The Frontier Line

Thought leadership and insights from Frontier

Issue 184 | **November 2021**

What managers really think

frontieradvisors.com.au

frontier

About us

Frontier has been at the forefront of institutional investment advice in Australia for over 25 years and provides advice over more than $500 billion of assets across the superannuation, charity, public sector, insurance and university sectors.

Frontier's purpose is to empower our clients to advance prosperity for their beneficiaries through knowledge sharing, customisation, technology solutions and an alignment and focus unconstrained by product or manager conflict.

Wayne Sullivan

Director of Marketing & Business Development

Wayne Sullivan manages business development activity and has responsibility for the marketing and communication program at Frontier, including brand management, content creation and publication, digital media, and public relations. Wayne has an extensive background in marketing of financial services, specifically in superannuation, having previously held senior marketing and communication roles with Hostplus, Sunsuper and QSuper.

He is a past Rainmaker Australian Superannuation Marketer of the Year and has won multiple industry awards for marketing and communication at each of the funds he has worked for. He holds a Bachelor of Economics from the Queensland University of Technology, a Diploma of Superannuation Management, and an Associate Diploma in Marketing. Wayne is a Fellow of the Association of Superannuation Funds of Australia.

What managers really think

There are a number of service providers that make important contributions to the success, or otherwise, of institutional investment portfolios. Naturally, we argue one of the most important is the asset consultant, however, concede that a close second are fund managers.

For that reason, Frontier conducts around 1,200 meetings with managers each year to review and refresh our understanding of managers we know and have met before and to unearth and examine emerging or evolving funds management businesses and strategies. We do this with managers all over the world and in multiple asset classes. Our meetings inform our understanding of the products, processes and personnel within firms and enable us to get a first-hand understanding of the culture present within each organisation, no matter how large or small.

Pre-COVID, Frontier would travel constantly to all corners of the globe to find the best of breed for our clients. Over the last two years, even though travel and face to face engagement has been restricted, we have maintained the depth and rigour of our research program through virtual meetings.

In fact, virtual trips mean more team members participate but also means not an many very late nights and very early mornings. We have also used an even closer liaison with our Global Investment Research Alliance partners in Europe and North America, LCP and Segal Marco Advisors, to help inform our views and understanding of what is happening in offshore markets.

With one of the most experienced research teams in the Australian market, we think we do a pretty good job of fund manager research and, more importantly, our clients agree.

Unrelated to our formal evaluation program, every year since 2014 Frontier has been surveying fund managers to take their read on a range of market issues and to test their predictive skills. At the same time, we ask our own staff to answer some of the same questions for comparison purposes.

In this paper we analyse the results of this year's survey and how responses illustrate evolution in our industry over the last eight years. We've started with a review of the predictive abilities of managers and Frontier, which has a slightly light-hearted objective at its core to fuel conversation at our annual Manager Dialogue event, then we examine opinions on asset owners, asset consultants and finally on asset managers themselves.

Note: Our survey was completed in September 2021 by 78 representatives from funds management organisations and 38 members of our consulting team.

Backdrop

Fund managers can be easy targets for asset owners and dare we say it, asset consultants, to deride, push on fees and apportion blame too! And, occasionally, for good reason. At the same time, while asset allocation is arguably the largest contributor to portfolio performance, returns are ultimately gained from the efforts of those investing the money.

Fund managers are extremely well rewarded for their efforts but the funds management industry in Australia has been under considerable and increasing strain since we began our study in 2014 and a number of fund managers and investment strategies have closed in that time. As superannuation funds, in particular, increase in size they are keen to optimise the benefits of their growing scale through demanding reduced fees and in many cases internalising investment management.

More recently, despite continued growth of assets in the industry, fund consolidation threatens to shrink the potential client base of managers significantly through the merger of portfolios and even greater internal capacity within funds. Since our study began the number of Australian superannuation funds (ex-SMSFs) has dwindled by 35% from 268 to 175[1].

Of course, in 2020 we saw the most volatile period for investors in more than a decade with major structural shifts across all sectors and regions accompanied by a huge disruption to business models and the operation of portfolio teams. All the while nervous investors were scrutinising managers intensely, and remotely, amidst the backdrop of uncertainty around valuations, liquidity and accelerating market evolution.

