CERULLI ASSOCIATES

10 × 10

10 of the world's leading institutional investors | 10 of the world's leading asset managers

Part Three

Seeking Future Returns

Commissioned by:

Russell Investments

February 2022

In 3Q 2021, Russell Investments held its annual Partner Innovation Lab, a roundtable event where large asset owners from various geographies brainstorm their greatest concerns and areas of interest. Russell Investments asked Cerulli Associates to interview participating organizations, as well as some of Russell Investments' asset management partners, to extract individual perspectives on topics discussed at the event. In aggregating insights, Cerulli sought to compare asset owner and manager views on key topics, as well as leverage data and insights from its existing suite of research on the institutional asset management space. Interviews were conducted from mid-July to mid-August and spanned a series of topics:

1. **Diversity & Inclusion**
2. **Climate Change Investing**
3. **Seeking Future Returns**

The third installation of this series covers research dedicated to asset owner and manager views on the future return environment, private markets, and fee compression in the asset management space.

Participating Firms

10 Asset Owners

Organization
The Boeing Company
Fujitsu Global
Mazda Motor Corporation
Microsoft
Mitsubishi Electric
Nestlé
Roche
Unilever
The New York Presbyterian Hospital
Robert Wood Johnson Foundation
Thomas Jefferson University

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10 Asset Managers

Organization
Brevan Howard
Hamilton Lane
Oaktree Capital Management
RBC Global Asset Management /BlueBay Asset Management
Western Asset Management Company
BlackRock
J.P. Morgan Asset Management
Morgan Stanley
Putnam Investments
Wellington Management

Summary

Coming on the heels of fiscal-year 2021, a period in which many investors posted superior performance, asset owner and managers expect a lower return environment going forward. Asset owners are faced with the decision of whether to change their risk exposures or maintain their current approaches. In addition to challenges associated with a lower return outlook, managers must look for ways to adapt to a lower fee environment, namely employing measures to reduce costs.

Some of the worlds' largest asset owners and managers shared insights on their views on the future return environment, the outlook for private markets, and fee compression. Cerulli found that asset owners and managers generally agree on a lower return outlook and that private markets offer an avenue through which investors can maintain return targets to an extent. Many 10X10 participants noted that private markets are not insulated from the lower return environment and went further to explain that private markets have become increasingly crowded. Still, many investors with existing allocations to traditional private equity are looking to expand their portfolios into different sectors of the private market landscape, including growth, venture capital, and private fixed income.

KEY POINTS

- Most asset owners and managers expect lower returns in 2022 and beyond. This group predominantly believes that central banks have run out of policy tools they can use to propel markets. The contrarian view – that returns will remain steady – is held mainly by those that believe central banks will continue to play an important role and remain accommodative. Some asset owners and managers with whom Cerulli spoke said that return expectations have been lower for years but markets have continued to surprise them.

- Given a lower expected return environment, investors are faced with the decision of whether to alter their policy risk exposures or remain steady. For those seeking to move up the risk spectrum and target higher returns, private investments and private fixed income, specifically, are key areas of interest. Investors that have already made headway into the private investment space are looking to expand from traditional private equity (*i.e.*, leveraged buyouts) into growth and venture capital. Investors with mature private investment programs mostly plan to hold steady and at least one said that due to superior performance it was scaling back additional allocations (in order to maintain policy allocations).

- Illiquidity is a distinguishing characteristic of private markets investing. While it is often cited as the source of premiums, participating asset owners and managers noted that it is not the sole source of premiums. Namely, premiums derived from the asset class are better described as complexity and access premiums, the former reflecting how investments are being managed and the latter reflecting how investments are brought together. Several 10X10 participants noted that illiquidity offers other benefits, including a smoothing effect on returns that insulate investors from temperamental changes in sentiment and being subject to otherwise-larger swings in required contributions. Others noted that the stability of private markets makes them appear superficially attractive.

- Many participants in this study noted that private markets are not insulated from a lower return outlook. Several cited high levels of dry powder as an indicator of bubble-like behavior. As investors continue to seek returns and increase allocations to private markets, the space has become more crowded and managers in the space will be forced to accept lower-yielding investments. Because there is so much committed capital, firms may have to make deals with lower payouts.

- In addition to a lower return outlook, asset managers must navigate an environment of declining margins. As bargaining power continues to shift towards investors, managers have been subject to fee pressure and greater service-level expectations. To remain competitive, many have leveraged high-quality client service capabilities and offered advice beyond the scope of traditional mandates. A common approach to control costs is leveraging technology to streamline their operations and increase efficiencies in client service initiatives. 10X10 participants noted that even private investment firms, which have traditionally been more insulated from fee pressure, may begin to feel effects in the coming years. Additionally, these firms are subject to the same trend of higher expectations surrounding client service.

Seeking Future Returns

The current investing environment is characterized by complexity and shrinking opportunity. With rates likely to increase institutional investors are faced with a complex decision of where to deploy their portfolios. Several participants in this study used the word "frothy" to describe markets. Most believe that future returns will be lower than they have been in the past. Given this dire outlook, Cerulli asked asset owners and managers how they are positioning their portfolios in pursuit of returns.

> If you have an incremental dollar, where do you want to put it? Equities are fully valued. Do you want to be buying bonds? Maybe if you think its QE forever...[The] other place is private equity and venture capital, but there's a ton of capital on the sideline. The valuations are very rich. [There is] not much value anywhere."
>
> – *asset owner*

> Looking at equities, how much more growth can we get before the bubble bursts? How much longer is this going to go on."
>
> – *asset owner*

> The longer it goes on, the greater the worries become that we get that asset price bubble. Even though we aren't out of the crisis, we are emerging with valuations that are fuller than they have been in other financial crises."
>
> – *asset manager*

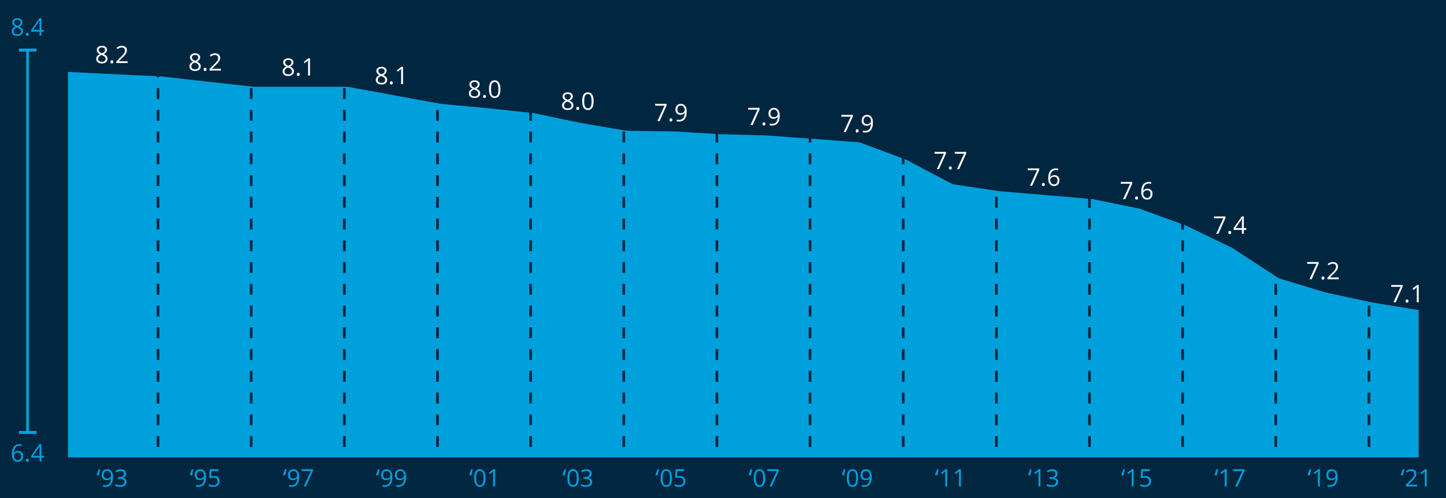
Most asset owners and managers anticipate a lower return environment going forward, especially in the short term. The contrarian view – that returns will remain steady – is held mainly by those that believe central banks will continue to play an important role and remain accommodative. The group that believes returns will be compressed argue that the central banks have run out of policy tools to use.

