Investment Management Association

Asset Management in the UK 2007

The IMA's Sixth Annual Survey

Contents

Index of charts, tables and figures

Charts

Tables

Figures

Key Data

£3.4trn
Total assets managed in the UK by IMA member firms as at December 2007

£570bn
Of UK-managed funds domiciled offshore

£1trn
Of assets managed on behalf of overseas clients

44%
Of UK domestic market capitalisation accounted for by IMA members' UK equity holdings.

£468bn
Managed in UK domiciled funds (OEICS, unit trusts)

£10.2bn
Revenue earned by UK-based asset management firms in 2007

Large-scale International Industry

- Assets managed in the UK by all IMA member firms totalled £3.4trn as at December 2007.
- Including a range of firms not captured by the survey, we estimate total assets under management in the UK at close to £3.8trn.
- Just under 60% of IMA firms are UK-headquartered. These firms managed £2.0trn in the UK as at December 2007 and a further £1.8trn overseas on behalf of both UK and overseas clients.
- In total, IMA member firms, or groups of which they are a part, manage a total of £15.8trn globally.

Wide Range of UK and Overseas Clients

- Institutional clients account for 76% of total assets under management, retail for 23% and private client money for 1%.
- The largest institutional clients are corporate pension funds (29%) and insurance companies (25%).
- Overseas clients (both institutional and retail) account for some 30% of total assets under management. This translates into a positive balance of payments contribution of £2.5bn-£3.0bn.

Increasingly Diversified Asset Mix

- Of the £3.4trn under management by IMA firms, 52% was invested in equities, 32% in fixed income, 9% in cash/money market instruments and 4% in property. The remaining 3% is accounted for by a variety of alternative asset classes, currency overlay and structured products.
- Headline numbers show that UK equities accounted for only 51% of total equity exposure, equating to 44% of total UK domestic market capitalisation.

Investment Funds

- The UK domiciled fund industry had £468bn under management as at December 2007, making it the fifth largest industry in Europe. However, in terms of investment funds managed in the UK (but which may be domiciled elsewhere), the figure is over £1trn.

Significant Revenue and Employment

- Total industry revenue was £10.2bn, up 16% year-on-year, with a GDP contribution estimated at 0.6%. Weighted average profitability was 32%.
- Direct employment by IMA member firms was 25,500 with thousands more employed indirectly in firms supplying services to the industry.

Introduction

This is the sixth annual survey undertaken of IMA member firms and continues to be the most representative overview of the UK asset management industry. It is based on questionnaire responses and in-depth interviews with senior figures in 21 leading firms, supplemented by internal IMA data. Questionnaire responses were obtained from 77 firms, managing between them £3.1trn in the UK (91% of total assets managed by IMA members). A list of respondent firms and of firms interviewed is provided in Appendices 3 and 4 respectively.

The survey presents a snapshot of the UK industry across both the institutional and retail landscape. It is important to emphasise that its focus is on assets actually managed in the UK, and will therefore include both overseas and domestic clients. While the majority of clients are UK-based, a significant proportion (around 30%) is not.

The strength of the UK as a centre for asset management activity is once again clearly in evidence. Assets managed by IMA members in the UK totalled an estimated £3.4trn as at December 2007. Including firms not covered by the survey – primarily hedge funds, property funds, private equity firms and private client investment managers – the total is likely to be closer to £3.8trn. While the majority of activity is concentrated in London, 14% of total assets are managed in Scotland.

Key Themes

The UK industry is continuing to undergo major change at a number of levels. Last year, we identified eight key themes. Both the questionnaire responses and the interviews confirm their ongoing importance, leading to a number of observations:

1. Greater polarisation, with the separation of alpha and beta, has been a pronounced feature of the asset management industry internationally in recent years and remains so. However, although the passive component of the institutional market remains significant, survey data does not point to a marked year-on-year increase in the overall proportion of assets accounted for by passive mandates.

2. Asset class diversification is happening not just across asset classes (most notably into alternatives such as commodities or infrastructure) but within them. In this respect, the rapidly growing popularity of global equity mandates over UK equity is a significant feature.

3. Specialisation is a well-established trend, with an accompanying fragmentation of the institutional market. We identify this year an intensifying focus on fund objectives that are not tied to 'traditional' benchmarks such as the FTSE All Share. This is leading to ever greater interest in absolute return and unconstrained mandates. At the same time, a greater number of managers emphasised the potential for 'new balanced'/diversified growth products, which tend to run against a cash or inflation benchmark. The use of alternative approaches and asset classes within the latter can be seen as part of the diversification trend.

