CAMMACK RETIREMENT

Investment Management Merger and Acquisition (M&A)

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As defined contribution plans evolve into the primary retirement savings vehicle for many workers, several powerful trends have dominated the asset management news in recent years: the persistent performance challenges faced by "active" managers; an increasingly complex legal and compliance environment; the increasing money flows to passive managers including exchange traded funds (ETFs); and the growth of target date funds (TDFs). While these well-documented trends are significant in isolation, in aggregate they are slowly and steadily reshaping the asset management industry.

There is an additional force that is also greatly impacting the industry, in large part as a result of the trends noted above: consistent merger and acquisition activity (M&A) at both the firm and individual fund levels. Below, we explore investment manager M&A and provide some topics that plan sponsors should consider if/when their investments have been affected by either a fund or firm-level merger.

DRIVING FORCES

Given the sheer number of firms in the industry, the full impact of these trends will take decades to unfold. Before we consider the potential effect of M&A activity, let's review the competitive forces driving fund and firm consolidation:

- **Pursuit of "economies of scale":** As active management struggles to outperform in some major asset classes, firms have combined to consolidate assets and eliminate duplicate services and staffing (e.g., cost savings for the Amundi-Pioneer combination were estimated at $160 million per year, along with potential cross-selling synergies of $30 million a year[1])
- **Response to asset outflows and fee pressure:** According to the Investment Company Institute, almost $1 trillion shifted from active to passive investment strategies and, on average, fees are estimated to earn 70 percent less.[2]
- **Corporate decisions to "build or buy" products in new asset classes or segments:** After evaluating their strategic options, some firms have decided that the most efficient route to enter new asset classes is to "buy" instead of "build." Examples include Goldman Sachs' purchase of Madison Investment Partners to build out TDF capabilities; Legg Mason's purchase of real estate manager Clarion Partners; and Eaton Vance's purchase of Calvert's socially responsible funds.
- **The consistent growth of target date funds (TDFs):** Assets under management through retail TDFs are approaching $1 trillion, with almost $27 billion estimated to flow into TDF strategies in just the second half of 2017. Much of the inflows are concentrated in several "winners," while numerous household names have experienced large outflows or stagnant asset levels. While TDFs can serve a very

[1] *P&I, Cambridge*
[2] *Bloomberg*

productive role for investors, they also result in the follow-on consequences of “mapping” existing assets into the TDFs and eliminating future flows into other funds in the plan. Thus resulting in negative consequences for some mutual funds in the plan.

- **The shift in assets produced by the “de-risking” of actively-managed assets in defined benefit plans to liability-matching strategies and/or group annuity purchases by large insurance companies:** This trend will unfold slowly and depend somewhat on the direction of interest rates and plan funding levels, but transactions that occur can involve large plans (e.g., Prudential’s group annuity transactions with General Motors and Verizon totaled $36.5 Billion). Asset flows in this category can be challenging to track and summarize, but transactions typically result in lost assets for the plan’s incumbent managers.
- **Potential litigation concerns driven by the uncertain outcomes of both the Department of Labor’s Fiduciary Rule and defined contribution lawsuits:** Given the complex political situation in 2017, many questions remain unanswered for asset managers and investors. Regardless of the outcome, the currently delayed legislation and potential for lengthy legal challenges adds to the complexity of a firm’s decision-making framework.
- **Monetization of assets during a bull market:** Quite simply, asset sellers are incentivized to sell firms after a 7-year bull market. This trend may be more acute for sales of privately-owned firms (e.g., Hartford Funds’ acquisition of ETF firm Lattice Strategies).

IMPACT OF TRENDS

The anticipated results of these trends will reshape the industry. Among the potential impact, investors can expect to see the following:

- Fewer investment management firms, some with significantly larger market share than they have held historically
- Increasing asset allocation to TDFs, passive investments and other low-fee vehicles
- Fewer independent, stand alone “boutique” investment managers and “style-box” focused strategies
- Fewer distinct funds available for investment

The transactions noted above have all occurred at the firm/organizational level, but investors should also be aware that they may also lead to the consolidation and/or liquidation of individual funds within a firm’s lineup. For example:

- In early 2016, performance challenges and asset outflows drove Artisan’s decision to merge its Small Cap Value fund ($806M) into its Mid Cap Value Fund.
- Similarly, in late 2016 after “experiencing net outflows for some time,” Transamerica reorganized its Transamerica Partners Funds into their Transamerica Asset Management Funds ”in an effort to streamline...and promote operating efficiencies.” In their press release, Transamerica offers their belief that “investors could benefit from the fund groups being combined and consolidated” through this “shell” reorganization.

- In a more striking example of the challenges faced by some active managers, the Third Avenue Focused Credit Fund was closed in late 2015, with investors receiving cash through a liquidating trust, as holdings can be sold over time.

BENEFITS AND DRAWBACKS FOR INVESTORS

While having fewer choices is sometimes characterized as a negative for consumers, a reduction in the number of firms and strategies could actually be beneficial for investors due to improved fee transparency, reduced trading costs, upgrades in technology and potential enhancements in risk-appropriate allocations through the growing utilization of TDFs. Perhaps most important for defined contribution investors will be the streamlining of their investment lineup, sometimes from hundreds of funds down to a more manageable range of 20-25 funds, including TDFs as their Qualified Default Investment Alternative (QDIA).

In short, investors should expect a continuation of the M&A activity as managers adapt to the increasing impact of defined benefit plan closures, target date funds, ETFs, and flows to passive strategies among other recent trends. When combined with structural improvements and the ongoing fee pressure on managers, individuals who save consistently through their defined contribution plans, including target date funds, should benefit from the ongoing consolidation of investment management firms.

While there are potential benefits for investors when funds and/or firms merge, there are also several downsides of which investors should be aware:

- Merged assets may be combined into a fund with a different strategy (reference the Artisan example, above)
- Potential tax consequences as the fund manager realigns new assets to fit the strategy of the receiving fund
- Potentially higher expense ratios in the receiving fund despite the firm's pursuit of economies of scale or other benefits

CONCLUSION

If investors encounter any of the scenarios described above, they would be well-served to start their analysis with the following questions:

- Will the investment strategy change?
- Will fees go up, down or sideways?
- What are the potential tax consequences?[3]

If an investor is comfortable with the answers to those three questions, then the transaction may make sense. If they are not comfortable, then the questions should form the basis for further due diligence and evaluation of the portfolio.

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For more information on our services, please contact **Mike Volo**, Senior Partner, at **781.997.1426** or **mvolo@cammackretirement.com**.

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[3] *WSJ Research*