Approaches

Cerulli asked asset owners how they plan to proceed in a low-return environment and asked asset managers how they are advising their clients. Specifically, are investors simply lowering their return expectations, or are they moving their portfolios up the risk spectrum? Two multi-asset class managers told Cerulli that most clients are doing a combination of both.

Several participants told Cerulli that they have lowered their return targets to match their current outlook. One asset manager told Cerulli that most of its clients have incrementally lowered their return targets over the past 10 years, specifying that it is difficult for institutions to make drastic changes to their return targets because it has implications for flows (required contributions and distributions). This manager told Cerulli that its clients generally reduced their return targets from 25 to 50 bps, annually.

State and Local Pension Investment Return Assumptions, 1992-2021



Source: Public Plans Database

> Everyone contracts return expectations similarly. The spreads on fixed income are at historically low levels but the same thing will happen across asset classes, so we have to live with lower returns. How much lower? It all depends. Money is chasing yield right now, and that's going to keep happening."
>
> *– asset manager*

> More and more conversations are around determining realistic objectives in a multi-asset portfolio. Prior targets just aren't sensible."
>
> *– asset manager*

Given that most investors have lowered their return targets in recent years, the next question is how they choose to combat those lower returns. Cerulli spoke with asset owners moving in one of the following three directions:

① Reduce risk to prepare for a correction

② Maintain current policy

③ Increase risk to get a higher return

Cerulli spoke with investors that were employing each of these approaches. Corporate pensions were the only group that plan to employ the first approach, but motives were more geared towards broader derisking objectives rather than timing the market for a correction. These investors all stated that they had healthy funded statuses; catalysts for reducing risk were a function of moving along a glidepath. A fully funded pension plan explained that it was primarily concerned with its funded status rather than chasing returns.

Corporate pensions in today's climate are generally wary of repeating mistakes from the previous downturn. Leading up to the Global Financial Crisis, most U.S. pension plans exhibited healthy funded statuses. Following the crisis, their funded statuses dropped to as low as 65.7% (on average) and have only recently recovered to pre-crisis levels. A multi-asset-class global asset manager told Cerulli that these investors are looking at the current market fundamentals (*e.g.,* high equity valuations) and deciding to take risk off the table. Notably, this approach is only practical for well-funded plans; poorly funded plans invest to close their funding gaps and are, hence, unable to derisk. Additionally, depressed bond yields mean that even fewer pensions are derisking.

> So [it's] hard to claw back from a large equity drawdown. How much equity and other forms of risk do you want to take at today's valuation levels, knowing another sharp drawdown could really hurt the prospects of meeting funded status?"
>
> *– asset manager*

Some investors are simply maintaining their current policy allocations and accepting lower returns. These tend to be long-term-oriented investors (*i.e.,* nonprofits) that already have significant alternatives allocations. One such investor told Cerulli that it had a favorable outlook for private markets but, due to consistent positive performance of the asset class, it had to scale back further allocations. Japanese pensions, which are known for being conservative, also fall in this bucket. One Japanese investor told Cerulli that it wants to consider investing in real estate and infrastructure to overcome the low-rate environment, but it is difficult to obtain approval for alternative allocations.

> [We have] no intention to take on more risk because of the maturity of [our] pension benefit assets. [We have] no intention to increase risk by raising the percentage of investment in alternatives."
>
> *– asset owner*

> We think we should start investing in real estate and infrastructure to overcome the low-interest rate environment, but it is difficult to gain approval for investing in alternative products."
>
> *– asset owner*

Moving Up the Risk Spectrum: Private Market Allocations

Instead of accepting lower returns, many investors have sought to move their portfolios up the risk spectrum in search of yield. Some investors cited moving money to non-traditional asset classes, like high yield, unconstrained fixed income, and private markets. Investors also pointed to moving money to different geographies, such as international equities and emerging markets. Some investors said they were targeting certain risks, including volatility risk, credit risk, and illiquidity risk. A multi-asset-class manager tells Cerulli that investors have generally looked to increase equity risk, both in public equity and private equity, and reduce allocations to traditional fixed income. Japanese pensions with whom Cerulli spoke mentioned that they are either reducing allocations to domestic fixed income or eliminating allocations entirely due to the low rates in Japan.

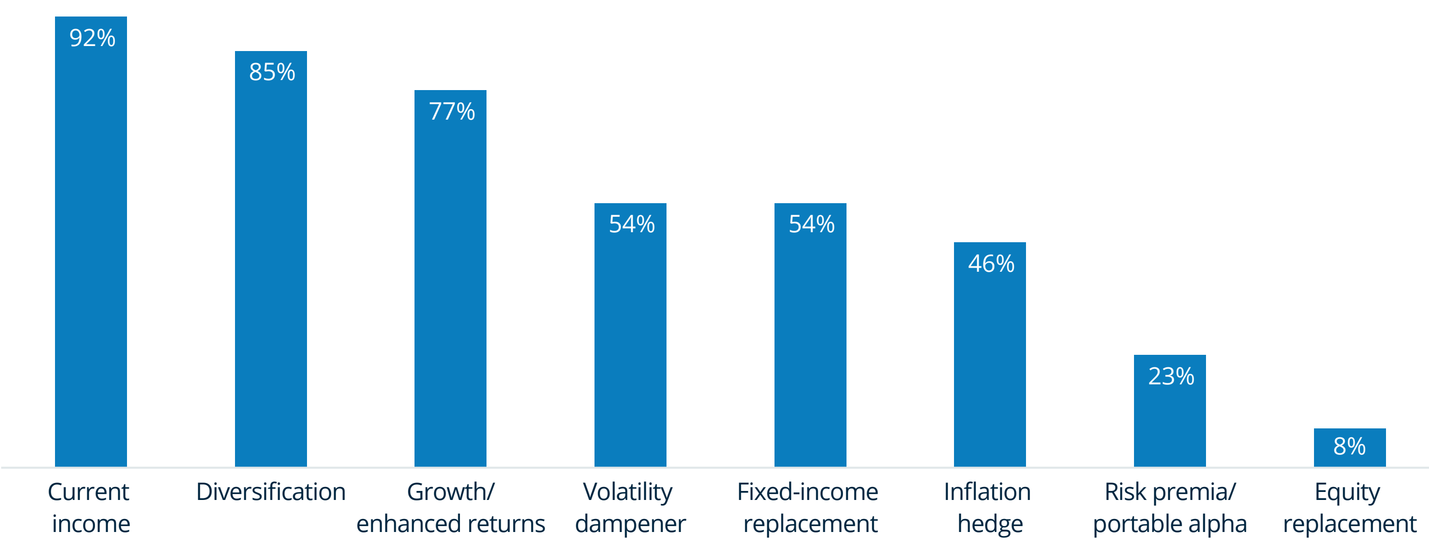
When asked about areas of opportunity, almost all asset owners and managers mentioned private markets. Most investors with whom Cerulli spoke had sophisticated private market portfolios, yet they were still looking to grow their allocations. There is an ongoing effort to access the full spectrum of private markets, broadly, and strategies within certain private market asset classes. For example, asset owners with allocations to traditional private equity (*i.e.*, leveraged buyouts) may be looking to expand into growth and venture capital. There is also demand for private fixed income. Several participants noted private market investments' role as a substitute for traditional fixed income, specifically citing asset classes such as real estate, private credit, and infrastructure. Several asset managers told Cerulli that they believe their clients can tolerate more illiquidity and, hence, allocate more to private markets.