But it's not all bad news for managers. At the same time as both recent challenges and structural headwinds have gathered pace, money continues to flow in to the Australian superannuation system with assets under management in that sector growing 78% over the period of our survey history – specifically, from $1.85T at June 2014 to $3.3T in June 2021[2].

Fund managers tend to be optimistic and bullish and this confidence has been largely justified with generally strong returns since 2014. Just two of the last eight years have produced a median balanced fund (60-76% growth assets) return of under 7%[3] - a generally accepted long-term average return target. This is an incredibly strong result in a low-inflation environment. Notably, 2020 saw a negative return (-0.82%) for the median fund before 2021 performance roared back with the strongest individual year of performance (17.85%) in the past 15 years and second strongest since 1992.

Of course, there have been challenges around performance for particular managers at various times of this period – 2018/19 was the worst year in decades for active Australian equities managers, for instance. Naturally, there have also been periods of quite extraordinary returns for select managers as well with the last year producing some extraordinary results off the back of COVID-related opportunistic themes.

The search for outperformance in an increasingly competitive and low-return expectation environment, along with well-resourced, inquisitive and competitive internal investment teams, has also shifted the way many investors approach their portfolio construction, often away from traditional managers and into newer or niche strategies.

With the introduction of Your Future Your Super legislation, funds now face the risk of moving away from benchmark, not just competitive underperformance, but potentially a death march. This too will shape investor behaviour in this sector. So, in light of this background, how has the mood and attitude of fund managers changed, or remained the same, over the last eight years?

[1] ASFA Superannuation Statistics September 2021

[2] APRA Releases Superannuation Statistics for June 2021

[3] SuperRatings

frontier

Predicting performance

Balanced fund returns

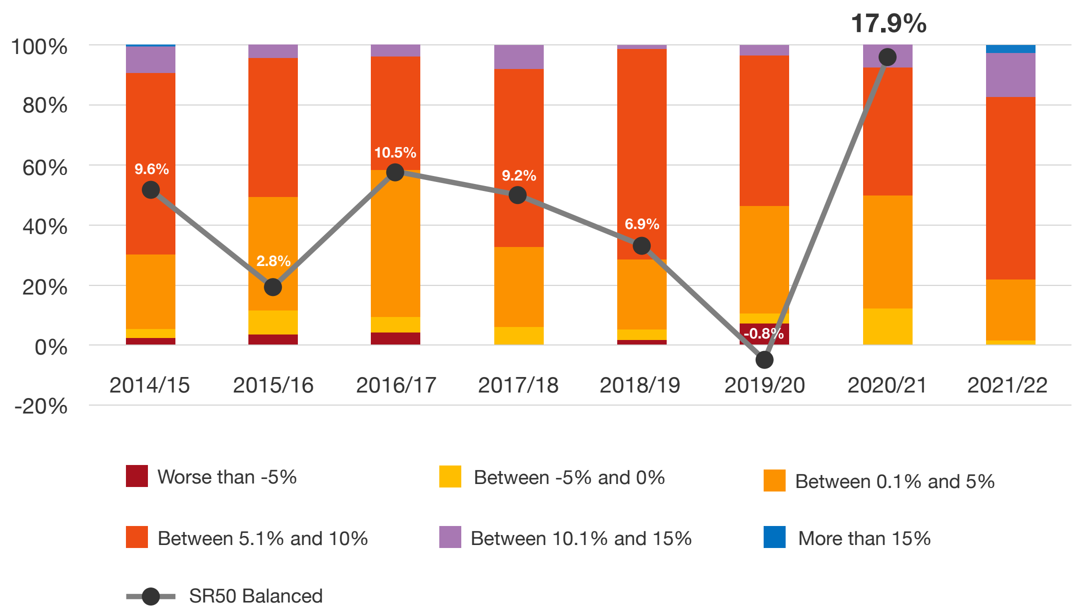
At the end of each financial year, when we survey fund managers, we ask them to predict the median return for the next financial year for a typical balanced fund, within generous 5% bands. Typically, most respondents (generally around 60%) settle for the conservative 5-10% band, however the result is often influenced by the performance achieved in the preceding year.

Last year, when asked to predict returns for 2020/21, the prior months of extreme volatility seemed to influence judgement with only 7.6% of managers predicting a double digit return and no one successfully forecasting a result over 15%.

