Systematic Risk from Investment Funds

This brief note seeks to address some issues highlighted by Section 2. Systemic Risk from Investment Funds.

The note reflects upon the key statement on Page 14 of the Discussion Paper:

"It is the collective action of investment funds that have the potential to generate systemic risk….. this risk is the potential to amplify shocks in other parts of the financial system and/or the real economy, particularly in times of stress.

The DP appropriately notes the role of leverage and liquidity mismatch in generating this risk.

This note seeks to highlight the unprecedented surge in M&A in Asset Management and it' s implications for fund holdings, concentrations and consequent volatility and potential market/economic outcomes.

The consolidation is profound, persistent and projected to increase, I believe this has clear implications for systemic risk

The Funds market isn't static.

Investors often focus on the relentless product development we see be it Absolute. Return funds, 130/30 funds, ESG funds, ETFs etc.

But it's not just the Funds that change – it's the managers.

One of the most powerful and consequential trends in the funds industry today is the wave of consolidation among fund management firms.

This concentration was noted in CBI's Follow up Thematic Review of December 2022. Many other sources note this trend. PWC highlight the following[1]. Top ten largest asset managers will control around half of mutual fund assets globally by 2027, up from 42.5% in 2020, with private markets to account for up to half of AWM revenues by 2027, up from 37.6% in 2020
One in six asset managers are expected to disappear by 2027.
Private Equity is also playing a role. In the first half of 2023 alone, the industry invested more capital than in any year of the past decade on deals to acquire asset management firms. Through July 20, there were 39 deals for $13 billion, *already* $2.6 billion higher than the previous peak in 2021, according to PitchBook[2] . PE's role is often to gather Asset Management companies and then amalgamate unlocking clearcut synergies.

The critical issue is that the trend is set to continue and intensify.

Nearly three-quarters (73%) of asset managers are considering a strategic consolidation with another asset manager in the next 24 months.

The industry is set for a new phase of consolidation. Future growth in Asset management consolidation is also supported by the creation of A&M specific executives at ExCo level.[3]

The big are getting bigger.