4. Convergence between both alternative and mainstream asset managers continues. In this respect, within the mainstream asset management industry, the term ‘long only’ is no longer entirely apposite. Survey returns this year show that half of respondents operate hedge funds and a fifth run 130/30 funds. At the same time, the retail and institutional markets are converging at product level, while distribution changes are eroding the conceptual distinction between retail and institutional business.

5. Liability preoccupations are driving the ongoing institutional adjustment that is seeing lower equity exposure by DB pension funds. At the same time, Liability Driven Investment (LDI) strategies are becoming a greater reality across the pensions industry and undergoing an evolution from earlier approaches. However, the number of asset management firms involved in delivering a full solution, as opposed to parts of LDI strategies, remains comparatively small as does the proportion of assets identifiable as LDI mandates.

6. Platform-based distribution is growing in scale and importance, with ongoing implications for asset managers. While there is watchfulness regarding margin compression, interviewees point to a more binary environment where perceived failure to perform can quickly result in ‘de-selection’ and negative flows.

7. Europeanisation of the regulatory and commercial environment is seen at a number of levels. In operational terms, other European centres remain key domicile locations for UK managed funds.

8. Globalisation is creating major opportunities. At client level, while far from being a new feature of the landscape, the profile of ‘sovereign wealth funds’ has risen substantially over the past year. Interviewees also pointed once again to government asset pools (in all their guises) as opportunities for institutional business. On the retail side, while UCITS is seen as a strong global brand, there was more caution expressed in certain quarters in relation to the challenges faced in exporting funds internationally.

Figure 1: Eight Key Themes

Greater polarisation brought about by alpha and beta separation, and the commoditisation of certain beta products.

Diversification as clients look towards wider sources of return.

Specialisation/fragmentation as institutional clients look for strong manager performance in specific asset classes.

Convergence between alternative and mainstream asset managers, and between retail and institutional products.

Liability preoccupations driving the development of a range of products designed to help defined benefit pension schemes better manage their funding challenges.

Platform-based distribution leading most asset managers to think of themselves as manufacturers or wholesalers.

Europeanisation of the regulatory and commercial operating environment.

Globalisation as a combination of new client and investment opportunities are provided.

Clearly, a major development since last year's survey is the current credit market crisis and we explore this issue in a special section of the survey. The immediate consequences for the asset management industry are generally not as significant as for those at the heart of the crisis, principally the banks. However, there will be consequences for the industry and its clients. Some changes – for example, in areas such as risk analysis and product development – will take time to take shape and it is therefore too early to predict precisely what impact they will have. There is also the risk of a more severe and/or sustained economic downturn, which would work to the detriment of the industry. At the same time though, the outlook is not entirely negative, with a view that the discrediting of highly leveraged vehicles may work to the benefit of proven 'alpha' generators in the mainstream asset management industry.

Finally, with respect to operational issues, one key change over the last year has been a series of critical comments about the tax and regulatory environment:

- On the tax side, the focus of interviewees tended to be on the broader environment rather than fund-specific taxation. Several issues provoked comment: taxation of individuals with non-domicile status; the way in which corporations are taxed on overseas profits; and the general manner in which the Government is behaving on tax policy. While there were divergent views expressed on the non-dom issue specifically, there is broad consensus that at a wider level a negative message is being sent both domestically and internationally about the business climate in the UK.

- On regulation, the major emphasis was on the Treating Customers Fairly (TCF) policy work being undertaken by the FSA. A range of concerns were expressed, on occasion very forcefully, by those we spoke to across the industry. The overall message was that while firms are committed to the principle of customers having access to the appropriate information set about retail products, the way in which the regulator is pursuing the TCF workstream is generally not seen positively.

Structure of Survey

All of these themes and issues are discussed further in the main body of the survey, which is in five parts:

- The first provides an overview of the UK industry, looking at its general structure, and the nature of the assets managed in the UK by client and asset type.
- The second looks in more detail at the institutional market.
- The third examines the funds market, with an emphasis on the UK domiciled investment fund (unit trust/OEIC) environment.
- The fourth explores the causes and consequences of the credit market crisis.
- The fifth looks at a range of operational issues, including profitability, the attraction of the UK as a country in which to do business, UK headcount and interaction with the market.

A number of general points should also be noted:

- Unless otherwise specified, all references to 'Assets Under Management in the UK' refer to assets under management by IMA members in the UK as at December 2007.
- Unless otherwise specified, the IMA survey and internal databases are the source of all data cited.
- Not all respondents have been able to provide information for all questions and not all questions have been answered on the same basis. Response rates have therefore differed across questions. An overview of responses is provided in Appendix 1.