> Post-2020 shock, private credit is pretty attractive, especially in Europe and parts of U.S.."
>
> *– asset owner*

> We have negative real yields… the bond market looks atrocious…. You are going to see a continued explosion in alternatives in places like private equity and credit. You will give up a lot of liquidity. Also real estate. Who knows how work-from-home will play out. I don't think cities will be abandoned. They might become equally residential as [they are] work-focused."
>
> *– asset manager*

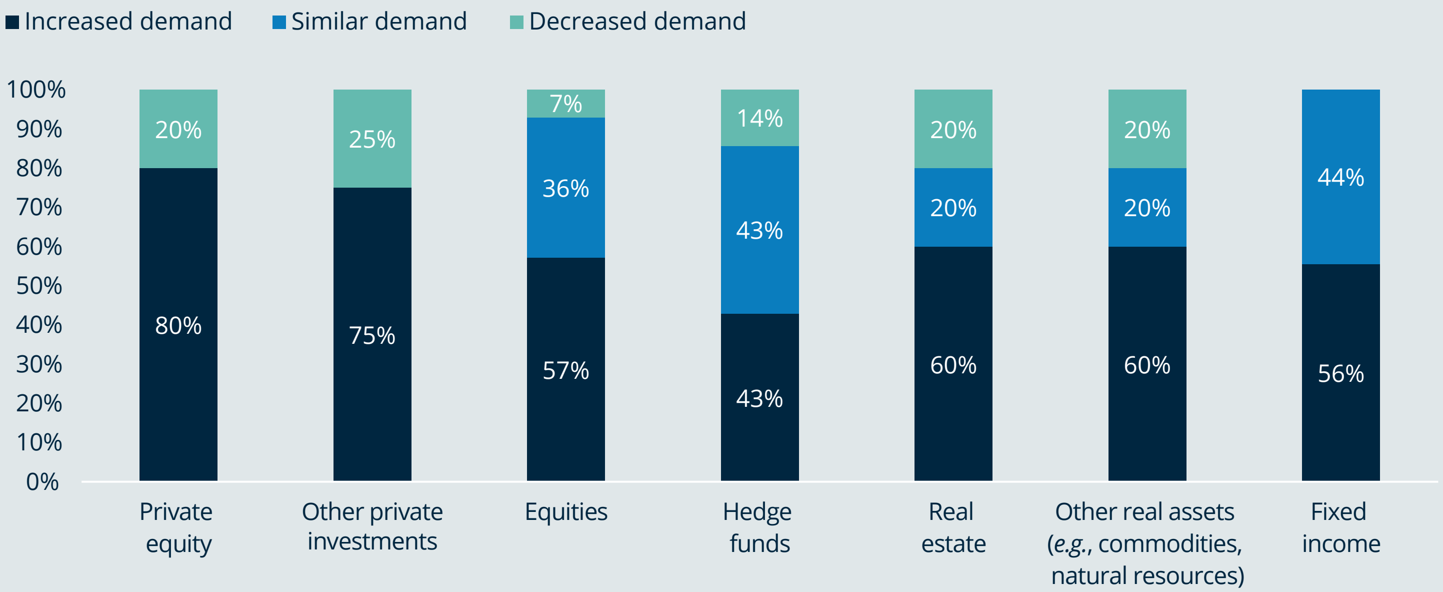
> What we are seeing today is a tremendous desire for private markets. That move is not finished; clients still want private markets where they can find yield and are willing to take more risk – either volatility risk, credit risk, or illiquidity risk – to fulfill their target returns."
>
> *– asset manager*

Asset Managers: Key Objectives of Private Market Investment Strategies, 2021



Source: Cerulli Associates | Analyst Note: "Deflation hedge" was provided as a choice but was not selected by any respondents. Respondents were asked to select all objectives that apply.

Asset Managers: Expected Changes in Asset Class Mandates, 2021



Source: Cerulli Associates

Superior performance of private market investments is generally credited toward an illiquidity premium. Asset managers interviewed for this study expanded on the idea of illiquidity premiums, asserting that "illiquidity" is not a comprehensive descriptor. An alternative manager tells Cerulli that investors are attracted to private markets because they have a "better chance at finding some overlooked bargains and a better chance at adding value with some proactive behavior." The ability to be early-stage investors and tax benefits are two additional features cited as valuable. One multi-asset-class manager tells Cerulli that the premiums derived from the asset class would be better described as complexity and access premiums. The former is a premium derived from how an investment is being managed, and the latter is a premium derived from how the investment is brought together.

> What you get in the private markets is you get to be an early-stage investor, tax benefits, and ownership. Those are attractive places to be. As more and more entities [expand] through VC, or PE, or private credit, you are seeing a proliferation of capital moving through those entities…You should see a lot of winners down the road. More and more of our client base likes it."
>
> *– asset manager*

> There's a premium. Not an illiquidity premium—more of a complexity or access premium. Either the asset being managed or the way it's brought together… Our advice has been that investors can tolerate more private assets than they have allocated, while at the same time, we are favorable on private markets from higher risk-adjusted return. [We are] acknowledging that investors have less of it in the portfolio than our recommended allocation."
>
> *– asset manager*

Aside from being a source of premium, illiquidity is an important consideration for investors. A nonprofit that is closed to new donations, for example, mentioned limitations for taking on additional illiquidity. Mainly, liquidity constraints are owed to the fact that the private nonprofit has a payout requirement based on net asset value. In addition to being an obstacle for investing, illiquidity can also be an asset. Several managers in this study said their clients valued the smoothing effects of private markets investing. Because these investments are not marked to market but are instead marked at book value, having them in a portfolio helps limit volatility. Public investments are subject to drastic swings in sentiment, while private investments are relatively insulated. Notably, some asset owners and managers look at this through a different lens, implying that the stability of private markets makes them look superficially attractive.