Asset manager consolidation smashes record at midyear

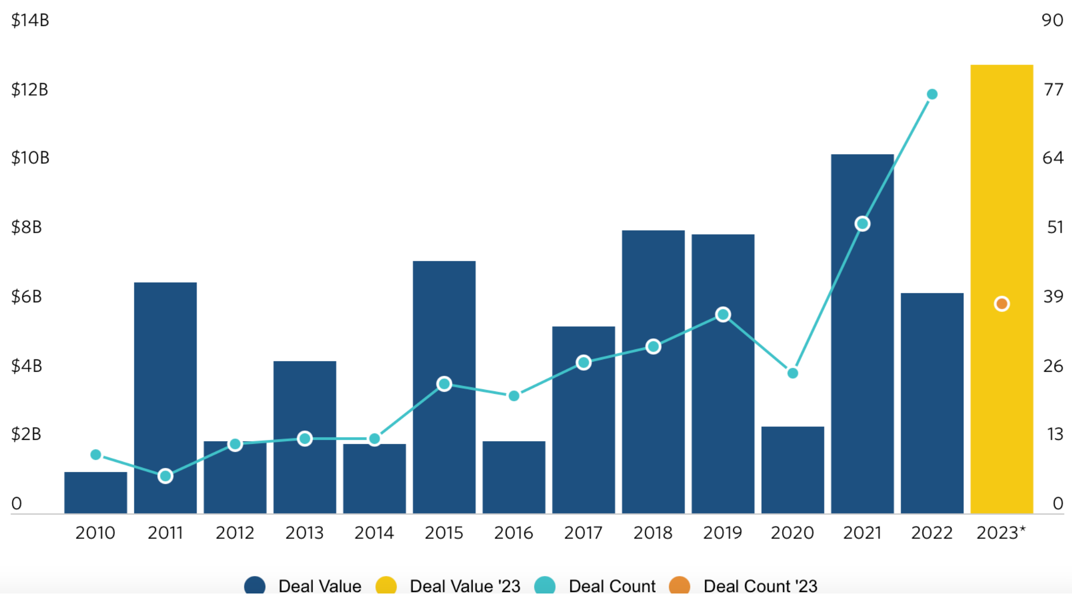
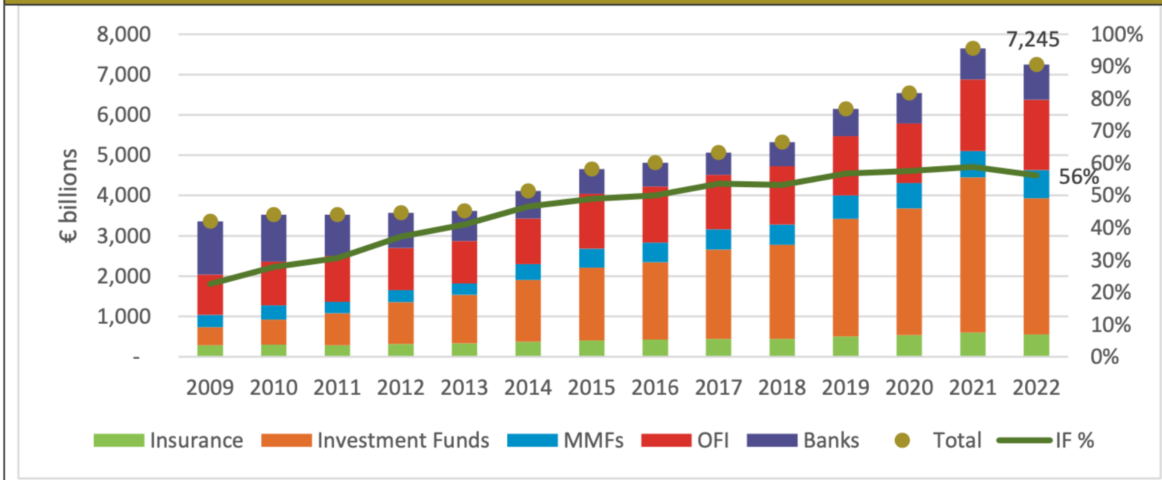


Chart 1. Growth of Regulated Financial Sector Assets in Ireland



Source: Central Bank of Ireland

What are the implications?
What happens when firms acquire other firms?

First of all it doesn't always work. Asset management cultures differ a lot and there is no shortage of Egos to mess things up. Liontrust and GAM are a good recent example of how tricky acquisitions can be. [4]

But irrespective of success, synergies will be sought. The key attraction of Asset Management is scalability and the ability to manage more and more assets with the same cost base.

One key synergy is the drive to merge funds even though they may not precisely have the same mandate or benchmark.[5] In wealth management examples it can also be a case of moving to one single "model" portfolio of underlying funds. Or it may centre around moving to a single platform which could have a smaller range of fund management companies on offer.

This on-going consolidation wave can therefore have consequences :

Impairing Investor Choice
Concentration risks in individual stocks

Consolidation leads to the funnelling of cash into "winner" names, those stocks in the portfolios/models of the dominant entity. This potentially increases the "fund" ownership in those names.
If the "dominant" fund (the one doing the acquiring) holds BP but the smaller fund prefers Shell; Shell may be sold and BP bought to move to the new consistent model. That stock may come from pension funds, retail investors, insurance companies, family offices etc. but now funds become an increasing share of the ownership of the stock. And that funds' element is managed by a smaller number of bigger funds.

So, some funds are growing significantly in excess of asset market moves and normal organic growth, of asset gathering. These funds can become "turbo-charged".

Greater concentration in individual stocks at the very least may lead to greater volatility of funds are subject to flows. Set against the projections for the continuance of M&A in asset management already noted, it is something to consider in terms of what it means for the sensitivity and price action of the underlying stock. As long term investors (pension funds/general insurance funds) are giving up ground to entities more subject to inflows/outflows, we may see such greater volatility. This volatility risk is the key factor I want to highlight.