As in the past, the survey has been designed with comparability to the previous survey in mind. However, even where firms replied in both years, some may have responded to a question last year but not this year or vice versa. Where meaningful comparisons are possible, they have been made.

The IMA would like to express its gratitude to all those firms who provided detailed questionnaire information, as well as to those individuals who gave their time for interviews.

1. Overview of UK Asset Management Industry

Key Findings

1. Overall Size and Location

- Assets managed in the UK by all IMA member firms totalled £3.4trn as at December 2007.
- Including a range of firms not captured by the survey, we estimate that total assets under management in the UK at close to £3.8trn.

2. Asset Management Activity

- IMA members run a full range of products out of the UK, including property and alternatives. Almost half of respondents run hedge funds.

3. Client Type

- Institutional clients account for 76% of total assets under management, retail for 23% and private client money for 1%.

4. International Dimension

- Overseas clients (both institutional and retail) account for some 30% of total assets under management.
- Internationally, IMA member firms or groups of which they are a part managed a total of £15.8trn.

5. Industry Concentration and Consolidation

- The industry remains relatively unconcentrated, with the top ten firms accounting for less than 50% of total assets under management. This has broadly been the case for the last five years.

- In terms of ownership, insurance-owned asset managers remain the largest single group, with 30% of assets under management. Asset/fund managers are the second largest group (27%).

6. Overall Asset Allocation

- Of the £3.4trn under management by IMA firms, 52% was invested in equities, 32% in fixed income, 9% in cash/money market instruments and 4% in property. The remaining 3% is accounted for by a variety of alternative asset classes, currency overlay and structured products.

- UK equities under management continue to fall, with quite a sharp drop over the 12 months to December 2007. Headline numbers show that UK equities accounted for only 51% of total equity exposure.

1. Overview of UK Asset Management Industry

1. Overall Size And Location

The survey covers a representative sample of 140 IMA member firms, who manage £3.4trn in the UK as at December 2007.[1] Respondents fall into five general categories:

- Asset management firms with a sizeable global footprint themselves, or which are part of firms with such a footprint. Such firms undertake a wide range of asset management activities across the institutional and retail market space and tend to have considerable overseas client money under management in the UK.
- Large and medium-size firms, whose business is primarily UK/European-focused and which offer a diverse product range.
- Firms whose business is primarily based on investment funds.
- Smaller asset management firms, which may be specialist boutiques or focused on the private client market.
- Occupational Pension Scheme (OPS) managers running in-house asset management operations.

Chart 1: Assets Managed in the UK by IMA Members (2002-2007)

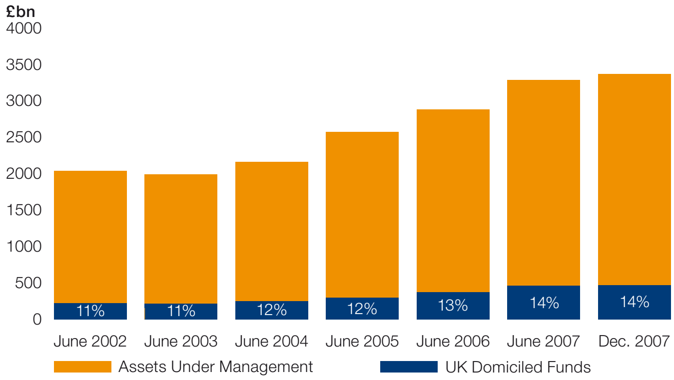


Chart 1 shows the progression over the five and a half years to December 2007, during which time assets under management in the UK rose by 65%. We have also included total assets for UK domiciled investment funds (unit trusts and open-ended investment vehicles), which are discussed in more detail in Part Three:

- The key element to note here is the distinction between what is commonly termed the 'UK funds industry' (i.e. UK domiciled investment funds) and the wider UK asset management industry, which is much larger. UK-based asset managers also manage a significant proportion of assets for overseas-domiciled investment funds (see p.21 and p.49)

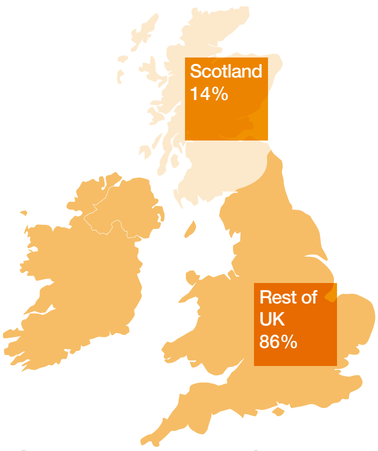
[1] This figure is calculated using a complete internal IMA data set for assets under management as at June 2007 and adjusting it based on survey questionnaire responses for December 2007.