> What's really changed at Amazon last week versus this week? But the stock moved 15%. As the big plans have to pay out benefits, [they] are feeling uncomfortable with volatility in the public markets."
>
> *– asset manager*

> Private assets can look superficially attractive because there's no volatility because there's no mark to market. Sometimes when you can look at private debt strategies, it looks like you achieved very nice returns and low volatility, but that's a misrepresentation."
>
> *– asset manager*

> Private equity - you can't do tactically; they are long-term in nature and difficult to reverse course. So the allocations we made 10 years ago, we are cognizant of how we are reinvesting this capital."
>
> *– asset owner*

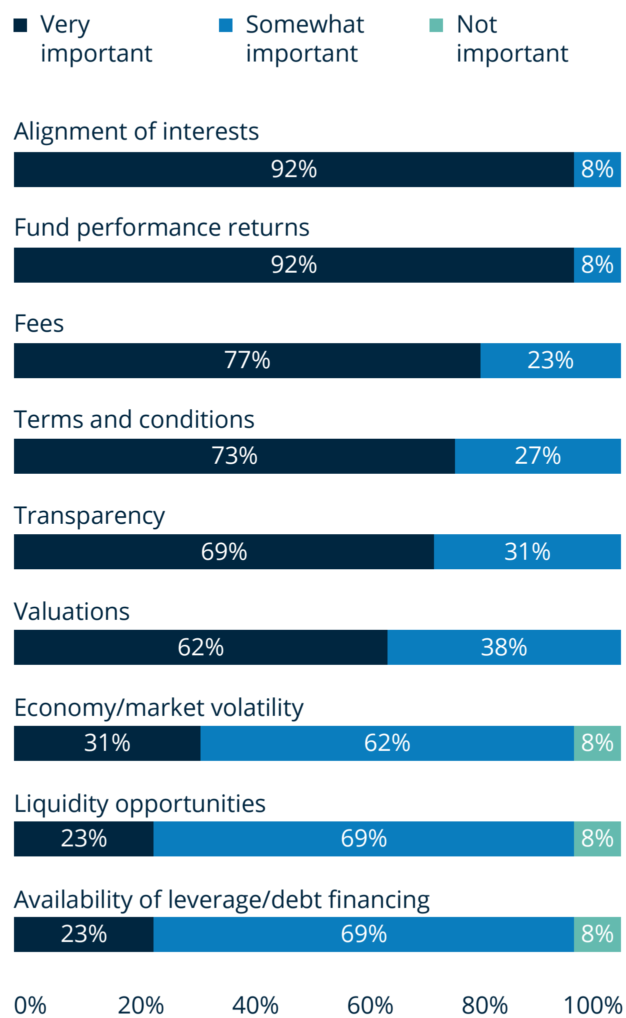
Another distinguishing characteristic of private markets investing is performance dispersion. The private markets space is known for its large performance dispersion between managers. This means that the private investment universe's superior performance is skewed, or disproportionately attributed to the top-performing general partners. The skewed performance means that general partners with good track records generally have more bargaining power in terms of things like fee negotiation. It also means the top performers can almost pick and choose their investors. When raising funds, they can go to the largest asset owners and are not burdened with managing a multitude of small relationships. This is why access to private markets is increasingly something investors focus on. It's also one of the key value-adds of working with an OCIO.

One manager with whom Cerulli spoke mentioned a unique challenge presented by illiquidity in private markets – performance measurement. Given that public equities are marked to market, performance can be evaluated regularly, giving asset owners the ability to tailor their analyses in more ways (*e.g.*, assess performance over short or long-time horizons). Because private market investments are marked at book value and performance really only matters upon exit, there is a large lag effect in assessing the general partner's track record. The most successful general partners have performance track records that display the success of their investment decisions from years ago. Furthermore, upon exit, things like market sentiment are brought back into the equation.

> We want to make contact with private equity managers, but do not have direct access with highly qualified ones. Addressability to highly qualified private equity is low, as few reputed private equity [managers] want to do business with the first-time investors like us. Currently, we are using funds of funds for private equity, but we would like to invest in PE directly."
>
> *– asset owner*

> Private is a more crowded space, and you want to make sure you are getting top-quartile investments."
>
> *– asset manager*

General Partners' Perception of the Most Important Attributes for Limited Partners and Investment Consultants, 2021



Source: Cerulli Associates

Although the private investment world has exhibited superior growth in recent years, 10X10 participants note that this does not shield them from the same outlook of other asset classes. There is also a unique challenge in the form of herd behavior. Superior performance in the private investment space has led to a large flow of institutional money. Throughout this research, Cerulli asked participants to comment on the excess dry powder in private markets. The most common response was that, due to excess dry powder, private equity returns will be compressed. Because there is so much committed capital, firms will have to make deals with lower payouts.

> “Given the shift in assets towards privates, effectively that means there is too much money looking for returns. We think there will be continued growth in private markets, but they will offer returns less attractive than they have been.”
>
> *– asset manager*

> “If there’s a lot of capital in them, that can lead to poor lending decisions… Performance [in private equity] has been falling, but the risk has also been low, so the risk and return ratio has remained steady.”
>
> *– asset manager*

> “The dry powder makes me believe returns will be diminished. Thinking about the flows into those sectors, they can’t invest that money into good investments fast enough.”
>
> *– asset manager*

> “There’s too much money in this part of the market. That means there will be transactions that aren’t credit-worthy—that wouldn’t have otherwise been done. A concern would be that a private debt portfolio that is being put to work today is likely to be invested in assets with less attractive yields, with a weaker pool of issuers. When you look at historic returns, you can’t necessarily extrapolate those into the future.”
>
> *– asset manager*

Biggest Risks Private Equity Firms Are Currently Facing, 2021

Source: Cerulli Associates

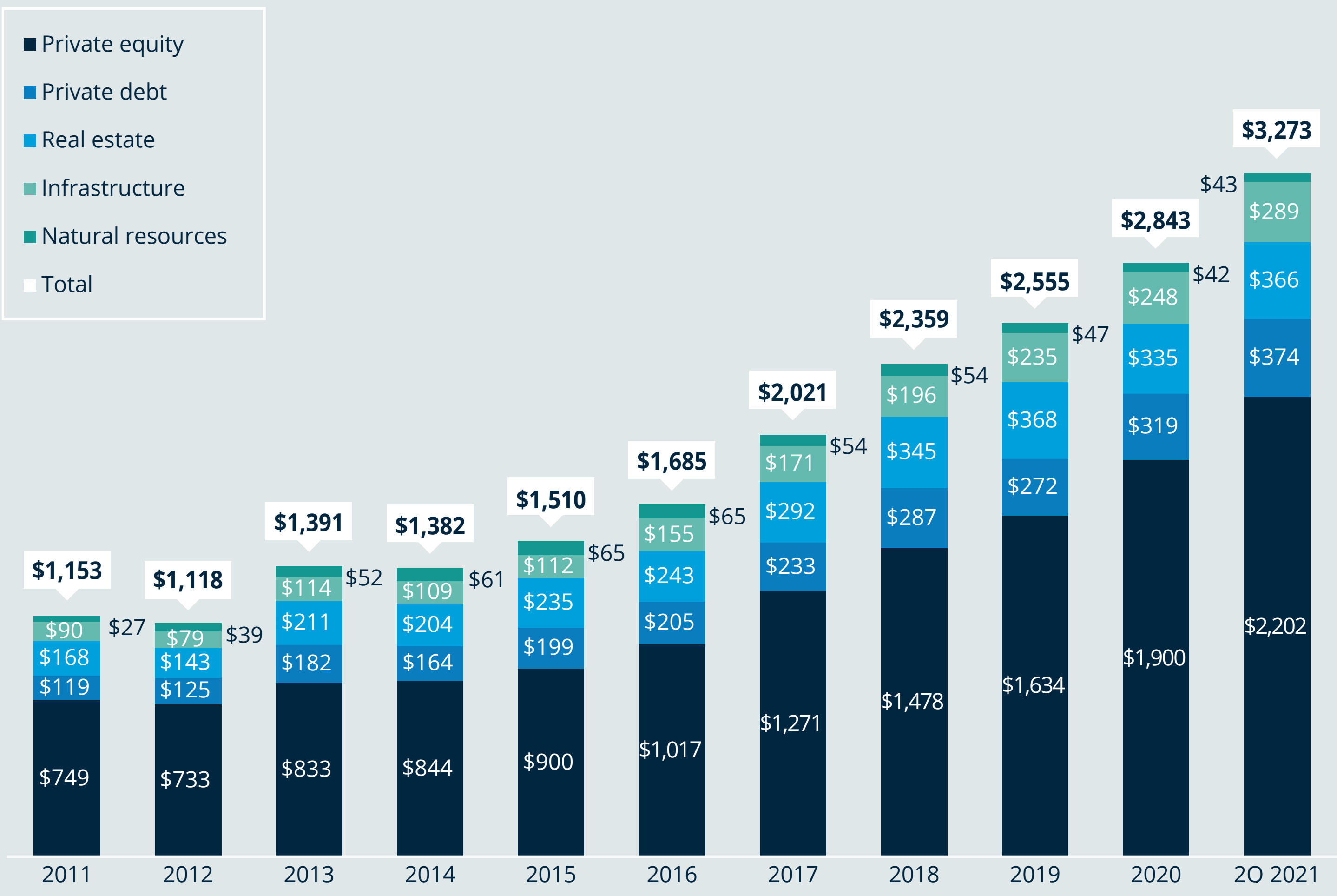
An alternative manager compared the current state of private equity to asset classes that experienced similar bubbles. Specifically, it described how the tech bubble burst. "When people got so excited about stocks, they amped up prices to the point where they could lose." As the economy went into a three-year decline, investors saw the performance of hedge funds and money aggressively followed, so much that hedge funds eventually followed a similar fate. "You don't hear about how clever they are anymore. Now, the hedge funds have dropped out and it's all about private equity."

