May 1998, Vol. 1, No. 2

SENIOR CONSULTANT
The Voice of the Investment Management Consultant

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The New Mutual Fund Marketing Environment

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From a product management perspective, mutual fund marketing is pretty simple, right? Whatever fund is up is what you sell. You charge a premium for fund families to have high internal exposure, and by limiting your shelf space and promotion, you do enough volume to hit all the breakpoints, thus maximizing current and recurring compensation. The mechanics are there to move the highest volume of business through the firm at the highest margins. From the perspective of the firm and the major mutual fund families, this has been a relationship made in heaven. The firm provides access to the broker (distribution), and the mutual fund company provides timely access to highly salable products – a perfect complementary product distribution relationship. But, the marketplace is telling us what has become today's conventional product distribution format is no longer serving the needs of the client, the broker or the firm. The needs of the firm have changed, and a more dynamic relationship is required, if the client is to be served.

THE MARKETPLACE IS TELLING US WHAT HAS BECOME TODAY'S CONVENTIONAL PRODUCT DISTRIBUTION FORMAT IS NO LONGER SERVING THE NEEDS OF THE CLIENT, THE BROKER OR THE FIRM

It has become clear that the product distribution mechanism at work in the marketplace is not serving the best interests of the investor. This has been affirmed by both a Morningstar study and the Tully Committee report on compensation practices commissioned by SEC chairman Arthur Levitt. Morningstar, over a five-year period ending May 1994, found that of the 219 growth mutual funds they monitored, the investment returns averaged 12.5%, while investor returns averaged -2.5%. The Morningstar study affirmed the widely held thesis that the investor is attracted to the allure of extraordinary returns, only to be disappointed when those returns cannot be sustained. Rather than buy and hold as the Morningstar investment returns suggest, the investor buys high and sells low as Morningstar's investor returns suggest.

The mechanics of product distribution are the broker (insurance agent, financial planner, banker) is paid a commission if and when they find investments that are attractive to the investor. Because of the immediate gratification stimulus associated with finding and executing attractive investments, the more attractive investments a broker can find and sell, the better. Thus, today we have a bias towards investments that look good right now or promise extraordinary short-term performance. This creates unrealistic performance expectations that, when not realized, cause the investor to sell and repeat the cycle. The allure of extraordinary returns as an abstract thesis, without discussion of the associated risk, or what level of performance can be sustained, or its tax efficiency, or its general relevancy to the client's portfolio, does not provide a clear picture of an investment. Yet, investment decisions are commonly made in a vacuum, based solely on the promise of extraordinary returns. It was with this phenomenon in mind that Arthur Levitt asked Dan Tully, chairman of Merrill Lynch, to form a committee to report on compensation practices.

The Tully Committee (which included among others, Warren Buffet, perhaps the most successful investor of our time, and Chip Mason, founder and chairman of Legg Mason) observed, "If the retail brokerage industry were being created today from the ground up, a majority of the committee that developed this report would not design a compensation system based on completed transactions …. The most important role of the registered representative is to provide investment counsel, not to generate transaction revenues. The prevailing commission-based compensation system inevitably leads to conflicts of interest among the parties involved." The report concludes in part, "Individual firms will survive and prosper in this competitive environment, only to the extent they deliver tangible value to customers."

This increasing awareness of clients, brokers, firms and regulators that clients are not being well served by this unhealthy focus on short-term performance has led responsible brokers and firms to a new distribution format, which by design empowers the broker and their

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firm to add value. It is built around the institutional investment management consulting services model which, based on Nobel Prize-winning technology and 40 years of application with the most discerning of institutions, offers a highly structured investment process. The emergence of the retail application of investment management consulting services will have a most profound impact on the delivery of financial products and services and an even more profound impact on the mutual fund industry, how it is structured, how it markets, how it manages money and how it adds value. Investment management consulting services will level the playing field between load and no-load funds, will require managers to manage in accordance to specific investment styles, will require new products to be created, will stretch the investor's time horizon from the short-term to the long-term and will dramatically alter the role of marketing.