- Historically, UK domiciled investment funds have been associated more with the retail market, as opposed to an institutional market where segregated mandates and other forms of pooled vehicle are the norm. However, investment funds are used both by retail, private client and institutional investors; for the latter, they are often a convenient way of gaining diversification or access to high-performing managers.

- Funds as a proportion of total assets under management have increased from 11% in 2002 to 14% in 2007.

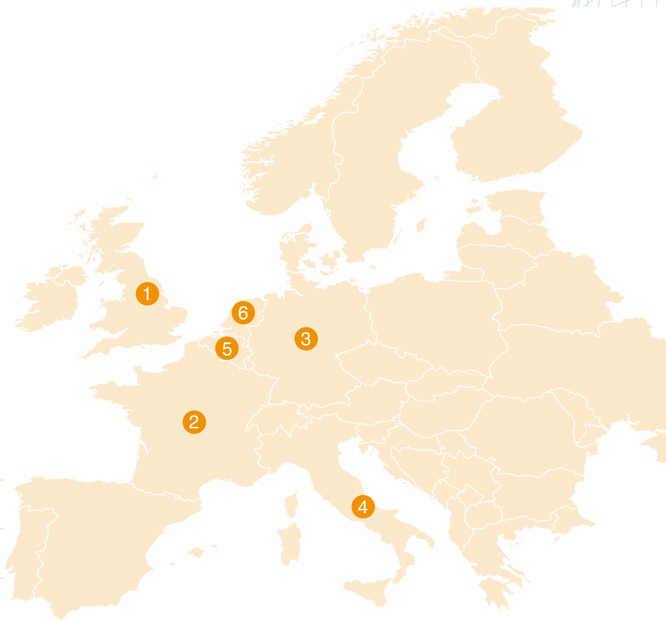
The majority of assets under management in the UK by IMA members are run out of London, but there is also a substantial Scottish asset management industry, primarily based in Edinburgh. We estimate that around 14% of total UK assets under management (£460bn) were managed in Scotland as at December 2007 (see Figure 2).

Figure 2: Scottish Share of UK Assets Under Management



In a comparative context, an EFAMA Asset Management Survey suggests that the UK industry accounts for 34% of total assets managed in Europe (€13.5trn as at end– 2006).

Figure 3: Assets Under Management in Europe (% Total European AUM)



Countries

1	United Kingdom	34%
2	France	20%
3	Germany	10%
4	Italy	6%
5	Belgium	4%
6	Netherlands	4%
●	Rest of Europe	22%

Source: EFAMA Annual Asset Management Report (July 2008)

2. Asset Management Activity

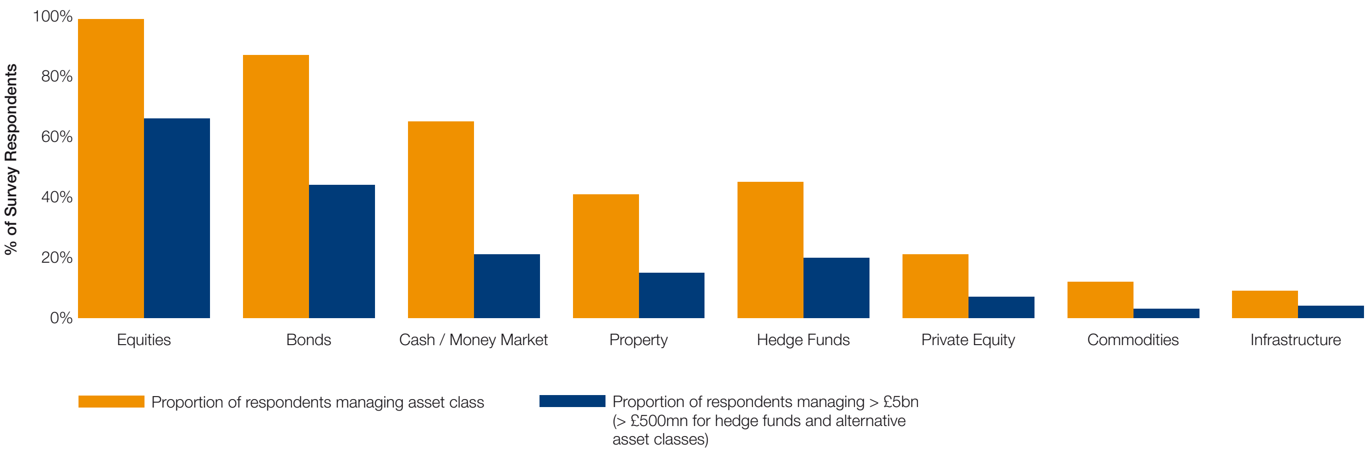
In terms of activities, IMA member firms operate across both the mainstream and alternative asset management spectrum. Chart 2 gives a profile of survey respondents in this respect:

