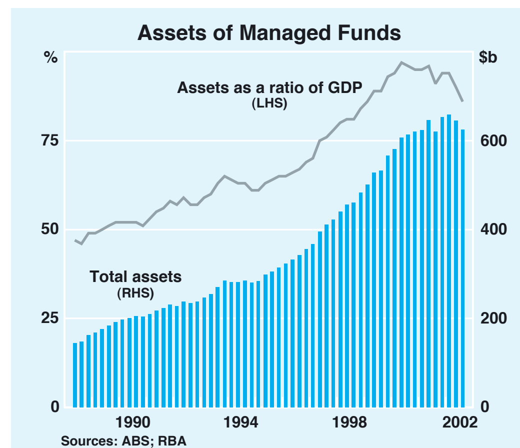
Australian Funds Management: Market Structure and Fees

In 2002, the Reserve Bank of Australia, along with several other central banks, participated in a study of the world's funds management industry co-ordinated by the Bank for International Settlements. This article sets out some facts on the Australian funds management industry that were gathered as part of that study. The information comes mainly from interviews with industry participants.[1] Two issues which received attention in the study are the role of specialist monitors, such as asset consultants and financial advisors, and the structure of fees charged by funds managers.

Market Structure

The value of funds under management in Australia has grown at an average annual rate of 11 per cent since the late 1980s, to now stand at 86 per cent of GDP (Graph 1). Over 70 per cent of these funds are invested through superannuation products. Most of the remainder is invested through unit trusts such as cash management trusts and managed equity funds.

Graph 1



Superannuation funds typically take one of five institutional forms:

1. corporate funds, which are sponsored by a single employer or group of related employers and cover employees;
2. public sector funds, which cover public sector employees;

1. Interviews were conducted with representatives of the following organisations: AMP Henderson Global Investors Limited, Assirt, AXA Australia, BT Funds Management, Colonial First State Investments Limited, Deutsche Asset Management, Frank Russell Company, Frontier Investment Consulting Pty Ltd, ING Investment Management (Australia), InTech Financial Services, National Australia Bank/MLC, Macquarie Investment Management Limited, Mercer Investment Consulting, Securities Industry Research Centre of Asia-Pacific, and Westpac Investment Management.

3. industry funds, which cater for employees as a result of an agreement between the parties to an industrial award and typically draw members from a large number of employers;
4. retail public offer funds, which allow members to join by purchasing investment units or policies; and
5. self-managed (or 'do-it-yourself') funds.

Over the past two years, industry and retail public offer funds have grown strongly and now account for 10 per cent and 35 per cent of superannuation assets respectively. Small funds (with less than 5 members) and self-managed funds have also grown considerably to now hold 20 per cent of superannuation assets. In contrast, the aggregate assets managed by corporate and public sector funds have fallen. Increasingly, private sector companies are outsourcing the provision of superannuation; as a result corporate funds' share of superannuation assets fell from 27 per cent in June 1995 to 14 per cent in June 2002. The fall in public sector funds' assets reflects a longer-term decline in public sector employment. Nevertheless, public sector funds still account for 21 per cent of superannuation assets.

While some superannuation funds invest directly in assets such as shares and property, it is more common for them to outsource the management of their assets. Accordingly, around two-thirds of all superannuation assets are placed with funds managers.

The funds management market in Australia is dominated by funds management companies owned by domestic banks, life insurance companies and international financial groups. The dominance of the large players has grown in recent years, with many mid-sized players (with funds under management of $5 billion to $15 billion) either merging or having been taken over by larger companies. As a result, the share of funds under management administered by the 10 largest managers has grown steadily, rising from 56 per cent in June 1997 to 65 per cent in June 2002. At the same time, however, there has been a stream of small, boutique fund managers entering the Australian market. These managers are usually independent companies which service the wholesale market only and concentrate on a relatively narrow range of assets.

The funds management market has historically been divided into retail and wholesale segments. The retail market serves individuals, such as those managing their superannuation on a 'do-it-yourself' basis, rolling over superannuation after changing employers, or investing in a master trust selected by their employer. The wholesale market serves superannuation funds and other large institutions. While overseas there is a tendency for the retail and wholesale sectors to be served by different funds managers, in Australia there is considerable overlap. About two-thirds of all funds are managed by funds managers that service both retail and institutional investors, and the five largest managers of retail assets are among the ten largest managers of wholesale assets (Table 1). Moreover, the distinction between retail and wholesale markets is blurring with the development of wrap accounts that offer wholesale-style products to retail investors.[2]

Specialist Monitors

With the growth in funds under management and an increase in the share of superannuation funds that have outsourced their funds management, the role of specialists who monitor the activities of funds managers has become more important. The monitors play an important role in determining which asset managers are used by superannuation funds and individual investors. There are three main types of monitors (often referred to as

2. Wrap accounts provide investors with a comprehensive portfolio management service. Benefits include access to a range of investment products, often at wholesale prices, sophisticated reporting tools and a relatively simple fee structure.