Leveling The Playing Field

In today's product distribution culture, where the emphasis is on product and not the client, the mutual fund company has become the arbiter of suitability by virtue of the emphasis on short-term performance. Indeed, whatever fund has the best short-term performance sells the best. Yet, with the advent of the retail application of investment management consulting services, there is a shift away from distributing products to adding value. In the process the balance of power shifts from the mutual fund company to the broker, as suitability is designed in terms of the client, not product. The investment process is totally objective and places far more emphasis on being in the appropriate asset classes and management styles than it does on the selection of individual managers. A particular fund can only add value when viewed in the context of the client's assets as a whole. It either increases performance, reduces risk or contributes to tax efficiency and liquidity of the client's portfolio. It is the investment advisor who adds value, not the fund. Thus, the fund that offers the best long-term performance at the lowest risk, in the lowest cost structure, at the highest degree of tax efficiency in its management style peer group is the fund best suited for the investor. Clearly, short-term performance and brand recognition are relatively unimportant as criteria that one would use to select a manager. To be successful in a consulting environment, a mutual fund must not only compete on the basis of the value it adds for each client, but it must meet a very high standard against which it will be measured, using the most discerning criteria. In this client-focused environment, the product-focused marketing and brand recognition of load funds is neutralized, leveling the playing field for no-load funds.

Virtually, an entirely new competitive environment is emerging that totally changes how we are engaged in our business. Put yourself in the shoes of an investment advisor who has to manage thousands of investment options, each having as many as 164 points of comparison (with an unlimited number of data points) for several hundred clients, each with their own needs and circumstances, goals and objectives, time horizons, risk constraints and tax considerations. Clearly, an investment process is needed to manage all this information so it can be delivered in terms meaningful to the client. Without an investment process structured as an expert system, the advisor has no choice but to offer investment recommendations as isolated, disjointed transactions. But with the investment process structured as an expert system, the broker cannot only add extraordinary value, but can be most rigorous in manager selection with every minute detail subject to immediate recall on both the manager and the portfolio level.

IN TODAY'S PRODUCT DISTRIBUTION CULTURE, WHERE THE EMPHASIS IS ON PRODUCT AND NOT THE CLIENT, THE MUTUAL FUND COMPANY HAS BECOME THE ARBITER OF SUITABILITY BY VIRTUE OF THE EMPHASIS ON SHORT-TERM PERFORMANCE

Cost structure, risk, performance, management style and tax efficiency will all become important criteria in the selection of a prospective manager from the investment process and will require fund companies to manage in a much more sharply focused manner than ever before. The days of brand loyalty and a short-term performance orientation are over for those who wish to add value for clients.

Definitive Management Styles

Bill Sharpe, the Nobel laureate economist who is one of the fathers of modern portfolio theory suggests that the building blocks of a portfolio are the investment management styles of managers. Given 90% of a manager's performance is determined by management style, portfolio performance is determined by how these management styles fit together as a portfolio. Once a broker has established the appropriate configuration of management styles or the appropriate asset allocation to construct the client's portfolio, you then know over the long term, precisely what you can expect from each management style incorporated within the client's portfolio.

Management styles are the key to risk management. By managing in accordance with a definitive style, one knows the level of risk they are assuming, the median and range of returns they can expect to achieve over the long term and has an established index-based benchmark against which they can evaluate themselves. Though risk can be measured in an eclectic management style, one never knows what to expect in terms of risk or return as the manager cuts across all management styles to find value. Thus, the eclectic style does not offer the management discipline that allows risk to be managed. Risk management is perhaps the most important value addressed by the investment process. Yet, more than 90% of load and no-load mutual funds do not have a high correlation to a particular management style. In fact, Smith Barney has copyrighted their Style Reliability Measure to help their consultants understand which funds are attractive to use in building portfolios. Of the 28 no-load fund families and the 400 no-load funds incorporated in Smith Barney's TRAK invest-

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ment process, only 65 funds, or 16%, were classified as having moderate, high or highest correlation to a particular management style. Clearly, in order for fund companies to be incorporated in the manager universe of most firm's investment processes, they will have to develop style-based funds.