- Almost all respondents manage equities, bonds and cash, with a large proportion running property mandates as well.
- Among alternatives, although private equity vehicles, commodity and infrastructure funds are not widespread, hedge funds are operated by just under half of all respondents.[2] Just over a fifth of respondents have more than £500mn each of assets under management in hedge funds.

The Chart is also indicative of two key points about the industry and the survey:

- While the IMA membership base has substantial property as well as alternative products and assets under management, there are a significant number of hedge fund and private equity vehicles not managed by IMA members and not covered in this survey. Including these, we believe that the total figure for assets under management in the UK is around £3.7trn.[3] Including private client assets managed in discretionary portfolios, the figure is likely to be close to £3.8trn.
- A number of large players in the hedge fund industry, who are also IMA members, are running sizeable parts of their hedge fund operations – both asset management and fund domicile – outside the UK. This is continuing to make hedge fund activity difficult to capture.

Chart 2: Proportion of Survey Respondents Managing Different Asset Classes/Products in the UK



[2] A direct comparison cannot be made with previous surveys due to a change in the way in which we are measuring hedge fund activity. Hedge funds are now classified as a product rather than as an asset class.

[3] We estimate that IMA members manage £30-35bn of hedge fund assets in the UK. Total UK managed hedge fund assets were estimated at $348.5bn (£175bn) as at December 2007 by a Eurohedge Survey.

3. Client Type

A general overview of assets managed in the UK by client type is given in Chart 3:

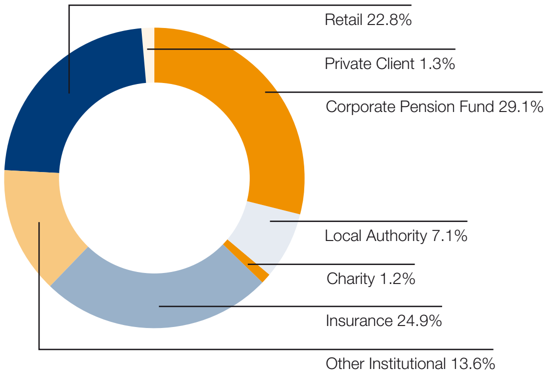
- Institutional assets under management account for 76% of the total, with the largest segments being corporate pension funds (29%) and insurance companies (25%). Retail assets account for 23% and private client money for 1%.

- The insurance segment (which counts both in-house and third party mandates) is lower than last year – 25% compared to 27% in December 2006, which itself was a marked drop year-on-year. Matched samples from 2005-2007 confirm the trend and suggest that this is not caused by a contraction in insurance assets, but by comparatively faster growth in other parts of the asset management market.

- After corporate pension fund and insurance mandates, retail continues to represent the third largest client type.[4]

- The 'Other Institutional' category includes a range of clients: for example, corporations, sovereign wealth funds and asset gatherers who are outsourcing their asset management.

Chart 3: Assets Managed in the UK – Client Type



Both the institutional and the retail parts of the industry are analysed in more detail in Parts Two and Three of the survey. However, as we identified in last year's survey, categorisation in terms of the traditional institutional versus retail divide is becoming increasingly problematic:

- A range of developments – primarily open architecture on bank and insurance platforms, the emergence of new platform technologies and the growing popularity of funds of funds and manager of manager products – are creating a greater distance between asset managers and end-investors.

- For many firms, a retail perspective is replaced with a wholesale view of the world, and it may not even be possible to know precisely who the ultimate beneficiary of fund holdings is.

[4] The survey does not collect retail market data on the same basis as the IMA monthly statistics. It focuses on assets under management in the UK, regardless of where the fund or client is domiciled. In consequence, it picks up a wider range of retail funds, which will explain why the percentage share here is larger than implied by the IMA monthly data. See p.49.