Of course, the correct answer was a whopping 17.9%. Overall, managers have been quite successful in predicting the correct return band. The current year predictions are notably more bullish than last year with 60.8% of managers predicting a return of between 5.1% and 10% (compared to 42.4% last year) while 17.6% are forecasting a return greater than 10%, almost double the number of any prior year in this study.

So, it seems recent past performance is seen by some as an indicator of expected future performance, at least in the case of our survey! Will we see another double digit result again for this year?

Chart 1: Fund manager return predictions versus actual results (SR50 Balanced)



Source: Frontier

On average, over the life of this survey, 33.6% of managers have been able to correctly predict performance for the year ahead – just one third. By extension, two thirds have not been able to. To be fair, this has been particularly difficult in the last two years!

For the record, fund managers have been marginally better at predicting performance than our team in this study (this is a survey of all Frontier staff, as opposed to our specialist capital markets team!).

However, Frontier has tended to be closer to predicting the result in years of low returns, while managers' optimism tends to suit years of strong performance, of which there have been more in the last eight years.

For the year ahead 71% of Frontierians are predicting a return between 5% and 10%, and only 5.2% of us are bold enough to forecast a return above that.

Asset class performance

Amongst the fund manager respondents, the asset classes predicted to be the best performing for 2021/22 tend to correlate with the sectors covered by those fund managers, perhaps unsurprisingly!

This pattern has been quite consistent through the life of the survey with international equities being the most nominated sector each year – albeit alternating between developed and emerging markets.

Developed markets have the nod for this year with 28.8% of managers favouring that sector.

Over the last three years however, an increasing number of managers have nominated private equity (PE) as the sector most likely to produce outperformance, the third most popular choice among both managers and Frontier.

In the first four years of our study not a single fund manager had ever flagged PE as their nominated top performer. Another sign of past performance influencing opinions?

Nominating the best performing asset class is an area where Frontier has consistently had more predictive success than managers during our study. For 2021/22 a quarter of our firm, 26.3%, has nominated unlisted infrastructure as the sector most likely to be the best performer for the year. This figure has been as high as 43.5% in previous years.

Like managers, more of us (18.4%) are now predicting private equity as the most likely sector to deliver outperformance in the year ahead than ever before.

Asset owners

Influencers

When we started this survey in 2014 superannuation funds made up around three quarters of our client numbers - now they are less than half. However, super fund investors are obviously still a major portion of the institutional investment market, many with very significant portfolios. For this reason the focus of our questions have been around super fund investors.

It has been interesting to watch the evolution of how managers answer the question of who are the most influential parties at superannuation funds when it comes to investment decision-making. From five choices of CEO, CIO, Board/Investment Committee, internal team or asset consultant, managers have nominated the fund CIO as the most influential person in every year of our study ... until this year.

This year, for the first time, internal teams have outranked their boss in terms of influence. And, outranked their bosses boss as well, with CEOs ranked the least influential from our set of five options - from the fund managers' perspective at least.

Just two years ago 51.7% of respondents ranked the CIO as the most influential with 26.7% nominating the internal team. This year those rates have changed to 38.4% for the CIO and 40.5% for internal teams. The Board and Investment Committee remain in third spot ahead of asset consultants and the CEO.

Our team has not changed its long-time ranking with 52.6% opting for the CIO as the most influential and only 15.8% weighting internal teams highest, behind Boards and ICs (26.3%).

Internal teams

The growth of internal investment teams across the eight years of our study has been a significant evolution for funds management businesses to negotiate, as it has been for asset consultancy firms as well. Each year we have asked managers to choose the answer they most agree with from a series of comments on internal teams.

The comments that "internal teams will change the philosophy and culture of funds for the better" and "internal teams are best placed to research and advise on investments for their fund" have consistently been the top two chosen comments for managers to agree with over the life of the study.

However, from our first survey to our most recent, the order of these sentiments has flipped, along with an increase in managers feeling that internal teams are "a major cost for funds and just add to the process".

This trend could reflect the fact that in 2014 the question was being answered from expectations of how internal teams might evolve, as they were just developing in many cases. Whereas now the question is being answered from actual experiences with more, and larger, internal teams and an acceptance of the calibre of personnel being recruited within many funds.