As more and more brokers choose to compete on the basis of the value they add, and as more and more clients get attuned to risk management and the other values that can only be achieved through a highly structured investment process, the shift of capital towards the investment process promises to be quite substantial. This is not a fad but a secular trend which will redefine our industry. The mutual fund industry as we know it today is not well prepared with style-based funds to participate in this metamorphosis.

New Products Required for New Environment

When firms and brokers start reporting performance in accordance to AIMR standards, they will discover it is very difficult for a manager to consistently beat the appropriate index-based benchmark for that management style net of fees over an extended period of time. In fact, consistently beating the index by more than 100 basis points is so extraordinary that only a very small number of managers are documented to have actually sustained that level of performance. The mutual fund industry will not only have to reconcile the question of active management relative to the index fund option, but in the process they must decide what business they are in. Surprisingly, some fund companies think of themselves as being in the marketing business or the product distribution business, not the asset management business. Those mutual fund families will likely see their marketshare continue to shrink as capital increasingly flows to brokers who compete on the basis of the value they add. If mutual funds are in the asset management business and define themselves in the broadest possible terms, we should see most mutual fund companies offer style-based funds, index funds and concentrated portfolios as investment options. Concentrated portfolios play to the strengths of active managers, by focusing on 5 to 10 stocks, the impact of stock selection can be 25% to 50% of total return as opposed to 3% in a fully diversified portfolio with 35 to 60 stocks. This more concentrated approach used by Warren Buffet and others can substantially outperform the index. The additional risk is mitigated by combining multiple concentrated managers with traditional core managers, and low turnover makes these portfolios very tax efficient.

As fund companies seek to reconcile the merit of active management, the tax code may become a significant ally in the tax-sensitive individual market. If returns are established after income and/or estate tax and recast as pretax equivalents, it is likely that a strong case could be made for active management, net of fees and relative to the index. Of course, this requires the investment process to be structured as an expert system to address the income and estate tax implications of the portfolio structure.

> **THE INVESTMENT BUSINESS IS IN A TRANSITION PERIOD FROM PRODUCT DISTRIBUTION WHICH FOCUSES ON SHORT-TERM PERFORMANCE TO THE INVESTMENT PROCESS WHICH ADDS VALUE**

The Role of Marketing

The investment business is in a transition period from product distribution which focuses on short-term performance to the investment process which adds value. It is no longer particularly important which name brand mutual fund was up 58%. The investor now wants to know at what level is that performance likely to be sustained, what kind of risk exposure is being assumed, how does the investment impact the income and estate tax structure of their portfolio, and what is the investment's overall relevancy to their assets as a whole. Only when the broker/consultant looks at an investment in the context of the investor's goals and objectives and their assets as a whole can the investor know if a particular investment is well advised. Because there are no secrets in an objective investment process, the broker/consultant can quickly search for a manager by management style, cost structure, risk exposure, tax efficiency and most any other criteria important to the investor. How does a mutual fund company market in an environment where investment suitability is a function of each client's unique needs and circumstances, goals and objectives? There is no product generalization to be made with regard to suitability as value is added in client-specific terms. Process marketing makes great sense, but that is the domain of the broker/consultant's firm. So, how does product marketing fit in? It may not. In fact, wholesale marketing as we know it has a limited application at best to the investment process and may have an inverse correlation to the funds cost structure. This is a world turned upside down for most mutual fund companies.