Others have also highlighted possible consequences from such concentration in stock ownership. According to Harvard Law School, it may pose a systemic threat to the global economy. HLS go on to say:

"It can create macro-level externalities on competition, wealth distribution and fiscal transparency……. on a micro level it can have adverse externalities on corporate sustainability and shareholder rights. " [6]

The OECD also highlight this systemic risk in a funds.[7] They point to long term changes we have seen – in the US, institutional investors held less than 20% of the equity market in the early 1970's to 70% today.

Note how regulators at different times become concerned over concentration of any type of owner in an asset class or stock. The US regulator's concerns over the so-called basis trade from specific hedge funds in US treasuries in September 2023 is an example. The BIS expressed similar concerns.[8] Similarly, the concentration of Chinese ownership in US bonds has regularly been a subject of concern. Pockets of risk can develop unexpectedly.

We can clearly see greater homogeneity in portfolios.

Equally as individual funds grow in size, the stock universe available to them shrinks. Regulators rightly emphasise liquidity in portfolio management. If one of the rules a fund manager chooses to apply is a max. percentage in any stock, an influx of new cash from an acquired fund may be problematic. Note it's the absolute weighting in the stock, not the portfolio percentage holding as the increase in AUM helps here. This may lead to an emphasis on the large liquid names as opposed to mid-cap. Is this an investment decision or portfolio construction outcome? And what does it mean for investor choice?

Looking at the UK as an example, a review of some of the largest companies' Actively Managed UK equity funds produces the following top ten holdings:

Holdings based on published Factsheets

Fund A	Fund B	Fund C	Fund D
Astrazeneca	Shell	Shell	Astrazeneca
RELX	Astrazeneca	Astrazeneca	Shell
Diageo	Unilever	Small Co Fund	RELX
Unilever	BP	RELX	Rio Tinto
Telecom Plus	HSBC	GSK	3i
Prudential	Diageo	StanChart	Compass
LSX	BAT	Unilver	Next
Weir	Glencore	Lloyds	Reckitt
Auto Trader	GSK	BP	LSX
Close	RELX	HSBC	Stanchart

Where stocks appear more than once, they are highlighted.

The following data showing Top Ten holdings is from the factsheets of three Eurozone equity funds available for sale in Ireland in mid-2023.

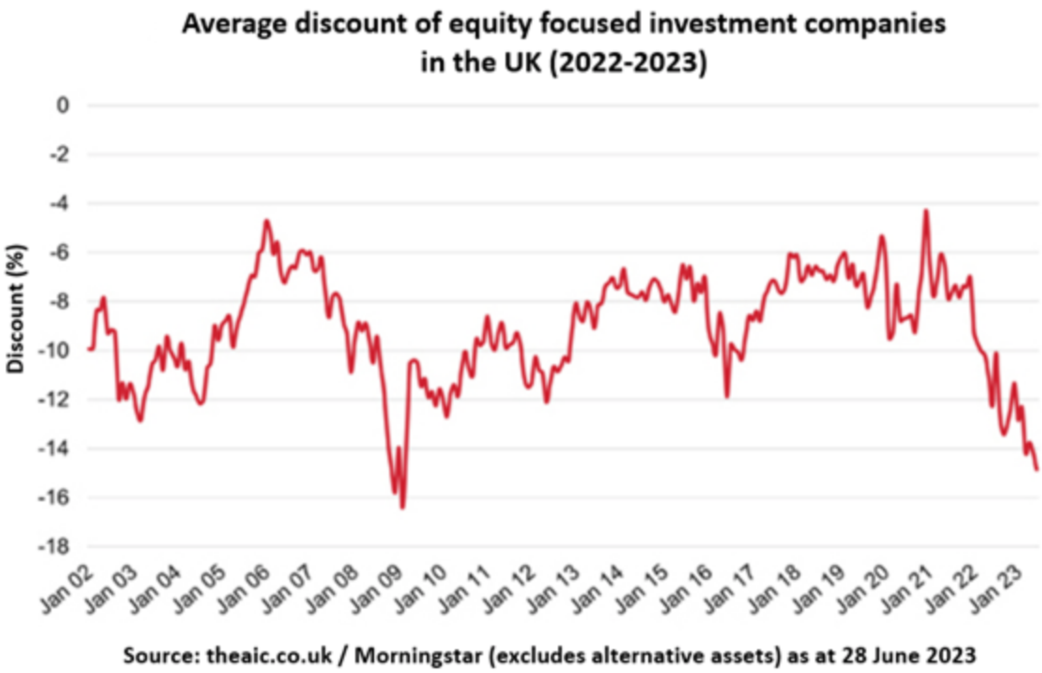
Fund A	Fund B	Fund c
“actively managed, well diversified portfolio”	“actively managed, may take off-benchmark positions”	“Indexed”
ASML	ASML	ASML
LVMH	SAP	LVMH
Total	Allianz	Total
Siemens	Air Liquide	SAP
SAP	Schneider	Siemens
Allianz	LVMH	Sanofi
Sanofi	Pernod	L’Oreal
BNP	L’Oreal	Schneider
L’Oreal	Deutsche Bank	Allianz
Prosus	Intesa	Air Liquide