4. International Dimension

This survey captures in detail only those assets managed in the UK (i.e. where the day-to-day management of assets is handled by asset managers based in this country). However, the UK asset management industry is highly international – and becoming more so – in a number of quite distinct ways, as Figure 4 illustrates.

Figure 4: Four Dimensions of the UK as an International Asset Management Centre

Overseas firms – A substantial number of overseas-owned asset management firms operate in London, accounting for 40% of total assets under management.

Overseas clients – Around 30% of total assets under management are accounted for by overseas clients, contracting either directly with the UK entity or via the sub-advisory route.

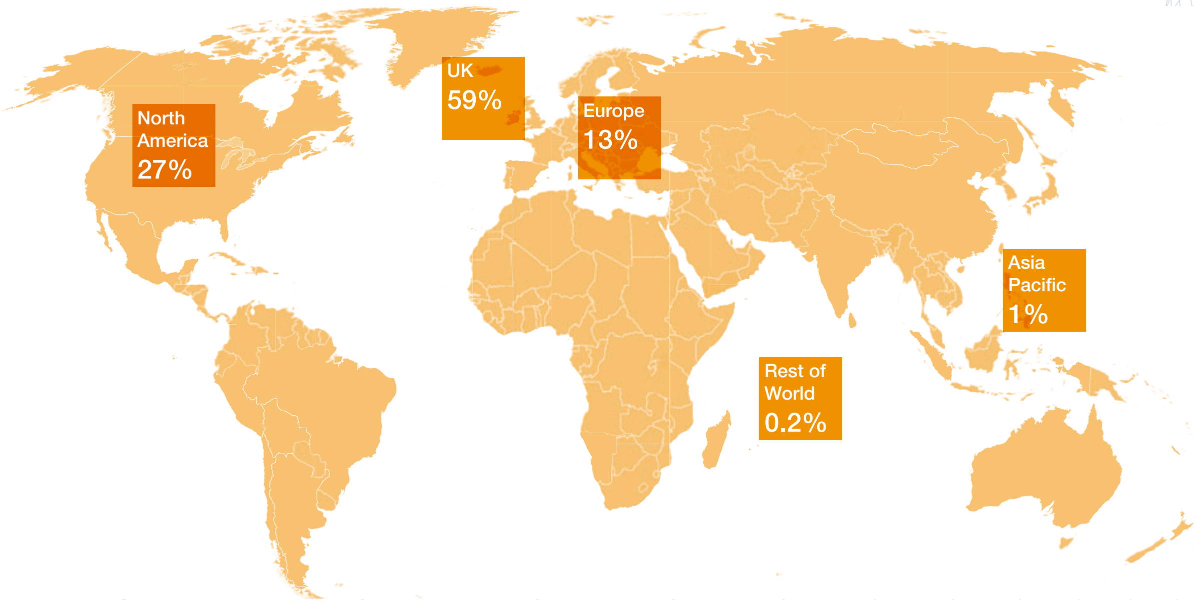
Overseas domicile – An estimated 17% of total assets under management in the UK are operated in funds domiciled overseas, primarily Dublin and Luxembourg.

Overseas management – UK firms also manage assets overseas for both UK and other clients. UK-headquartered asset management firms manage a further £1.8trn globally. Taken together, asset management firms operating in the UK manage a further £12.4trn globally.

Overseas Firms Operating in the UK

There are a number of international firms with a sizeable global footprint operating in the UK. Figure 5 breaks down total assets under management in the UK by region of group (or parent group where relevant) headquarters. While just under 60% of UK assets under management are accounted for by UK asset management firms, North America (overwhelmingly the United States) accounts for 27%. Europe makes up 13%.

Figure 5: Assets Under Management in the UK by Region of Group Headquarters



Overseas Clients

Assets are managed in the UK on behalf of a wide range of international clients. Data this year suggests that 30% of total assets managed in the UK – over £1trn – are managed on behalf of overseas clients, either directly contracted with the UK management firm or contracted with an overseas office of that firm, which delegates the management to the UK. This is a clear increase on last year (27%) and matched samples confirm a marked upward movement. It also suggests a positive balance of payments contribution of £2.5bn-£3.0bn in 2007.

The overseas client data continues to illustrate a strong degree of polarisation within the UK asset management industry between a comparatively large number of firms, for whom overseas clients constitute less than 10% of assets under management, and a smaller, but nonetheless significant number, for whom such clients are a key part of their UK business. This is illustrated in Table 1. For 34% of respondents, managing between them £672bn in the UK, over half of their assets under management in the UK are managed for overseas clients. While we do not split out client types by client domicile in the survey, interview information and other sources suggest that this client base is wide-ranging, across both the institutional and retail space.

