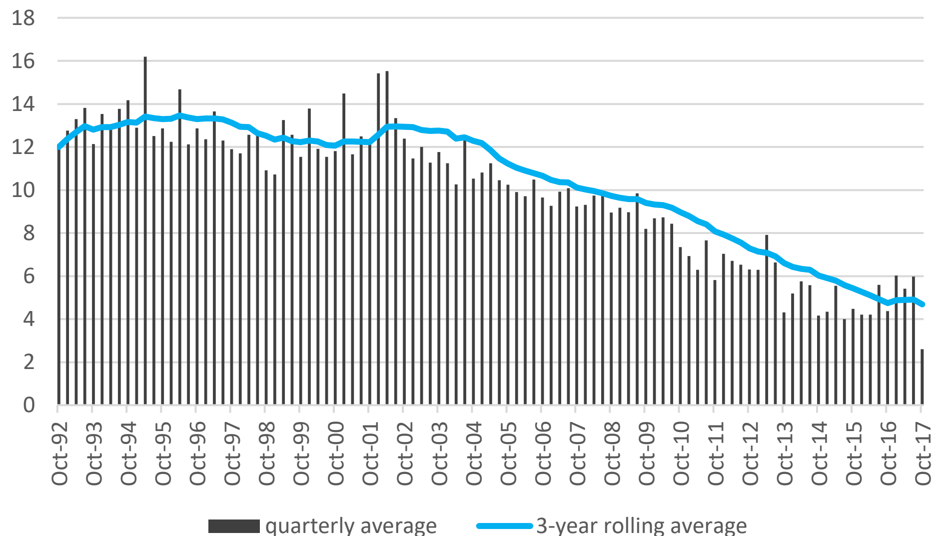

Figure 12: Average tenure (years) of longest-tenured manager on new fund launches

Active management is often advertised as part art and part science, relying on the expertise of the manager to find attractive securities. In contrast, passive investing is largely scientific in nature, with little or no manager subjectivity injected into the process. As such, quantitatively oriented managers, often with PhD credentials are sought for such funds.

Since 2001 there's been a large surge in the percent of PhDs managing newly launched funds.

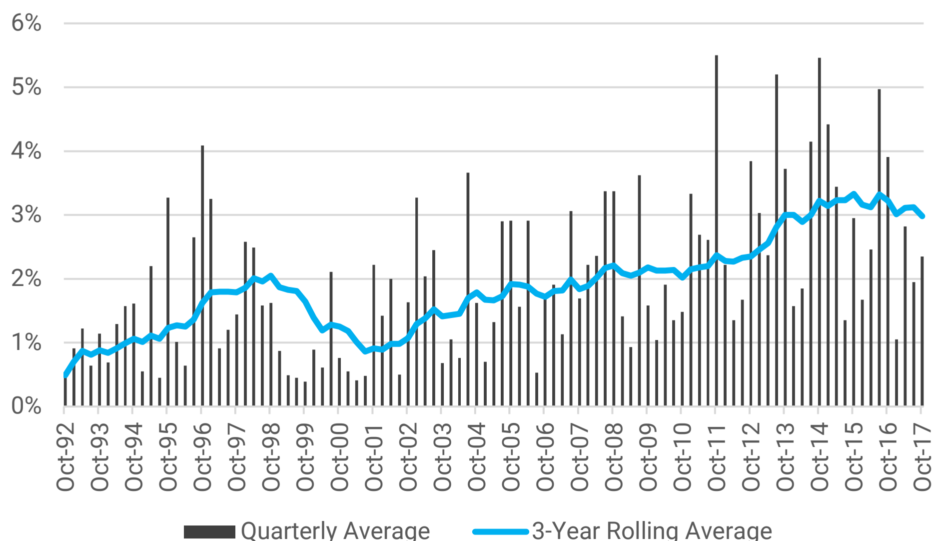

Figure 13: Percent of managers with a PhD across new fund launches

Finally, and surprisingly, we see a slight decline in the percent of female managers among newly launched funds. Flowspring's internal research indicates that gender-diversity among managers leads to an increase in fund flows. Morningstar also noted that female managers are 1.36 times more likely to manage a passive fund than an active fund within the same category. Today, only roughly 10% of portfolio managers are female across all investment products.

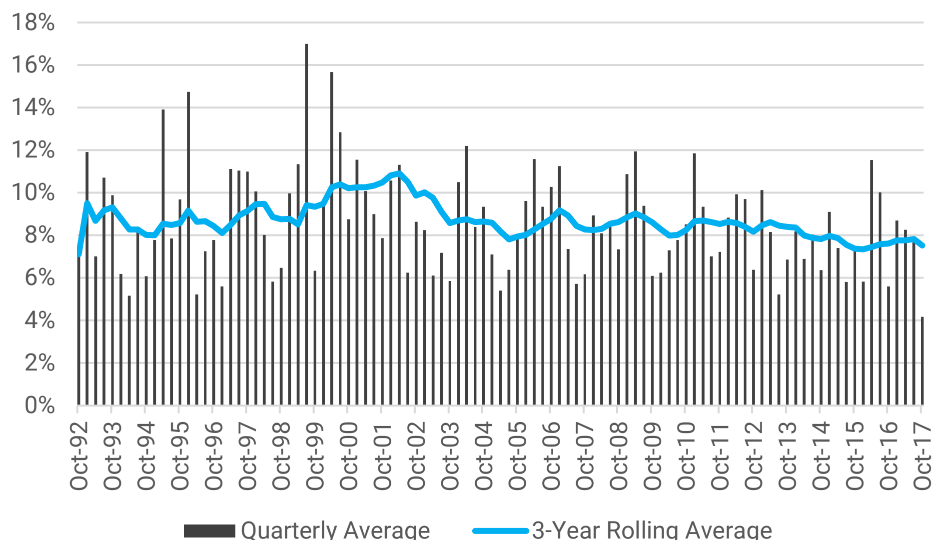

Figure 14: Percent of managers that are female across new fund launches

Conclusion

For fund investors to achieve their goals, they must have a quality selection of investment products to choose from. Increasing knowledge of fees impact on performance and the

increasing prevalence of goal-based investment objectives have been major drivers behind the transformation of the investment landscape over the last 20 years.

We examine the main driver of this transformation, the characteristics of new fund launches, and find that, if anything, the transformation to passive, low-fee investment products is accelerating.

We expect to see continuing launch of passive investment products, coinciding with lower fees, higher r-squared to best fit indexes, and more funds that are exchange-traded. These changes have implications for portfolio management teams as well, which may result fewer managers per fund, lower manager tenure, and more quantitatively oriented managers.

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