Highlighted names show degree of overlap.

At face value, there does seem to be concentration at issue level. This also points to another issue around labelling. Are active funds genuinely active? They may charge an active fee but are they delivering an active outcome. Irish, UK and Scandinavian regulators have all highlighted the issue and acted where appropriate. CBI ‘s thematic review and letter of July 2019 is a clear and comprehensive appraisal of the issue.[9]
This is not the main issue in this note but it is worth noting how issues like liquidity factors, broker concentration, career risk can play in portfolio construction.

Case Study: Where size restricts choice

Many UK equity funds in the past would be active buyers of investment trusts partly for portfolio construction reasons – maintaining active exposure while researching new ideas. But as funds growth has exceeded investment trust growth, any new injection of cash may be too big in the context of the size of the trust. Investment Trusts could almost be seen as "stranded assets". The absence of this buyer pushes out the discount in trusts even further.



This anomaly has led to capital now being raised to specifically exploit the discount factor.[10]

So the risks from this powerful consolidation trend and possibly being pushed to larger liquid names revolve around:

Investor Choice – increasing homogeneity of funds.

Labelling – does it morph into closet indexing ?

Systemic risk – could wholesale selling of a security, driven perhaps by stock specific issues, by funds with a large share of market value, lead to issues like covenant beaches or loss of confidence with trade counterparties etc. and "real" world implications such as bankruptcy/job losses etc.

Example:
Highly leveraged IT company, with material holdings by a small number of funds, suffers major hit to business, due to renewed US trade sanctions on China. Immediate fall in share price amplified by "funds" forced to sell due to redemptions. Stock decline of 80% triggers debt covenants and closing of credit lines. Company closes plants.

Mitigants

Choice: Cross reference of flagship/core funds on an ongoing basis

Labelling: Fund audit incorporating active share, correlation, marginal contribution to risk etc. Regulators already have the full "tool-kit". Already a part of regulator/fund manager dialogue, but may need elevation as portfolio examples point to it still being an issue.

Systemic Risk: Consideration of possible final portfolio from Regulator or Competition Authority in deal analysis (may already happen?)

It is hard to imagine the relentless drive to M&A in Asset Management doesn't have consequences.
The key is to build resilience before the crisis occurs

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[1] PWC Study March 2023
[2] Pitchbook 2022
[3] Quilter creates director role to lead acquisitions Moneymarketing Sept 2023
[4] Liontrust, GAM bled €2bn from funds during failed takeover Financial News Sept 2023
[5] Fund manager Aberdeen to merge once mighty Gars (Sky July 2023)
[6] Harvard Law School Forum Feb 2020
[7] OECD Corporate Ownership and Concentration 2022
[8] FT September 2023
[9] Thematic Review Closet Indexing CBI July 2019
[10] Investment Week Oct 26 2023