Table 1: Proportion of Assets Under Management (AUM) Accounted for by Overseas Clients

Assets Managed in the UK for Overseas Clients (% of AUM)	Proportion of Respondents (%)
0-10%	51%
11-25%	8%
26-50%	8%
51-75%	17%
76%+	17%
Total	**100% (65 Firms)**

For those firms with a more international focus, opportunities continue to be seen across the globe. While Europe is an obvious market, a number of firms are also seeing substantial new business in Asia, the Middle East, Latin America and Australia.

Last year, we identified four key drivers of the growing international opportunities:

- Diminishing regulatory barriers and the success of UCITS as a global brand.
- The trend towards open architecture.
- An increasing variety of government asset pools.
- A gradual expansion in individual savings pools.

All four of those drivers are still significant and interviewees for the current survey made a number of further points on several of these areas:

Government asset pools. Many noted the rising profile of sovereign wealth funds (SWFs), while also emphasising that these funds are not a new phenomenon and have been a feature of the landscape – and clients of asset management firms – for many years. However, three elements are significant in their current prominence:

- Rapid growth. SWFs are growing rapidly. Growth estimates vary, but one report suggests that total SWF assets could rise by $1trn a year over the next five years, with 20% of those assets being outsourced to external managers.[5]
- High profile. More attention is being focused on SWFs as a consequence of their increasing prominence internationally, for example, high profile stake-building in large western corporates.
- Increasing diversity. There is an increasing diversity of what is grouped together under the 'SWF' banner. As we noted in the previous survey, one relatively innovative factor is the emergence of government asset pools specifically earmarked for retirement funding: for example, the National Pension Reserve Fund (NPRF) in Ireland, the *Fonds de réserve pour les retraites* (FRR) in France or China's National Social Security Fund (NSSF).

International funds market. UCITS is becoming a strong global brand and facilitating fund exports. Indeed, there is a general view that the growth of savings pools internationally is likely to create considerable opportunities for the asset management industry in the longer term. This is confirmed by a recent EFAMA Survey, which pointed to an overwhelming conviction that UCITS sales would increase in Asia, Latin America and the Middle East over the next 3-5 years.[6]

Despite this optimism, there are signs of caution among some firms, particularly over the ease with which certain international markets can be accessed by overseas fund operators:

'The old days of setting up a Luxembourg-based SICAV and distributing it out of Hong Kong and doing well in South East Asia are going. While there's a growing global, institutional market, the regional [retail] markets in South East Asia are becoming increasingly localised. If you want to do business in Taiwan or Korea, you're going to need a local partner.'

'The disappointing thing at the moment is the way that Asia is going very local again. UCITS isn't becoming a panacea for Asian markets. The tax treatments tend to favour local products in Taiwan and Korea. It's early days for us, but we really haven't cracked it.'

5. See Stephen Jen, 'How Much Assets Could SWFs Farm Out?', Morgan Stanley Perspectives, April 4, 2008. See also Simon Johnson, 'The Rise of Sovereign Wealth Funds', Finance and Development (IMF bulletin) 44/3.
6 'UCITS as a Global Brand: An industry survey by EFAMA', July 4, 2008.

Overseas Domicile

A considerable proportion of funds are domiciled overseas, with the asset management taking place in the UK:

- Luxembourg and Dublin are key locations for overseas-domiciled assets. UK promoters are thought to account for 38% of total net asset value for Irish-registered investment funds, and 11% of Luxembourg funds, equating to around £420bn as at end December 2007.[7] At the same time, assets will also be managed in the UK for US promoters with funds domiciled in Dublin and Luxembourg.

- Overseas domiciled investment funds are promoted in Europe, Asia and other regions internationally. As yet, there is little sign of significant sales of overseas-domiciled funds into the UK retail market. This is addressed further in Part Three of the survey.

- In terms of the composition of overseas-domiciled funds, almost all institutional money market funds whose assets are managed in the UK are domiciled in Dublin and Luxembourg. Other overseas-domiciled vehicles comprise a range of institutional and retail products, including hedge funds and exchange-traded funds (ETFs).

Overall, data from the survey suggests that around £570bn of assets are managed in the UK by IMA members for overseas-domiciled funds (including hedge funds). This equates to 17% of total assets under management in the UK. Including hedge funds not covered by IMA membership, that figure would rise by around £140bn.

Overseas Management

Assets are of course also managed outside the UK on behalf of both UK and international clients. Indeed, it may be the case that funds managed on behalf of a UK client are both domiciled and managed overseas.

