# Changes Expected in Mutual Fund Distribution and its Implications

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Korea's fund market and the regulatory framework have recently undergone significant changes, e.g., rapid growth in the exchange-traded funds, the newly introduced fund supermarket, the upward trend in pension assets, and the government-led plan to facilitate financial advisory services, etc. Such changes suggest that a substantial portion of mutual funds could be sold via financial advisory or investment management services in the future. However, it is important to note that the success of new fund distribution channels will depend on the quality of those services. In response to changes in market conditions and the regulatory framework, the relevant industries need to exert utmost efforts in improving service quality; differentiating services; and developing a wide variety of products.

## Changes in the fund investment environment

Recently, the Korean market has undergone potent changes that could bring about a fundamental shift in how mutual funds are distributed. First, ETFs have grown rapidly because of its low-cost investment diversification opportunities and low fees as compared to other funds. Second, in addition to existing online-only funds, an online fund supermarket began its operation in 2014, lowering costs of fund investments for retail investors. Third, pension assets such as retirement and personal pensions have increased sharply, which could be a crucial demand base for mutual funds in the low growth and population aging trend. Fourth, a number

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of regulatory reforms have been or will be implemented, e.g., individual savings account (ISAs) launched in March 2016; independent financial advisors (IFAs) and robo advisers to be adopted in the near future; and online discretionary and non-discretionary investment advisory services to be phased in.[1)]

All of those changes in market conditions and the regulatory framework imply that a substantial portion of mutual funds could be sold via financial advisory or investment management services in the future.[2)] In particular, financial advisory and investment management platforms such as IFAs and robo advisors will offer low-cost, customized investment advice to retail investors who are neither institutional investors nor high net worth individuals. If it comes to that, such changes in the environment will contribute to not only efficient management of wealth, but also development of the fund industry.

Under the aforementioned new fund distribution environment, investors will have to directly pay investment advisors fees in exchange for investment advisory services.[3)] But advisory fees are an unfamiliar concept in Korea unlike in the US where such fees are generally accepted and in the UK where such fees are explicitly stipulated in the relevant regulation.[4)] Furthermore, Jongmin Kim (2014) argued that the new mutual fund sales environment would have different impacts on fund distribution channels and investors respectively.[5)] Hence, it may take a long period of time until fund distribution via financial advisory and investment management services takes hold in Korea. Hereupon, this article outlines the US case where fund distribution centered on investment advisory fees is common, and then seeks the implications.

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1) For this, refer to the Financial Services Commission's press release titled "Plan to Stimulate Financial Advisory Services" (March 24, 2016).

2) Recent shifts in market conditions and the regulatory framework, namely, ETF market growth, introduction of the fund supermarket and robo advisers, etc. seemingly suggest an increase in demand for self-directed fund investments without professional help for product selection or investment advice. However, overseas cases show that the size of that demand may be dwarfed by the demand for advice-driven fund purchases.

3) According to the FSC Plan unveiled on March 24, 2016, financial advisors must receive fees from their clients, regardless of the size of customer assets, the number of service provision, and the content of portfolios. Exceptionally, non-IFA financial advisors can receive commissions from product providers besides advisory fees they receive from their clients. In that case, however, they must disclose such payments to their clients.

4) To prevent mis-sales and conflicts of interest that may arise in fund distribution, the UK adopted the Retail Distribution Review (RDR) in 2013. Under the RDR, independent advisors are banned from receiving front-end loads from investors, but instead allowed to charge advisory fees agreed in advance.

5) Jongmin Kim, 2014, Changes in US Mutual Fund Distribution and Implications, Capital Market Perspective 2014 Vol.6, No.2.

