Declining Management Fees and Challenges for the AM Industry

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Recently, Korea's asset management (AM) industry faces two contradicting market situations; the declining average management fee, and increasing assets under management (AUM). First, management fees have declined due to increased institutional holdings that generate low fees, and intensified competition among asset management companies (AMC). Because the decline in management fees may lead to a setback in AMC's operating income structure, the industry should step up their efforts to cope with the situation. Korean AMCs must build their capacity to manage overseas investments not to lose Korean institutional investors' overseas assets to global players. Simultaneously, they must gear up for overseas expansion by creating demand of overseas clients and attracting more investments. Also important is to regain retail investors' confidence and lure those investors back into the equity funds market.

Korea's AM industry has recently observed two contradicting market trends. First, the overall market size grew dramatically. AMCs licensed in Korea have two core revenue-generating channels; management of both publicly offered and privately placed funds, and discretionary investment services. The total AUM of those two channels stood at KRW788 trillion as of June 2014, which increased approximately 56% for five years from June 2010. By contrast, management fees, an important determinant of AMC's operating revenue, fell drastically. The industry average of management fees for publicly placed funds stood at 0.46% of AUM in June

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2010, but the figure dropped to 0.29% in June 2015. Given that privately placed funds and discretionary investment services charge less management fees than publicly placed funds do, the average management fee for all assets are presumed to be much lower than 0.29%.[1)]

Causes behind the declining management fee

The continued decline in the industry average of management fees seems to stem from the shift in client composition, and the resultant change in product structures. For the recent few years, the composition of clients in the AM industry has shifted from retail investors toward institutional investors such as pension funds, financial institutions, and other corporate entities. In the overall AM market, the proportion of privately placed funds and discretionary investment services where institutional ownership is high increased sharply from 55.6% in June 2010 to 71.0% in June 2015. Furthermore, institutional holdings have increased persistently in the publicly offered fund market.

Compared to retail investors, institutional investors have low demand for equity products, which holds true for both funds and discretionary investment assets. As a result, the percentage of equity funds that charge relatively higher management fees than other investment assets abruptly fell from 27.3% in June 2010 to 18.9% in Jun 2015 in the overall market for funds and discretionary investment services. And the downward trend in equity products still continues. Instead, bond funds and MMFs charging lower management fees are quickly replacing equity funds.

On top of the changes in client composition and product structures, intensified competition in the AM industry appears to have significant impacts on the average management fee. Behind the explosive growth in demand for indirect investments is fierce competition. Although funds and discretionary investment services are core businesses of AMCs, they meet with cutthroat competition with other services, e.g., managed accounts of securities firms, discretionary investments by discretionary investment advisors, and private banking services of banks. Equity funds have been particularly affected by the trend: Among publicly placed funds, equity funds have seen the largest fall in management fees. Presumably, this is because equity funds face competition not only with other AMCs, but also with direct stock investments.

1) It is impossible to figure out the exact industry average of management fees because management fees for privately placed funds and discretionary investment services are not publicly disclosed.

Falling management fees worsen the industry's operating income

AMCs have a simple structure for operating revenues, most of which comes from management fees from fund assets or discretionary investment assets. Although they generate revenues from principal investments, the portion is small because most AMCs have small equity capital and manage it through cash equivalents. Therefore, it is safe to say that AMCs' operating revenues are determined by the size of AUM and the level of management fees. Because AMC's operating expenses do not increase in proportion to operating revenues, their operation income largely depends on AUM and management fees.

The AM industry's operating income peaked at KRW651.9 billion in 2008 when the global financial crisis just began, and fell 32.3% for just four years to reach KRW441.3 billion in 2012. Such a drastic contraction is exceptional given that the industry's AUM rose about 18.2% during the same period. When the AUM explosively grew in 2013 and in 2014, the industry's operating income did rise a bit, but failed to recover the 2008 level.