> Good performance brings more money, and more money brings bad performance if you let the process go unchecked."
>
> *– asset manager*

> So you think private equity is different from equity? In some ways it is, but you have high fees and I'm not convinced people will get the returns they expect in that area either, especially looking at the amount of dry powder out there."
>
> *– asset owner*

> There's a ton of flows in private investments. That's why we constrain our annual investments, so we don't get ahead of our skis… We make an upfront commitment to the investment committee, and if we don't find anything, we don't spend it."
>
> *– asset owner*

Global Private Investment Dry Powder, 2011-2Q 2021



Source: Preqin

Acknowledging the excess dry powder in the private space, a multi-asset-class manager told Cerulli that there's a lot of liquidity everywhere, beyond just private markets. This manager posits that excess liquidity just means that the cost of funding for startups will go down. Another manager seemingly agreed, saying the growth of the public equity space has been substantial so the opportunity set in private companies should be growing commensurately.

> There's a lot of liquidity everywhere...it just means that the cost of funding for these startups will go down. I think it's pretty healthy. End-returns might come down a bit. But maybe there's a whole new generation of privates that sprout up in sustainable or tech space[s]."
>
> *– asset manager*

> The growth of the public equity market has been quite substantial. Private market commitment levels and the opportunity set is growing commensurately as well...We think there are distinguishing characteristics in the middle market. That gives some added benefit in terms of the overall commitment to the private market."
>
> *– asset manager*

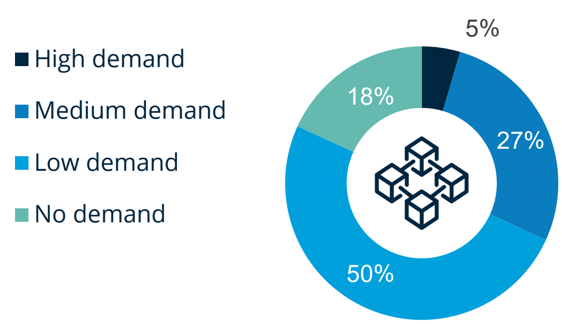
Institutional Allocations to Cryptocurrency

Cerulli asked asset owners and managers about their thoughts on cryptocurrency. While there were varying levels of interest, no asset owners had current allocations, nor did any asset managers have institutional clients with current allocations. Rather, this is a topic that is sometimes debated in internal investment office meetings. Multiple participants cited a generational divide in these debates, with younger employees more pro-crypto than older employees.

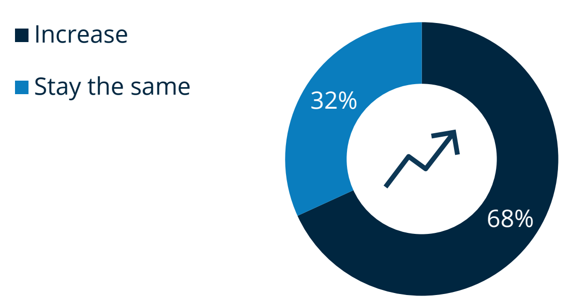
> We talk about crypto a lot. We have quite big diversity on crypto between the older folks and younger folks on the team. The younger folks are much more interested."
>
> *– asset owner*

Asset Managers: Perceived Demand for Cryptocurrency Exposures, 2021

Demand for Cryptocurrency Exposure



Expected Change in Demand



Source: Cerulli Associates | Analyst Note: Survey respondents were asked about their perceptions of demand from both institutional and retail clients.

The main barrier to investing in crypto is the lack of framework surrounding its role in institutional portfolios. Unlike other asset classes, crypto does not yet exhibit a risk-return profile. Participants were skeptical of its valuation. Some said it is more of a tool for speculation and cited its drastic volatility as a concern. Still, some participants said it has the potential to be a store-of-value asset.

> I can't see any [crypto-currency] investments in the near future. Partly it's around the fact [that] I can't see them, evidenced by the volatility, as a store of value. They are like an infinitely dated zero-coupon bond. If that's the case, you get massive volatility...Apart from speculation, I can't think of another reason to hold it. They don't produce income, they are not stable value, [and] they have poor regulation. At least for something like gold, you have some certainty. You know it pays no income and it has a cost of storage, it's inversely correlated with interest rates, [there is] limited supply, and [it exhibits a] history of volatility over time."
>
> *– asset owner*

> We struggle with the valuation of crypto / defining it as an asset class without a cash flow stream. [It's] not clear how we can ever make that allocation as an implicit part of a strategic portfolio. People do trade Bitcoin futures at the firm. It's never been sanctioned by governments. Could we find that as a way it becomes more of a store of value? A government would have to do that, and China has done the opposite. Other central banks are trying to create their own digital currencies. Less cash in the economy leads to higher tax revenue. It seems like displacement of crypto currencies with digital currencies is the theme in the long term. Crypto doesn't have an obvious place in a portfolio."
>
> *– asset manager*

> We do not feel that digital currency and blockchain are reliable. As a pension fund with AUM of more than Y1 trillion of assets, investing a small amount has no meaning, and we cannot see the exact impact from such a small investment. However, this might change if the central bank secures digital currency by any measures."
>
> *– asset owner*

> [It's a] hard no...it is way too speculative for our taste. [There's] room for it in some portfolios, but we are conservative portfolio."
>
> *– asset owner*

> We need to have more information on this before starting such investments."
>
> *– asset owner*

Those that are more pro-crypto said that it has the potential to become a store-of-value asset, and that digital currencies are the future of this space. An alternative manager and corporate pension sponsor told Cerulli that they had exposure to crypto albeit indirectly, holding investments on the infrastructure around crypto.