With major load funds having all their sales derived from the traditional product distribution model, they face a significant challenge in adapting their product line and cost structure to the fast-emerging investment management consulting services business. They are in a Catch 22. If they challenge the consulting services business, they say the client is not important, which is marketing suicide. If they challenge value being added, they say the broker/consultant is not important, which is sales suicide. If they ignore the consulting business, they choose not to compete on the basis of the value they add and, in effect, resign from the marketplace. The only logical choice for the major load mutual funds is to become a player in the investment management consulting services business. This is accomplished through asset management: winning business based on merit, not through marketing. All the marketing and brand recognition one could hope for will not impact the massive flow of assets to the investment process. To survive and prosper in this environment, mutual fund companies must adapt to a most rigorous set of selection criteria which will be applied by the consulting community on behalf of their clients. This shift from the broker distributing product to adding value also shifts the balance of power from the fund company to the broker. Because value can only be added in the context of each client's circumstances, the role of mutual fund marketing, as we know it, is sure to change.

Conclusion

In the final analysis, marketing of the 21st century will be built around the investment process and adding construction so specific that it would be very difficult not to be objective. The consultant is looking for the best performing manager in their management style peer group with the lowest risk and cost structure, with the most tax-efficient results. Any single criteria can exclude a manager from consideration, and only the most extraordinary investment managers are advanced for consideration. A new genre of tax-sensitive, risk-sensitive, cost-sensitive manager is emerging, which is accounting for an increasingly large portion of marketshare. Yet, even with this movement toward more efficient investment vehicles, the most successful consultants are far more interested in portfolio construction technology and asset allocation than in manager selection. The fact that consultants emphasize portfolio construction while their brokerage cousins emphasize manager selection is a good indicator of how far a firm has come with their consulting initiative.

Dr. Charles Ellis, the father of investment policy, observes "the usefulness of investment policy depends on the clarity and rigor with which investment objectives and the policy guidelines established to achieve those objectives are stated. If policy is not determined through carefully developed mutual understanding, it will be determined in an uninformed, anecdotal 'ad hoc racy' …. To the extent that the client, the consultant and the investment manager understand the realities of the situation as a whole, they will be able to understand what individual bits of data and specific events mean and do not mean for the portfolio they are managing together …. The principal reason for articulating long-term investment policy explicitly and in writing is to enable the client and portfolio manager to protect the portfolio from ad hoc revisions of sound long-term policy when short-term circumstances are most distressing and policy is most in doubt …. Clients can do more for their portfolios long-term rates of return by developing a sustaining, wise, long-range policies that commit the portfolio to an appropriate structure of investments than can be done by the most skillful manipulation of the individual holdings within the portfolio. (Investors, by nature, are attracted to the allure of extraordinary returns, only to be disappointed when those returns are not sustained. They then sell only to repeat the cycle. By definition, extraordinary returns can never be sustained; that is why they are extraordinary.) The best shield for long-term policy against acute distress and myopic thinking are knowledge and understanding committed to writing …. The primary reason for investment policy is to protect us from ourselves. If a major decision is truly fiduciary in nature, it never needs to be done quickly …. The real opportunity to achieve superior results is not in scrambling to outperform the market but in establishing and adhering to appropriate investment policies over the long-term - policies that position the portfolio to benefit from riding with the main long-term forces in the market. Investment policy wisely formulated by realistic, well-informed clients with a long-term perspective and clearly defined objectives is the foundation upon which portfolios should be constructed and managed over and through market cycles …. In reality, very few investors have developed such investment policies."

We are greatly indebted to the work of Charles Ellis in pioneering the development of investment policy in the institutional markets. As advances in technology make this level of investment counsel possible for literally every investor, the nature of our industry changes from trade execution to advisory services. How firms and financial consultants integrate investment policy and its associated investment process technology into their practices will, in large part, shape their future course and determine their long-term success in addressing the investment concerns most important to the investor. The investment literacy of the financial consultant will become an increasingly important factor in the growth and development of our industry. ■

Notes

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