Table 1: Largest Retail and Wholesale Funds Managers
September 2002

Retail			Wholesale		
	Total assets	**Market share**		**Total assets**	**Market share**
	$b	Per cent		$b	Per cent
Commonwealth Bank/ Colonial First State	46.1	20	Commonwealth Bank/ Colonial First State	19.0	15
National Bank/MLC	32.4	14	AMP	14.3	12
AMP	27.8	12	Vanguard Investments	9.4	8
ANZ Bank/ING	20.1	9	National Bank/MLC	8.0	6
Westpac	16.0	7	Credit Suisse Asset Management	7.4	6
AXA Asia Pacific	14.4	6	Perpetual Investments	6.9	6
Macquarie Bank	10.9	5	Merrill Lynch	6.6	5
BT Financial Group	10.6	5	Westpac	5.8	5
Perpetual	6.6	3	ING	5.7	5
Tower	4.1	2	Maple-Brown Abbott	5.3	4
Total	**189.0**	**83**	**Total**	**88.4**	**72**

Source: Assirt

'gate keepers'): asset consultants, the operators of master trusts and financial planning advisors.

Asset consultants

Asset consultants provide advice to wholesale investors on a wide range of issues, with their main role being to rank and recommend funds managers. Many of the asset consultants' clients are trustees responsible for administering superannuation funds. Consultants are thus particularly influential in determining the short-list of managers that trustees consider. About 85 to 90 per cent of wholesale mandates administered by funds managers come to them as a result of asset consultants' recommendations.

Asset consultants also provide advice as to how investors should spread their investments across a range of assets. Over the past decade or so, there has been a shift away from balanced funds (which invest across a range of broad asset classes – equities, bonds, property) towards funds that focus on only one asset class. This has created an increasing role, usually performed by asset consultants, to advise trustees on how to allocate investments across asset classes.

It is usual for asset consultants to be remunerated on a fixed fee-for-service basis. This has limited the potential for fee income to rise in line with the value of funds under advice. One response of asset consultants to this has been to move into 'implemented consulting', whereby an asset consultant actually manages clients' funds by investing those funds with a selection of funds managers. In effect, the asset consultant operates its own 'fund of funds', moving funds between managers on the basis of its assessment of the managers' likely future investment performance. This practice in effect delegates the selection of funds managers to asset consultants, and has therefore strengthened their influence over the direction of investment. Some players in the funds management industry are concerned that consultants' dual role of being in competition with funds managers while also

Table 2: Composition of the Asset Consultant Market
June 2002

Consultant	**Number of funds advised**	**Funds under advice** $ billion	**Share of funds under advice** Per cent
John A Nolan & Associates (JANA)	24	34.0	20
Mercer Investment Consulting	217	33.0	19
InTech Asset Consulting	7	25.7	15
Frontier Investment Consulting	15	17.1	10
Towers Perrin	51	16.5	10
Frank Russell Australia	20	14.5	8
TRM/JANA	2	9.8	6
Watson Wyatt Worldwide	34	5.0	3
Sovereign Investment Research	1	2.9	2
AMP Consulting	28	2.5	1
Total – Ten largest consultants	**399**	**161.0**	**94**
Market total	**504**	**172.1**	**100**

Source: Rainmaker Information

evaluating them may present a conflict of interest.

The asset consultant industry is more highly concentrated than the funds management industry. According to Rainmaker Information's survey of around 500 corporate, government and industry superannuation funds, the top five asset consultants account for three-quarters of funds under advice (Table 2). To some extent, the greater concentration is to be expected as asset consulting is a more specialised role with potential for economies of scale in information processing. The concentration of asset consultants can, however, carry the risk of a lack of diversity in investment advice.

Master trusts

Master trusts aggregate superannuation funds from employees of a number of unrelated employers and allocate them to funds managers. In the same way as asset consultants are influential in determining the short-list of managers considered by the trustees of a superannuation fund, master trusts can influence the allocation of retail investors' funds across individual funds managers.

Master trusts are typically operated by financial institutions. While many of these also own funds managers, the trusts do not limit investments to funds managed by their related funds manager. Master trusts generally take one of two forms. Discretionary master trusts allow the investor to choose from a menu of investment funds (i.e. the investor selects both the product type and the funds manager). Non-discretionary (or fund-of-funds) master trusts allow investors to select a broad investment strategy but the trust selects the funds managers to implement that strategy. Although the number of funds listed on a discretionary trust's menu may be large, by specifying the list of investment funds an investor may choose from, discretionary master trusts shepherd funds towards the managers on their menus. Non-discretionary master trusts exert more direct influence on the distribution of investment across asset classes and individual funds managers.