A more detailed look reveals that the AM industry faces difficult situations. In the manufacturing industry, sales margin is measured by operating margin, a ratio of operating income to net sales. To apply the concept to the AM industry, a ratio of the industry's operating income to the industry's AUM can be used. The figure stood at 13.1bp (basis point) in 2008, but fell to 7.5bp in 2012. Although it began to rise in 2013 and reached 9.1bp in 2014, it is lower than the 2008 peak. This implies an important fact: Although AMCs could increase operating margin slightly by managing operating expenses well, the improvement was insignificant given the large capital inflows to the AM industry for the recent two years.

The average operating income for each AMC shows a similar trend. Once peaked at KRW9.9 billion in 2008, it plunged to KRW5.3 billion in 2012, and recovered slightly to KRW7.0 billion in 2014.

To make matters worse, top 10 players manage a significant portion of AUM in the AM industry, suggesting that the rest of them have worse operating income. Hence, it is too early to conclude that the growing capital inflows to the industry mean improvements in industry conditions.

Challenges ahead of the AM industry

The shift in client composition from retail to institutional investors is an inevitable and irreversible trend of today. Going forward, institutional holdings in the market will grow further as the National Pension Fund and retirement pension funds are expected to grow exponentially, and public funds, insurance companies, and financial and non-financial companies accumulate more and more assets. This means that the two contradicting industry trends (the expansion in Korea's indirect investment market, and the increase in AUM creating low revenues) are expected to prolong in the future.

Under the circumstances, which direction should the AM industry head in? First, AMCs should concentrate their efforts to provide more external asset management services for Korea's institutional clients whose assets are rapidly increasing. More specifically, AMCs should make their utmost efforts to build their overseas investment capacity. Led by the National Pension Fund, institutional investors will sharply increase their overseas investments. There have been discussions pertaining to the role of pension funds in Korean AMCs' overseas expansion, but this will be possible only when AMCs have sufficient capacity. Otherwise, most of overseas investments by Korean institutional investors will be managed by global AMCs.

Once Korean AMCs build the overseas investment capacity, they should ardently expand overseas to broaden their client base. Especially, large AMCs with high market share and capital strength in Korea must play a leading role in overseas expansion. According to the data of the Financial Supervisory Service, a total of 13 Korean AMCs had physical overseas operations such as offices, branches, and subsidiaries as of December 2014. But most assets in those operations are from Korean investors. Only few players manage assets for foreign clients, and the asset size is small. AMCs with comparably large sizes must change their overseas expansion strategy toward securing foreign clients, going beyond managing Korean clients' overseas assets. In the early stage, it is recommended to focus on exporting fund products, which is possible without equity investments and thus has low risk and incurs small losses in the case of any failure. It is possible to use a fund established under the Undertakings for Collective Investment in Transferable Securities (UCITS), an integrated regulatory framework for EU funds. In the long run, Korean AMCs will have to establish an overseas subsidiary or take over a foreign firm. Because this is risky, Korean AMCs must be fully prepared beforehand. They should specify a target country; secure capital strength; precisely understand the target market; and devise a clear sales strategy tailored for the market. Among others, this requires the full commitment and strong willingness of the high-level executive with decision-making power in each AMC.

Moreover, AMCs must put all efforts into regaining the confidence of retail investors who left equity funds. After the global financial crisis, retail investors have shown a strong tendency of short-term investments in the equity funds market. This is evidenced by abrupt outflows from and inflows to the market according to stock market fluctuations, a trend that has persisted for past few years. Higher returns alone cannot offer a guarantee for investor confidence in the AM market. Investor confidence is affected by many factors, e.g., whether fund performance is based on a system and management philosophy, whether the agency problem exists, whether promises with customers are kept well, etc. Korean AMCs should look back those factors and think through why retail customers turned their back on equity funds. Policy measures will soon begin to help facilitate retail demand, e.g., tax exemptions on overseas investment funds, and individual savings accounts (ISA). Apart from those, AMCs must seek ways to bring back retail investors' confidence. Efforts to root out herding behavior among AMCs, or to discover and develop each AMC's own strength are as acute as ever.