There are still a reasonable number of managers yet to be convinced of the merits of ever-expanding internal teams with a number of comments accompanying an 'other' option (9.6%) and reflecting thoughts ranging from "not enough time elapsed to tell" through to "too much focus on saving fees over generating alpha".

Don't bite the hand that feeds you never seemed so apt.

Table 1: Fund manager responses on internal teams

Internal teams	2014 (%)	2021 (%)
Change the philosophy and culture of funds for the better	30.5%	20.6%
Best placed to research and advise on investments for their fund	23.4%	35.6%
A major cost for funds but worth it for their value add	17.1%	13.7%
A major cost for funds and just add to the process	11.7%	16.4%
Change the philosophy and culture of funds for the worse	3.9%	4.1%

Source: Frontier

Fees

Fee pressure is often cited as a major challenge for fund managers. Frontier has been leading the charge for many years on the issue of a fair fee regime with the argument that asset owners should retain more of the benefits of their scale for their members. Since 2015 we have asked managers in our survey whether they think super funds focus too much on minimising costs and not enough on maximising net returns.

Responses to this question have been very clear over time and becoming increasingly 'clear' as the study continues. In our most recent survey, well more than three quarters (83.8%) of managers feel returns are being compromised in the quest to contain costs. This score has been steadily climbing each year since 2015 (69.8%) with this year's result being the highest score recorded during the life of this study.

Just 2.7% of managers think funds should try harder to control costs. Conversely, and again unsurprisingly, Frontier had a different view on fees with only 41% of our team feeling that funds have too strong a focus on fees over returns – less than half the rate of managers.

In this year's study, for the first time, we asked managers and our own staff, to rank the most fee sensitive investor groups from across the institutional investment market. In terms of ranking first, the results do differ between managers and our own assessment on a volume basis, though not order.

But, perhaps the most significant element to come out of this question is a very strong sense the largest investors, the large super funds (>$40b), are the most fee sensitive with 82.2% of managers nominating that group first and 47.2% of our team. Virtually the remainder of managers gave their number one vote to small super funds, while almost a quarter of Frontierians (22.2%) nominated charities as being the most fee sensitive.

In a weighted sense, behind super funds, managers ranked insurers then universities and charities next, while Frontier responses had that order reversed and a slightly higher score for smaller super funds than large funds.

Table 2: Most fee sensitive investors

	Large super	Small super	Insurers	Universities	Charities	Family offices	Private wealth
Managers	1 (6.7)	2 (6.0)	3 (4.3)	4 (3.5)	5 (3.2)	6 (2.2)	6 (2.2)
Frontier	2 (5.7)	1 (5.8)	5 (3.6)	4 (3.9)	3 (4.6)	6 (2.6)	7 (2.1)

Source: Frontier

These results could reflect a manager focus on the total fee value, given the larger sums being invested by the bigger asset owners. The fact asset consultants have more nuance across their responses covering all groups could reflect the more detailed and strategic discussions we are involved with, relative to managers.

Asset consultants

During the life of our study, we have asked managers for their views on asset consultants. When asked about the most important attributes of a good asset consultant the rankings of attributes have not changed over eight years, but the weight apportioned to them has evolved substantially and consistently over that time.

While the quality of personnel remains the most important attribute for an asset consulting firm, this is now seen as less significant than previously with increasing weight given to both the depth and coverage of manager research; being a source of thought leadership in the industry; and the importance of independence and unconflicted advice. Table 3 lists the evolution of answers around important attributes over the life of the study.

In terms of their view of Frontier, managers have consistently nominated independence as one of Frontier's most important comparative advantages. The weight given to this has been as high as 52% in 2019 following the mood in the industry set by the Royal Commission into Financial Services held around that time.

This year the number of managers citing that aspect of Frontier has returned to a level more consistent with the average over the life of the study at 32.9%.

The quality of our personnel remains our most important attribute in the eyes of managers, as it was at the start of our survey. While our Australian market knowledge is seen as our standout attribute by less managers now than it once was, we think it is not the case this is no longer seen as positive, just not our primary attribute by as many respondents.

There is now a greater likelihood for managers to regard our personnel as our key competitive advantage and we think is a clear endorsement of the evolution of our team over time.