> There's a new generation that feels that there are other stores of value than dollars in a bank...We have seen clients that want an allocation to this. I would say, 99.99% are non-institutional clients, mostly private."
>
> – *asset manager*

> Crypto is where ESG was five years ago - a lot of people talking about it but no one really doing it... Gen Z and Gen Y think about it differently than older generations. Does that influence consumer behavior as they become a larger portion of the economy?"
>
> – *asset owner*

> No one in our world is investing directly in crypto... It just isn't in our world today. We view the infrastructure around crypto as part of our venture portfolio, not as a separate asset class."
>
> – *asset manager*

In addition to the lack of an investing framework, participants mentioned additional concerns, including uncertainty in how governments will treat the assets in the future. One manager mentioned that cryptos are not ESG-friendly, specifically pointing to its record of being a channel for funding nefarious activities and circumventing tax payments, as well as its energy-intensive mining process. Another manager said that, although there is general interest, the space is not ready for institutional money, as it has yet to go through its growing pains and remains highly unregulated.

> I think blockchain is a great innovation but, really, when you look at crypto currency, it largely exists today as a tool for speculation. They own it because they want to get rich quick."
>
> – *asset manager*

> It's the Wild West. Up until recently it wasn't clear what custody meant...This space is not yet ready for institutional investment...More institutional regulation would be good for us, but at the moment, it's a crazy space."
>
> – *asset manager*

Fee Compression

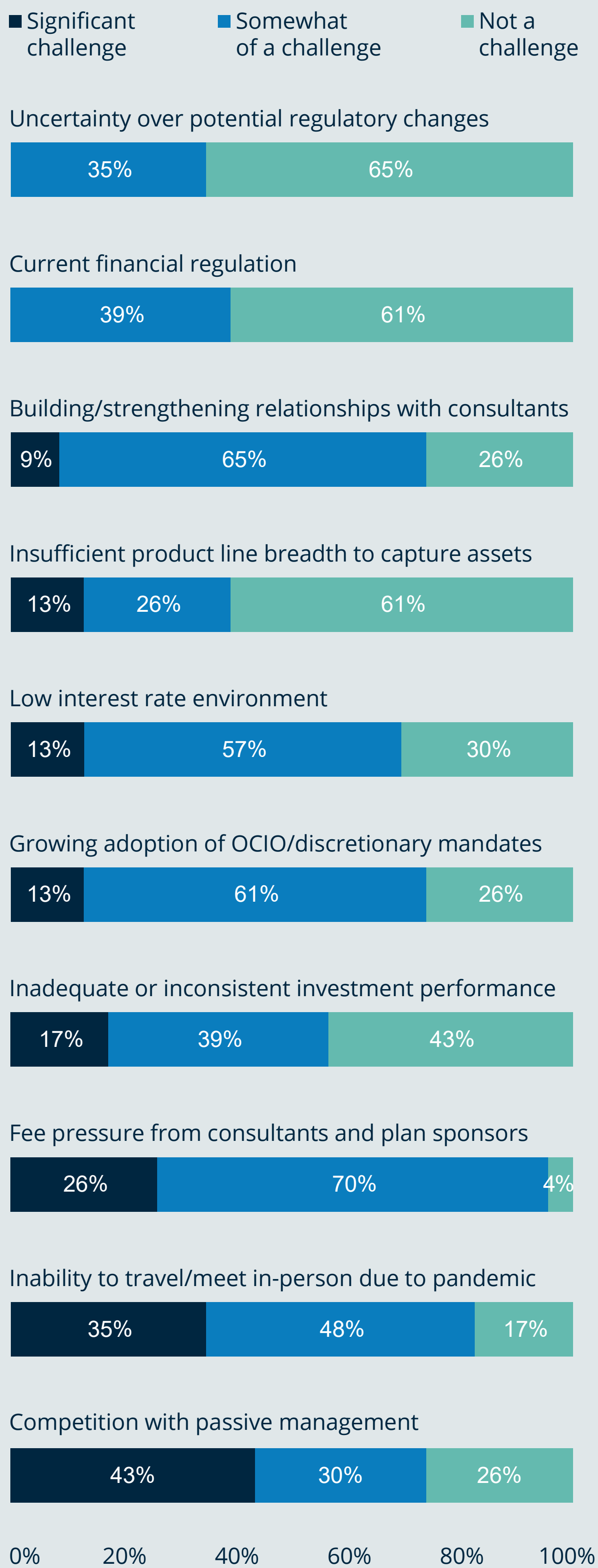
While the pursuit of returns is ongoing, many investors have focused efforts into addressing costs. Management fees have been declining over multiple decades across many asset classes. However, there are multiple factors that make fee compression a greater challenge for asset managers today than it has been in the past. Over the past decade, many active asset managers have struggled to deliver alpha relative to the indices, and, as a result, asset owners have allocated more heavily to low-cost passive products.

> They love us when we make money for them in tough times and then hate us when things are all good and question our fees...I think we prove our worth when times are difficult."
>
> *– asset manager*

In several ways, asset management has become a commoditized business. Advances in technology have made the costs to entry relatively low for new managers that want to compete for assets. In order to differentiate themselves, asset managers have touted high-quality client service and provided advice beyond the scope of a traditional mandate. One fixed-income asset manager told Cerulli that he tells his sales team, "We cannot control performance, but we can control everything else. So, let's make sure we have excellent service, and clients will be willing to give [us] the benefit of the doubt on fees." Higher levels of service often take the shape of more frequent communication, access to key investment decision makers, customized reporting, or knowledge sharing beyond the scope of the mandate. All of these require a substantial strain on resources. In this way, asset managers are faced with a challenge to not only top-line revenues, but to profitability as well.

> There's no question that the amount of services we provide has gone up. For the dollar of income we got 30 years ago, that has gone down because we are doing far more for our clients."
>
> *– asset manager*

Asset Managers: Biggest Challenges to Acquiring Institutional Client Assets During 2020

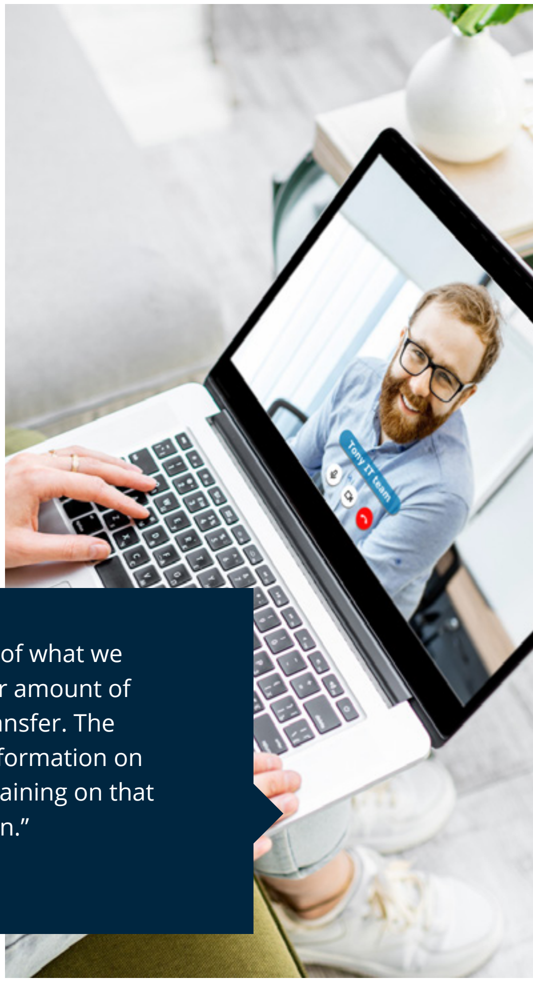


Source: Cerulli Associates | Analyst Note: Other responses indicate that "valuation levels for U.S." and "continuing growth vs. value disparity" are both significant challenges.

