Active Fund Consolidations Reflect Need to Compete With Popular ETFs

# Mutual Fund Mergers Narrow Investors' Choices

by Craig Guillot

**Recent trends point to more consolidation in the mutual fund industry and analysts say the result could be a mixed bag for investors. Pressured by declining performance and high fees, many active funds are entering into mergers and acquisitions to reduce costs and expand their expertise so that active funds can better compete against lower-cost exchange-traded funds.**

As more fund companies form alliances, analysts say investors will have to be vigilant of potential changes to their fund's strategy and exposure. Although the repercussions are usually minimal for the investor, consolidations can occasionally produce alterations in a fund's culture, management and strategy.

## Ongoing Trend in the Fund Industry

The mutual fund industry has been on a continuous path of consolidation. According to the 2016 *Investment Company Fact Book* by the Investment Company Institute, the shares of invested assets managed by the five largest firms rose from 32 percent in 2000 to 45 percent in 2015.

Big firms are quickly cornering the industry. Notably, U.K.-based Henderson Group PLC entered into a $2.6 billion agreement in early October to buy Janus Capital Group. Combined, the new Janus Henderson Global Investors PLC will hold more than $320 billion in assets. TIAA-CREF also purchased Nuveen Investments for $6.25 billion in 2014, while over the past decade Invesco has acquired such companies as PowerShares, AIM and Van Kampen.

Years of outflows are forcing companies to look for ways to centralize operations and lower costs. Morningstar reports that investors withdrew more than $160 billion from actively managed funds through August of this year. During that time, they funneled nearly $110 billion into passive ETFs managed by such groups as Vanguard, BlackRock and iShares.

Jeff Ptak, head of global manager research for Morningstar, says many of these mergers are strategic moves to increase scale and lower costs. He says mangers are looking more intently at their own operations and at opportunities to combine with other firms where they feel it would be synergistic.

Ptak says many fund companies are specifically acquiring companies to enter into areas where they lack experience or that may otherwise be inaccessible.

"The imperatives for these mergers can vary," he says. "There could be a need to (scale) or they just believe they have complementary assets or capabilities."

Laurence Fink, chairman and CEO of BlackRock, said at the Deutsche Bank Global Financial Services Conference in May that he expects even more consolidation among asset managers who have difficulty beating their benchmarks.

He also predicted that a new fiduciary rule from the Labor Department, which requires brokers to put their clients' interests ahead of their own, will drive more investors to passive strategies.

Fink says that although those in the industry "fundamentally believe there will be a massive shift more into passive strategies," this will create opportunities for active management to succeed by becoming "more realistic." As large fund companies continue to acquire smaller ones, there will be little incentive to keep losers on the market, thus increasing performance by keeping only the winners.

## The Bottom Line? Cutting Costs, Bumping Up Performance

Many mergers and acquisitions are being driven by a desire to reduce costs. Fund companies want to lower costs not only to boost their own bottom line, but also to reduce expense ratios and better compete with passive ETFs.

Mutual fund expense ratios have been on the decline but are still more than five times that of the average index fund. Janus and Henderson said they expect to save $110 million per year in combined expenses by eliminating redundant staffing and office facilities.

Some smaller funds are also looking to be acquired because it's becoming more difficult to compete with the lower costs larger fund companies achieve through scale. Fund companies are also making strategic acquisitions to meet the growing demands of their customers.

This all comes at a time when a rising percentage of active managers are failing to meet their benchmarks. According to Standard & Poor's most recent S&P Indices Versus Active (SPIVA) scorecard, 90 percent of the actively managed funds that invest in domestic equities failed to beat their benchmarks after factoring in fees.

Mergers can offer not only cost advantages but also the benefit of adding institutional knowledge. For example, in the Janus-Henderson deal, Janus will gain scale and lower costs, while Henderson gains the knowledge of world-renowned bond fund manager Bill Gross.

Janus will also be able to bolster its revenue by selling its U.S. products in Europe through Henderson's distribution network, while Henderson will obtain access to the U.S. and Japan. "Janus is really primarily a U.S. player, and Henderson for their part is primarily a non-U.S. player, and so I think with their responsive sales and distribution avenues, they could be more effective together than apart," Morningstar's Ptak says.

Most analysts expect the trend of fund mergers and acquisitions to continue. Mac Sykes, an analyst at Gabelli & Company, told Barrons.com that some mutual fund companies that could be candidates for further acquisitions or mergers include Waddell & Reed Financial, Cohen & Steers and Legg Mason.

### What About the Investor?

Fund mergers and acquisitions can offer a varying spectrum of change for most investors. Michael Chadwick of Chadwick Financial Advisors in Unionville, Conn., says investors in a large fund company that acquires a smaller one would see little, if any, impact.

Shareholders in a smaller fund, however, might see changes if the fund is acquired by a larger company. Although this could include the potential for more investment options and lower costs, there might also be modifications in strategy and management during a consolidation.

Chadwick says the growth in fund mergers and acquisitions of funds could also water down opportunities and options for investors as more funds are liquidated or consumed by larger ones.

He says the larger a fund grows, the more difficult it becomes to take a meaningful stake in some investments. These large funds are also less flexible and can't move as quickly to capitalize on any new opportunities.

"They can't exploit some opportunities, especially in the smaller-cap space," Chadwick says. "It will eventually mean fewer choices for investors and (the remaining funds) will be bigger, stodgier and less mobile and nimble."

Ptak says that although it's important to remember that two investment firms merging doesn't necessarily equate to any meaningful changes, investors need to remain vigilant and understand the implications. Because fund companies are ultimately human capital organizations, changes in culture could impact strategies in funds over time. Investors glued to a certain manager should be aware that the acquiring company might make changes in management after the merger.

"You want to know what (the other fund) is invested in and also understand the impact it could have on personnel," Ptak says. "Oftentimes when you have mergers, it can shift people around." B