Assets under management in master trusts have risen from less than $12 billion four years ago to over $130 billion as at June 2002. The use of master trusts has been supported by the shift from defined benefit to defined contribution superannuation funds. In

1982/83 82 per cent of superannuation fund members were in defined-benefit schemes; by 2002 that share had fallen to 14 per cent. This shift to defined contribution schemes has in turn led to funds offering employee investment choice. Master trusts provide a ready means for employers to offer such choice. Whereas superannuation funds that operate the funds themselves typically have either no investment choice or only limited choice, the average master trust offers a menu of about 60 investment funds.

A second factor supporting the growth of master trusts has been the imposition of more rigorous prudential requirements for superannuation funds. This has increased the costs of running small superannuation funds. Master trusts allow superannuation funds to outsource the investment management function. In the past five years, almost half of all corporate superannuation funds (by number) have closed, and their funds under management have been rolled into master trusts or industry funds.

Like the asset consulting industry, the master trust industry is quite concentrated. For example, the three largest discretionary master trusts account for almost 50 per cent of funds invested through such trusts.

Financial planners

In the retail sector, financial planners perform a role analogous to that provided by asset consultants in the wholesale market. In providing investment and taxation advice as well as estate planning, financial planners make recommendations about individual funds managers and their investment products.

Around 60 per cent of the retail funds invested with funds managers are sourced via financial planners. The remainder comes through distribution channels such as the banks, the internet and stockbrokers.

Like many areas of the funds management industry, the number of financial planners has grown strongly, with the number of members of the Financial Planning Association increasing by two-thirds over the past five years to stand at 14 500. Although many financial planners are aligned with funds managers and life insurance companies, the financial planning industry is less concentrated than the asset consulting or master trust sectors.

Much of financial planners' income comes from entry fees and trailing commissions (which average around 0.4 per cent of funds under management) paid by funds managers when the planner places investments on clients' behalf. According to the Financial Planning Association small financial planning businesses (i.e. those with 20 or fewer representatives) are most likely to charge either flat or time-based fees for placing investments, and only around one-fifth of such planners do so.

Funds Managers' Fees

Fee structures in the retail component of the funds management industry are quite different to those in the wholesale component. In the retail market, fees can have three elements: entry, exit and ongoing fees. In the wholesale market entry and exit fees are rare. The average expense rate for retail superannuation funds, at around 2 per cent, is around twice that of wholesale funds (Table 3).

With regards to the fees charged by funds managers themselves, fees vary considerably across asset types and size of fund. Typically, fees are highest on those assets that are relatively costly to manage, such as emerging market assets, and lowest on cash-based funds. In the wholesale sector, fees also tend to be slightly higher on smaller funds (Table 4). For example, average fees on a $50 million Australian equity mandate are around 0.60 per cent of funds under management, compared to 0.57 per cent on a $200 million mandate.

There is some evidence that, for a given type of investment, there has been a slight decline in fees charged by funds managers over recent

Table 3: Average Superannuation Fund Per Annum Expense Rates
June 2001

Type of fund	Employer fund size $million	Expense rate Per cent
Wholesale		
Corporate	<50	1.50
	50–250	1.00
	250–1000	0.80
	>1000	0.60
Employer master trust	5–10	1.30
	10–50	1.10
	>50	0.85
Industry	<1000	1.30
	>1000	1.15
Government		0.43
Retail		
Self-managed (do-it-yourself)		1.05
Employer master trust	<5	2.00
Personal super		2.34
Post-retirement		1.70
Retirement savings accounts		2.50
Eligible rollover funds		2.00

Note: Expenses include the cost of administration, distribution and advice, and investment management.
Source: Phillips Fox Actuaries and Consultants/Investment and Financial Services Association

Table 4: Median Per Annum Fees
Per cent of funds under management; wholesale funds managers

	Mandate size ($ million)			
	5	**50**	**100**	**200**
Balanced/growth	0.70	0.60	0.58	0.58
Capital stable	0.61	0.57	0.54	0.48
High growth	0.74	0.61	0.60	0.60
Australian equities	0.70	0.60	0.58	0.57
Global equities	0.77	0.71	0.67	0.61
Emerging markets	1.15	1.10	1.10	1.06
Direct property	0.69	0.58	0.54	0.52
Listed property	0.61	0.55	0.55	0.54
Australian bonds	0.36	0.33	0.32	0.31
Global bonds	0.50	0.45	0.45	0.43
Cash	0.28	0.23	0.20	0.19

Notes: Actively managed pooled funds. Fees quoted as at 30 September 2000.
Source: William M Mercer Wholesale Investment Management Fee Survey March 2001

years.[3] In the retail sector, entry fees in particular are under some downward pressure from internet and other discount brokers. In the case of ongoing fees, a KPMG/Investment and Financial Services Association survey found that between 1996 and 2001 the average fee fell about 0.07 of a percentage point to 1.46 per cent of funds under management. In the wholesale market, an InTech/Deutsche survey found that the average fee on a mandate of $50 million fell from 0.54 per cent to 0.52 per cent between 1998 and 2001.