Table 3: Most important attributes of an asset consultant

Attribute	2014 (%)	2021 (%)
Quality of personnel	42.6%	30.6%
Depth of manager/ product research	17.8%	20.8%
Thought leadership	13.9%	16.7%
Coverage of manager/ product research	7.0%	11.1%
Independence	5.4%	9.7%
Local environment understanding	3.1%	5.6%
Other	10.2%	5.5%

Source: Frontier

Table 4: Frontier's most important competitive advantages

Attribute	2014 (%)	2021 (%)
Quality of personnel	27.3%	37.0%
Independence	26.6%	32.9%
Australian market knowledge	21.1%	13.7%
Thought leadership	4.7%	6.9%
GIRA	4.7%	5.5%
Other	10.2%	5.5%

Source: Frontier

frontier

Asset managers

When asked about their own businesses, fund managers have generally consistent views across periods, though some shifts over time are interesting to note.

Asked to choose one of a series of statements they most agree with, managers have felt strongly they provide a depth of research and development that internal teams can't match. Alignment with this comment has increased steadily from 44.1% in the first year of the study through to a high of 58.3% in this year's results. This increase correlates with the increased perceived influence of internal teams over this time.

However, it is at odds with the trend increase regarding internal teams being best placed to research and advise their own funds.

On the notion fund managers should primarily be remunerated on performance, managers this year gave the lowest score on record at 29.2%, down from a high of 41.7% in 2017. Given the bumper returns just delivered in 2020/21 this is a little surprising but maybe indicative of a view future alpha might be more muted.

The full set of choices and this year's results are shown in Table 4. Note, managers were asked to choose the statement they most agree with.

Table 5: Statements on fund managers

Statement	2014 (%)	2021 (%)
Should be primarily remunerated on performance	34.1%	29.2%
Provide a depth of research and development internal teams can't match	44.2%	58.3%
Will need to trim fees to remain competitive	5.4%	5.6%
Will reduce product complexity and performance to meet fee targets	0.8%	1.4%
Will drop in numbers in the Australian market in the next five years	9.3%	5.6%

Source: Frontier

Growth perspective

Despite the many challenges facing them, managers are a remarkably positive lot when it comes to their own business prospects. When asked if they expect their businesses to grow over the next five years (other than via market growth) the overwhelming majority are optimistic, a trend which has not wavered since our study began in 2014. Indeed, this year 91.8% of managers are predicting business growth between now and 2026. This figure has been as high as 97.3% back in 2016, and only ever as low as 85.7% the following year.

Despite that optimism, there are a number of headwinds to the growth of fund managers' institutional businesses. The pattern around these factors was quite consistent in the first four years of our study, from 2014 to 2017, with "pressure from clients for fees to contract and impact on revenue" clearly being offered as the single biggest challenge, generally by around 30% of managers.

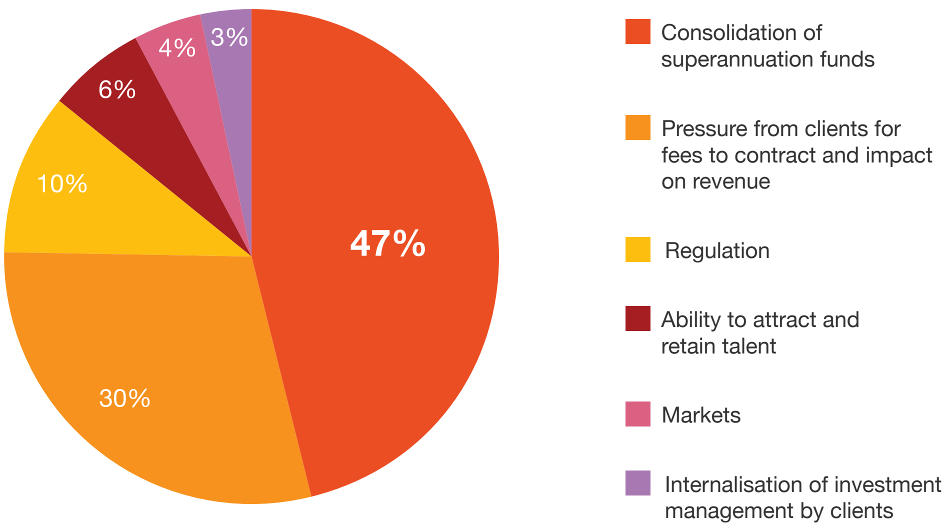
However, in the last four years, two other factors have emerged as significant threats. These are internalisation of investment management by clients, and consolidation of superannuation funds. This year consolidation was seen as the most significant issue by almost half of respondents (43.2%).