Public vs. Private Markets

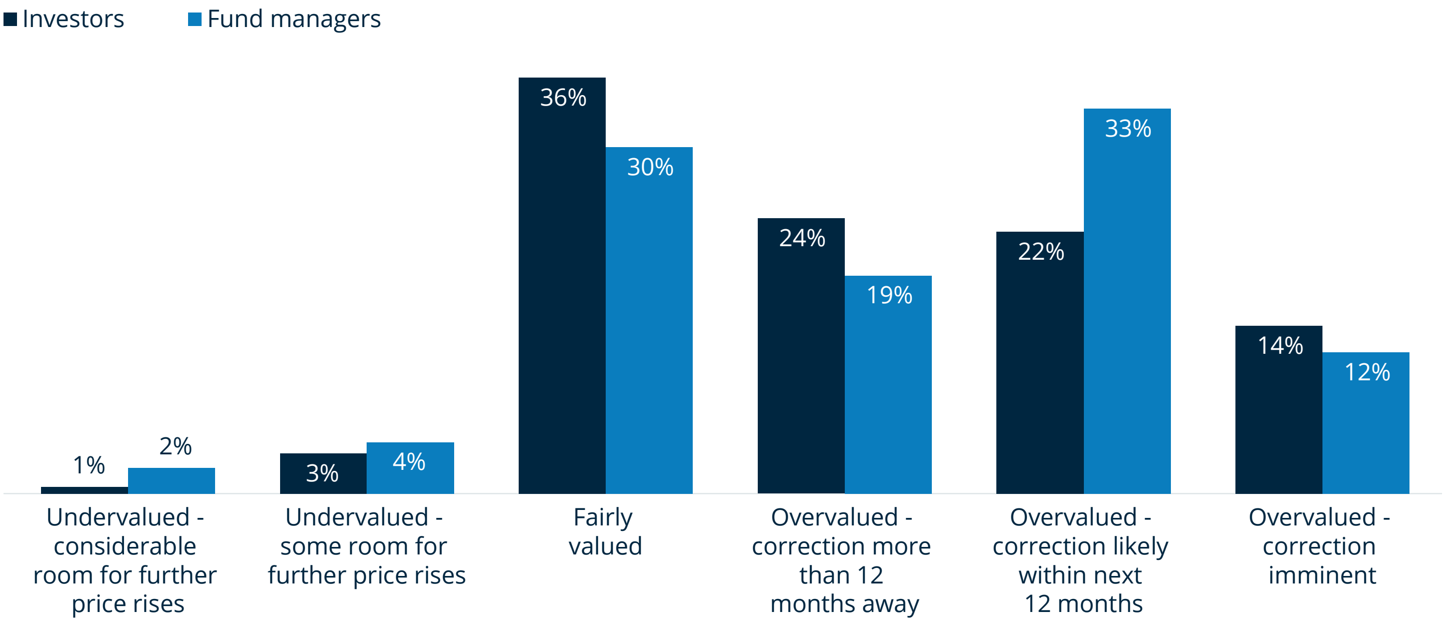
Fee compression occurs mostly in the public markets and specifically in asset classes that are less capacity constrained. In private markets, general partners are less willing to negotiate on fees for several reasons, including the existence of capacity constraints, complexity of the investment solution, and inability to provide discounting due to existing most-favored-nation (MFN) clauses. As one alternative asset manager told Cerulli, "In the alternatives space, high-performing managers aren't going to get fee pressure because the ability to get into the funds is a scarce commodity." Because alternative funds are not marked-to-market, managers with strong historical performance track records are at an advantage in setting fees. Managers without a strong track record may be more willing to succumb to fee pressure and explore structures where they can justify their fees, such as offering co-investment opportunities.

Asset managers in private markets have not been insulated from the trend of increasing service levels. In fact, asset owners expect a high level of service to justify the relatively high management fees. So, while private market managers have not yet experienced the amount of pressure on fees that managers in the public markets have, they are also facing pressure to their profit margins as they are committing additional resources to servicing their clients. One alternative asset manager told Cerulli, "One of the ways we've evolved the business is that we have tried to be better partners with our stakeholders to advise them in their investment strategies."



> "Training is now a normal part of what we offer clients. They expect a fair amount of knowledge and technology transfer. The software we use to provide information on their portfolio – they expect training on that and want to use it on their own."
>
> *– asset manager*

Investors vs Managers: Views on Private Equity Pricing, 2019



Source: Preqin

Asset Owner Perspective

Asset owners will often, and are sometimes legally obligated to, explore opportunities where they can reduce management fees. Fees may appear low in terms of basis points, especially when compared to where they were in prior years; however, asset owners are evaluating fees in nominal values that represent substantial costs to their institution. Several asset owners explained that their thinking on fees is shaped, in part, by fee benchmarking reports supplied by their investment consultant. However, fees are not the only priority in the investment decision-making process. As one corporate retirement plan sponsor told Cerulli, "We don't let the tail wag the dog. We don't let fee considerations impact investment decisions." A Japanese pension explained further, "Our process is to choose a manager and negotiate fees after they have been selected." Fees are an important consideration when selecting a manager for a mandate; however, asset owners are open to higher fees where it can be justified through strong investment performance, and to a lesser extent, high-quality client service. The primary question asset owners are trying to answer when evaluating fees is, "Am I getting what I am paying for?"

> We aren't of the mindset that lower fees are always better, because you get what you pay for. All things equal, lower fees are better, but we've tried to make sure we are ever diligent that our fees are incredibly competitive."
>
> *– asset owner*

An asset owner's evaluation of fees can differ depending on the size and sophistication of the manager. When a manager of scale can provide strong investment performance along with a high level of service, an asset owner will often evaluate opportunities to employ a broader mandate with that manager in an effort to reduce the overall management fee. One corporate retirement plan sponsor explained to Cerulli that it originally had two separate, smaller mandates with the same manager in two different geographies. In an effort to reduce fees, they explained, "We want [the manager] to look at the amount of assets we have globally and treat us as a global client rather than from each individual market." Relationship pricing (*i.e.*, management fees based on the total size of the relationship rather than each individual mandate) is a common fee reduction strategy that presents a win-win opportunity between asset owners and asset managers. More competitive pricing for total relationships has led to asset owners consolidating their manager lineups.