The prevalence of fees expressed as a share of funds under management has seen funds managers' revenues grow solidly over the past decade. This, combined with the recent spate of negative earnings, has focused public attention on two aspects of the size and structure of funds managers' fees, namely:

- whether those managers that actively manage investments (rather than passively invest in a portfolio that matches a market benchmark) earn returns sufficient to compensate for the higher fees that they charge; and
- how managers' fees should be related to the returns they earn.

Passive versus active management

Active managers charge higher fees than passive managers. This reflects both the cost of research undertaken by active managers and higher transactions costs. The difference in average fees ranges from 0.1 percentage points to 0.5 percentage points, depending on the asset class (Table 5). Over the past 18 months or so, fees charged by passive managers have fallen markedly, with, for example, fees charged by Australian equity funds having fallen by around one-third on average.

Use of passive managers has become more prevalent over the past five years, reflecting the difficulty that investors have in determining which active managers will outperform. The share of funds under management placed with index funds has risen from around 6 per cent in 1997 to 13 per cent in 2002. Around one-third to one-half of superannuation funds place some of their funds with a passive manager. There is also some tendency for larger funds to exhibit a higher incidence of indexing. In part, this reflects the fact that trading costs tend to rise as funds under management become large relative to the markets in which they are invested.

Table 5: Fees on Actively and Passively Managed Products[(a)]

Per cent of funds under management; per annum; wholesale funds managers

Asset class	Active	Passive	Differential
Balanced/growth	0.58	0.16	0.42
Capital stable	0.54	0.08	0.46
Australian equities	0.58	0.13	0.45
Global equities	0.67	0.16	0.51
Listed property	0.55	0.10	0.45
Australian bonds	0.32	0.10	0.22
Cash	0.20	0.09	0.11

(a) Pooled investments, mandate of $100 million, fees quoted as at 30th September 2000.

Source: William M Mercer Wholesale Investment Management Fee Survey March 2001

3. The fees charged by funds managers are one component of the costs faced by superannuation funds. According to a recent APRA study, expenses incurred by superannuation funds for the administration, investment and internal management of funds (as a share of fund assets) rose slightly between 1996 and 2002 (Coleman ADF, N Esho and M Wong, 'The Investment Performance of Australian Superannuation Funds', APRA Working Paper 2003-02).

Performance-based fees

Fee structures that explicitly reward funds managers for high returns are rare in the retail market, but about 20 per cent of wholesale funds offer clients the option of a performance-based fee. While the usage of performance fees increased in the late 1990s, it has levelled off more recently.

Performance fees typically take the following form. No fee is charged (or a fee is charged which just covers the fund managers' basic costs) if the funds manager does not achieve a target return. The target return may be a benchmark return or a threshold above the benchmark. The fee (expressed as a share of funds under management) increases once returns are achieved above the target return. In some cases, but not often, the increase in the fee for extra out-performance is capped.

Consistent with performance-based fees being tailored to meet the demands of individual investors, there is a much lower incidence of performance-based fees amongst pooled funds than individual mandates (Table 6).[3] Domestic equity managers are most likely to offer performance-based fees.

Table 6: Funds Offering Performance-based Fees
February 2001

Asset class	Per cent of all funds
Individual mandates	
Australian equities	49
International equities	14
Property	18
Australian bonds	27
Overseas bonds	14
Pooled investment vehicles	
Australian equities	27
International equities	4
Property	9
Australian bonds	4
Overseas bonds	4

Notes: Individual mandates are those mandates managed by funds managers on a stand-alone basis. Pooled investment vehicles combine the funds from a number of individual client mandates and manage the combined funds as a single pool of funds.

Source: Towers Perrin

One advantage of performance-based fees, over fees expressed as a constant share of funds under management, is that such fees provide an incentive for funds managers to maintain an overall fund size that yields an optimal return. As funds become large relative to the size of the markets they invest in there is some tendency for portfolio adjustments to become more cumbersome and costly. Concerns that growth in fund size may detract from a manager's returns have also led some asset consultants to seek to negotiate flat fees (i.e. a fixed dollar amount per year) for their clients, but such fee structures remain rare. ✰

3. When a mandate is agreed between a superannuation fund and a funds manager, the funds manager may combine the money invested with funds from other clients into a pooled investment vehicle or manage the individual mandate on a stand-alone basis.