As recently as three years ago consolidation was the third factor nominated with just 15.3% of managers choosing this as the biggest issue for them, and in 2016 only 8.3%.

Over time the challenge of internalisation has been growing in terms of its prominence in responses. This year however, virtually no one (2.7%) selected this as their most significant issue. This is not to say internalisation has ceased to be an issue for managers, just not the most significant. Nonetheless, it is intriguing it has fallen from being the most important issue in 2017, chosen by 26.5% of respondents, and as recently as last year still listed by 20.7% of managers, to this year being the least commonly selected. Perhaps, for managers concerned about the structural challenges of both consolidation and internalisation, consolidation looms as a more immediate threat this year and hence received their primary vote.

When we began our survey in 2014 there were 198 'profit-for-members' funds. Fast forward to today and there are currently 82[4]. Of course, there is substantially more money needing to be invested in the superannuation system now but the concentration of that money across an ever-reducing number of funds is clearly causing concern for fund managers with respect to their operations.

Chart 2: Primary concern for funds management businesses



Source: Frontier

[4] ASFA Superannuation Statistics September 2021

Assessing fund managers

In testing the factors that are most important in assessing an investment manager there has been little shift over the course of the study, other than a recognition of the increasing importance of a sound responsible investment approach with a weighted score for that factor of 2.4 up from 1.9 in the early days of this study.

There is also quite strong correlation between managers and Frontier with "quality of personnel" continuing as the most likely attribute to be ranked the highest, along with being regarded as "ethical and trustworthy". Process is seen as being more important than performance.

Table 6: Importance of factors in assessing fund managers

	Quality of personnel	Ethical / trustworthy	Investment process	Net performance	Responsible investment	Diversity of personnel
Managers	1 (4.7)	2 (4.5)	3 (4.0)	4 (3.8)	5 (2.4)	6 (1.7)
Frontier	1 (4.6)	2 (4.6)	3 (4.3)	4 (3.4)	5 (2.3)	6 (2.0)

Source: Frontier

Responsible investment

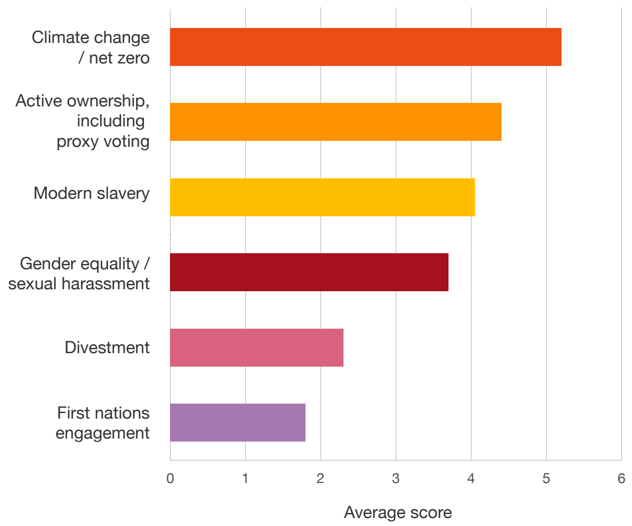
We introduced a new question this year to reflect the emergence of a range of specific responsible investment matters that now demand attention.

We gave managers a range of elements across the E, S and G areas to rank in terms of their current focus with more than half of our respondents indicating "climate change and net zero" was their primary focus in the responsible investment space, ahead of "active ownership, including proxy voting".

On a weighted basis there is certainly a mix of areas of focus across different managers, no doubt based on the nature of their particular strategies and sectors.

A low score does not necessarily mean that area is not seen as important, it merely reflects its rank relative to other areas of focus.

Chart 3: Areas of responsible investment focus



Source: Frontier

COVID-19

The value in any longitudinal study is being able to track results over time to understand change and evolution. This year's survey, however, provided an opportunity to check in on the specific issue of COVID-19 related lockdowns. Hopefully, this is not a theme we ever need to revisit again.