> There are fewer managers within institutional investors' portfolios, so as a result they are looking for fewer managers but managers that can do more than one thing. So you are seeing a growth in the number of multi-asset mandates."
>
> *– asset manager*

Employing larger, broader mandates with an individual manager creates efficiencies on the pricing and client service side. It allows the relationship to become more akin to a partnership than a standard transactional relationship. In an effort to provide a high level of service to sophisticated clients, one multi-asset-class global asset manager told Cerulli, "We provide a lot of investment advice, share research, share [our thoughts] about strategic asset allocation, and we know that forges a stronger connection." This level of service requires a manager to have a robust platform that has the infrastructure to support a more involved client relationship without adding additional resources.

Asset owners do not always apply the same level of pressure on fees for emerging managers that they do for established managers. Some asset owners have implemented initiatives where they are working with emerging managers who fulfill a key diversity metric (*e.g.*, women or minority ownership). In these instances, asset owners are hoping to create long-term, sustainable relationships. One nonprofit investor told Cerulli, "If it's a brand-new manager, we may start with high fees, and ramp down as they get further in the management process. So as we put more money in, and as other firms put money in, we will ramp down the fees." Reducing fees in those situations can impact the stability of the relationship and the viability of the manager long-term.

> We don't want to create a situation where the manager is fighting for every cent. We want that to be a sustainable business long-term."
>
> *– asset owner*

Managers' Adaptations

In an environment of reduced alpha, asset managers have had to differentiate themselves through a reduction in fees and an increase in the quality of service they provide to their clients. Shrinking margins present a challenge for asset managers that do not have the scale to deliver an enhanced client service model without constraining resources. Fee compression has left little pricing power in the hands of managers. Reducing service levels is not an option either, as one multi-asset global asset manager explained, "You cut service at your own peril." The only options for managers are to add scale or streamline their operations through the use of technology.

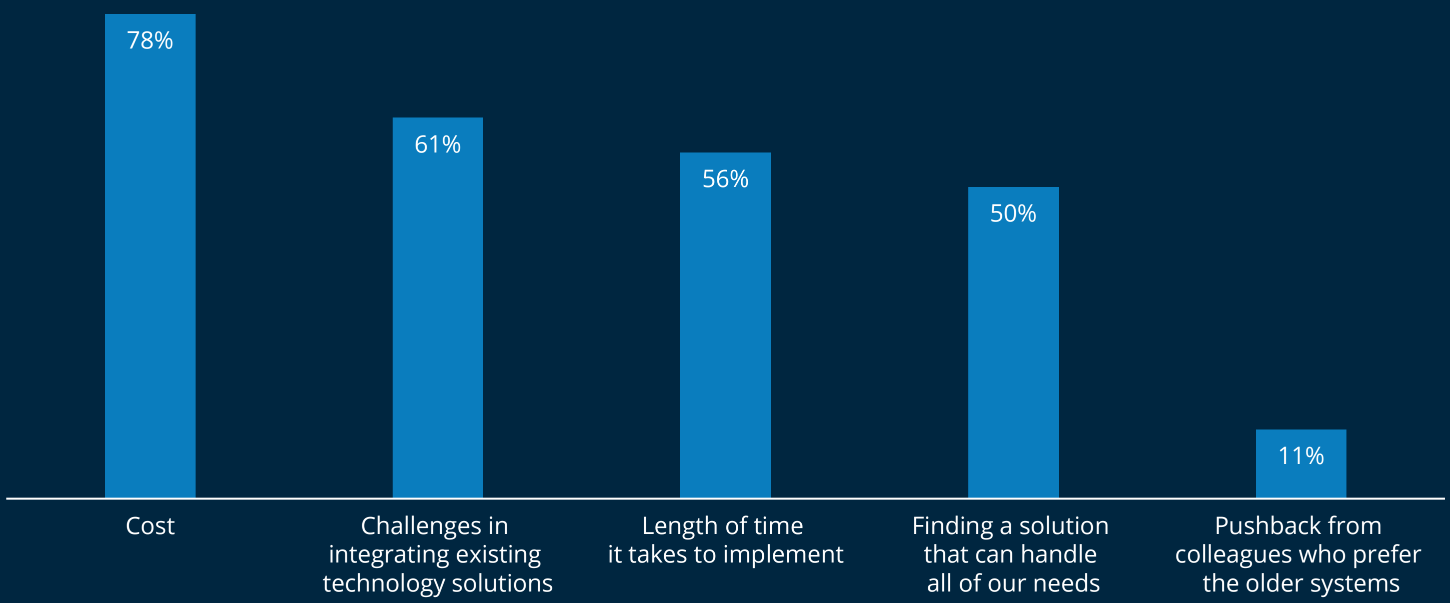
> "We are investing heavily in technology. There was a time when PMs would manage one or two portfolios, now they manage 20 or 30. We are working to make ourselves as lean as we can."
>
> – *asset manager*

Leveraging technology is a common method for managers to create efficiencies in their investment and client service processes. One asset manager explained to Cerulli that implementing technology is just a natural progression of the business, and that, regardless of fee pressure, they would still be exploring areas to improve the business. However, many found that technology could improve their workflows and reduce the stress put on their client service teams. Online portals where a client can access various tools to run portfolio analytics in their own offices was cited as a beneficial mechanism by both asset managers and asset owners.

> "One of the piece of data analytics we designed is so that the client can do everything they need in their own office."
>
> – *asset manager*

Asset managers and asset owners alike have found that the increased use of videoconferencing due to the COVID-19 pandemic has been beneficial in terms of enhancing the quality of routine meetings. Specifically, videoconferencing has allowed managers to gather their expertise from around the globe and give clients access to more individuals. Where videoconferencing is less effective is in building new relationships between asset owners and asset managers. So, while in-person meetings have been occurring with increasing frequency, Cerulli expects that videoconference meetings will continue to play a role for routine, relationship-maintenance type meetings.

Asset Managers: Challenges in Implementing Technology Changes, 2021



Source: Cerulli Associates

Long-Term Ramifications

A common theme in the discussions with asset owners and asset managers around fees is that fee pressure will inevitably drive consolidation in the asset management industry. One fixed-income asset manager told Cerulli, "You have pressure on revenues and administration. Asset managers are struggling to deliver a profitable outcome." The dynamics for smaller, specialist managers are different due to their boutique service offering. Many asset owners and managers expect that the asset management industry will evolve into subsets of large, established managers with robust platforms and small, boutique managers. This leaves a diminished middle-tier of managers. Some asset managers with whom Cerulli spoke believe that consolidation will return some of the pricing power back to asset managers.

> "I think there will be the big-scale players that will achieve profitability because they have a robust operating platform. So they can scale without adding cost or headcount. And then you will have the specialty boutique firms, or hedge funds. I think we are heading towards a core-satellite model – scale players and boutiques."
>
> *– asset manager*

Attributes Highlighted by Asset Managers when Selling to OCIO Providers, 2021

Source: Cerulli Associates

Fee pressure in the institutional asset management industry is not a new challenge, but it is being met in conjunction with an increased demand for better client service. Fee compression has evolved from a revenue to a profitability challenge and this shift has long-term ramifications for the industry. Asset owners are looking to consolidate their manager lineups and employ relationship pricing where possible. Asset managers are leveraging technology-based solutions like client portals in an effort to become more efficient. For many, a reduction in profit margins is a signal of an upcoming period of consolidation that will leave only large-scale asset managers and boutique specialists. Consolidation may eventually give asset managers more pricing power, but for now the pressure on asset managers' profit margins remains.

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info@cerulli.com www.cerulli.com @cerulli_assoc /cerulli-associates