## Changes in fund sales in the US

Strategic Insight (2012, 2013) paid attention to the changes in fund distribution that had taken place in the US since the 2000s.[6] According to Strategic Insight (2013), fund sales based on wraps or advisory programs comprised 47% of total fund sales, the largest proportion as of 2012. This was a two-fold increase for five years from 25% in 2007. The figure would rise to the 60% level excluding direct-sold and retirement plan funds, and to the 80%~85% range including new funds sales only. That is, a significant portion of mutual funds in the US were sold via fee-based wraps or advisory programs, as also evidenced by ICI (2015).[7] According to ICI (2015), 80% of investors who purchased mutual funds via channels outside retirement plans such as 401K invested in funds with either direct or indirect help from investment professionals. Under such a fee-based sales structure, advisory fees can be paid by funds embedded in the total expense ratio (TER) or by investors. In practice, the latter happened in most cases.[8]

In fact, most mutual fund sales in the US in the 1990s were transaction-based, where a fund distribution channel charged a front-end load to investors. However, such a distribution structure began to change gradually when fund wraps charging advisory fees were introduced in 1989, which was followed by an increase in no-load fund sales with the introduction of fund supermarkets in 1992. Evidently, the increased instances where registered investment advisors (RIAs) and broker dealers began to adopt fintech-based platforms for financial advisory and investment management services triggered a transition to the fee-based fund distribution we see today.

Strategic Insight (2012) explained such transition in the US from commission-based to fee-based distribution with the desire of fund distributors to establish a more stable revenue source. That is to say that fund distribution channels came to recognize advisory fees charged in exchange for diverse financial advisory and investment management services as a more stable revenue source, as compared to one-off commissions that could be volatile depending on market situations. In particular, the fact that market discipline was the main driver for such

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6) Strategic Insight, 2012, A Perspective on the Evolution in Structure, Investor Demand, Distribution, Pricing, and Shareholders' Total Costs in the U.S. Mutual Fund Industry; Strategic Insight, 2013, The Strategic Insight 2012 Fund Sales Survey: Perspective on Intermediary Sales by Distribution Channel and by Share Class.

7) ICI, 2015, 2015 Investment Company Fact Book.

8) The TER of funds distributed via financial advisory and investment management services stood at 0.85%. Advisory fees increased in proportion to the investment size, but in general hovered around the 1%~1.5% range. Hence, the total cost of investments in the fee-based distribution structure is estimated to be the 2% range.

transition makes the US differentiated from the UK where regulatory mandates were the key to change. It is worth noting that distribution channels' revenues mainly depend on how many funds they sell in the commission-based structure whereas revenues under the fee-based structure are linked to investor returns. Hence, the fee-based structure, as compared to commission-based one, is far less likely to develop conflicts of interest among investors and distribution channels.

## Impacts on fund distribution channels and investors

With the focus on the aforementioned transition in US mutual fund distribution, Jongmin Kim (2014) set up a number of hypothetical funds to carry out a comparative analysis on the impact of commission-based and fee-based distribution structures on distribution channels' revenues and investor returns. The results are summed up as follows. As suggested by Strategic Insight (2012), fee-based fund distribution was found to be more advantageous to distribution channels for longer investment periods and higher investor returns. However, commission-based distribution was found to serve better for investors, if not properly backed by substantial improvements in investment returns from funds chosen via financial advisory and investment management services. This is because of the increased cost of investments in fee-based fund sales: Although such a sales model charges less fund fees overall, investors must pay advisory fees separately, which in effect lowers fund returns. By contrast, the commission-based sales model charges investors with high one-off, front-end loads without additional cost burdens. In addition, the investment costs except for front-end loads get lower, thereby generating higher returns for investors as the investment period gets longer.

Such analysis results imply that the transition to the fee-based distribution may not help investors without substantial improvements in the quality of financial advisory and investment management services. Furthermore, it may adversely impact on fund distributors' revenues by crowding out investors, as opposed to the purpose. After all, service quality is the key to success of the new mutual fund distribution structure. This requires Korea's fund industry to exert utmost efforts in developing a wide variety of products, improving service quality, and differentiating their services in response to changes in market conditions and the regulatory framework.