COVID-19, and the subsequent lockdowns enforced in most countries around the world, have affected funds management businesses, as has been the case for virtually all industries. For fund managers this has impacted not just investment performance but the way those businesses have been able to operate in terms of completing research and due diligence, functioning as a team and working with their clients. Of course, it is important to acknowledge first and foremost the varying human costs of COVID-19 in our community. However, we thought it would be interesting to understand how fund managers have been impacted by the pandemic and re-imagined ways of completing their work so asked them to nominate three key challenges posed by lockdowns.

The primary area of concern has been the inability to meet with investors in person to discuss strategies. Seven in ten of our respondents indicated this had been a significant issue for them. The next most challenging aspect was the difficulty in maintaining relationships from a business development perspective, with one third noting this as a significant issue. This is obviously related to the first in terms of the challenge of virtual communication, however the difference is the two-way nature of the engagement in the case of discussing strategies with investors.

The business development dilemma is exacerbated by the fact asset owners are more reluctant to engage 'virtually' in the kind of casual dialogue that helps build relationships and allows service providers, like fund managers, to learn more about the needs and plans of investors through more general conversation.

Reduced collaboration with colleagues was cited by 28.8% as being a key issue. Again, as all businesses have found, while modern communication technology is very successful at allowing remote discussion with both individuals and groups, there is an element of synergy and innovative problem solving that comes from face-to-face team interaction and collaboration that is difficult to replace through screens.

A reduced ability to inspect assets and perform due diligence on proposed investments was listed as a concern for 17.8% of managers. Certainly at Frontier our traditional method of travelling extensively to meet across the desk with key personnel around the globe, or complete in-person inspection of specific assets, has not been possible. For Frontier, our Global Investment Research Alliance partners in North America and the UK and Europe have been increasingly important and provided us with perspectives we would not have had without that partnership. No doubt like many managers have, Frontier has been able to re-think the delivery of our processes in the face of these restrictions without compromising on the depth or scrutiny we apply to our work.

It is worth noting around one third of managers (32.9%) responded they had faced no material impacts from lockdowns and in some cases, not even any minor impacts.

The final word

The institutional investment market has evolved significantly over the last decade and particularly so for fund managers and asset consultants alike. Our longitudinal study provides an interesting picture of how views on the structural factors that impact funds management businesses in Australia have evolved over time.

Over the life of the study, the number of superannuation funds has reduced while assets in the sector have climbed. For larger funds, strong internal capability has been developed both in terms of in-house research and direct investment.

The way asset owners have remodelled their businesses has presented challenges for managers. Although the sentiment towards internal teams remains generally positive, this mood has shifted as funds' aspirations to bring more investing activity in-house have moved to reality.

This, along with superannuation fund consolidation, has occurred at a much faster rate than most had predicted at the beginning of our study.

This eight-year period has seen generally very positive markets for investors, although the last two years have produced volatility in returns driven by a once in a century global pandemic, which of course has delivered its own set of challenges for fund managers beyond investment markets.

While managing fees remains a critical factor for funds, government regulations may also start to influence investors' strategies and broader objectives. This will likely impact the type of products investors seek and managers will need to respond.

Studies of this nature often show there are fundamental elements that always remain. But gradual incremental shifts can lead to significant trends over time. There will always be opportunities for well run, innovative and fairly priced funds management businesses to adapt to changing circumstances in the way they partner with investors. Frontier will continue to enjoy the opportunity we have to work with both asset owners and fund managers as the industry continues to evolve.

frontier

Frontier

Level 17, 130 Lonsdale Street, Melbourne, Victoria 3000

Tel +61 3 8648 4300

Frontier is one of Australia's leading asset consultants. We offer a range of services and solutions to some of the nation's largest institutional investors including superannuation funds, charities, government / sovereign wealth funds and universities. Our services range from asset allocation and portfolio configuration advice, through to fund manager research and rating, investment auditing and assurance, quantitative modelling and analysis and general investment consulting advice. We have been providing investment advice to clients since 1994. Our advice is fully independent of product, manager, or broker conflicts which means our focus is firmly on tailoring optimal solutions and opportunities for our clients.

Frontier Advisors Pty Ltd ABN 21 074 287 406 AFS Licence No. 241266