While some firms centralise their asset management, many have the reverse philosophy (i.e. portfolio management and trading being located in the region of the asset rather than the client). The latter will delegate formally or simply manage the assets directly in overseas offices in the relevant region: for example, regardless of client domicile, a firm might manage its UK and European equities out of the UK but run its US equities out of North America or its Asian equities out of Tokyo, Singapore or Hong Kong:

- UK-headquartered firms manage £2.0trn in the UK. Globally, they – or firms within their group – manage a further £1.8trn.

- In total, we estimate that IMA members or the groups of which they are a part, managed over £15.8trn globally as at end December 2007.[8]

[7] Source: Irish Funds Industry Association and the Commission de Surveillance du Secteur Financier, Luxembourg.
[8] This estimate is based on a combination of survey data and public source information (primarily annual financial reports).

5. Industry Concentration and Consolidation

The size range of firms managing assets in the UK (as measured by an internal IMA data set from June 2007) is illustrated in Chart 4. We do not include here investment fund operators who outsource all of their asset management operations.

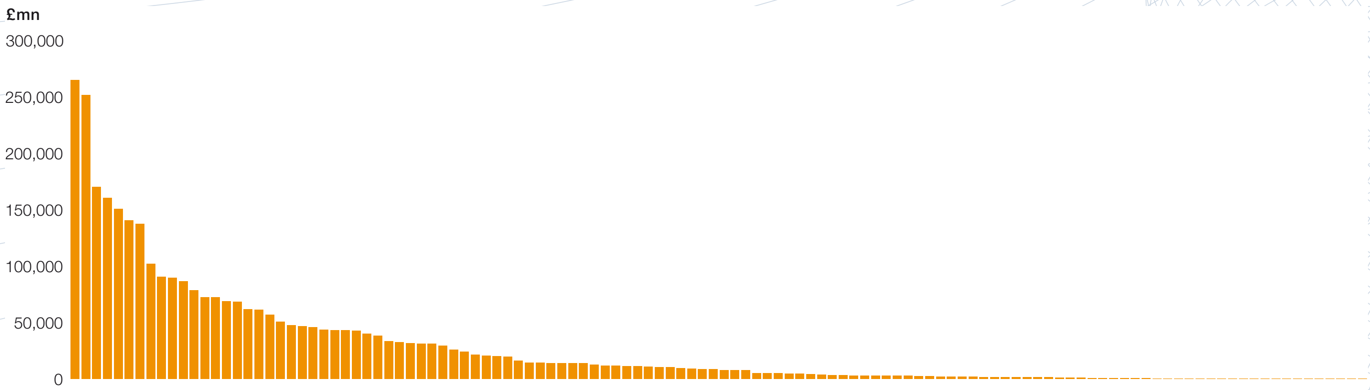
As in the past, the chart shows a steep curve downwards from a comparatively small number of very large firms, and a long tail:

- The average is £27.4bn with the median at only £8.1bn.
- While 19 IMA member firms each managed in excess of £50bn (see Table 2), 78 managed less than £16bn, 27 of whom managed less than £1bn.[10]

Table 2: Assets Managed in the UK by IMA Firm Size (June 2007)

Assets Under Management	Number of Firms (June 2007)	Survey Respondents (Dec. 2007)
>£100bn	8	8
£51-100bn	11	11
£26-50bn	16	13
£16-25bn	7	6
£1-15bn	51	32
<£1bn	27	5
Total	**120**	**75**[11]

Chart 4: Firms Ranked by Assets Managed in the UK (June 2007, £mn)[9]



[9] Internal IMA data is used for this analysis and is not available for December 2007.
[10] The IMA membership includes a number of fund management firms who outsource their asset management operations. The numbers provided in this section are therefore a sub-set of the total.
[11] Although 77 responses were received, two of the firms are mutual fund operators which undertake no in-house asset management.

Overall though, concentration remains low. Looking at the position of the largest firms (ranked by asset management conducted in the UK):

- The top five firms accounted for 30% of assets managed in the UK by IMA members. This is unchanged from a year earlier.
- The market share of the ten largest firms was also broadly unchanged at 47%.

As Chart 5 illustrates, this situation has changed little over the past five years for which IMA data is available. At no time in this period has the share of the largest ten firms exceeded 50% of the market. The funds market is slightly less concentrated with the share of the top ten still only 45% (see p.55).

Chart 5: Market Share of Largest Asset Management Firms (% Total UK AUM, 2002-2007)

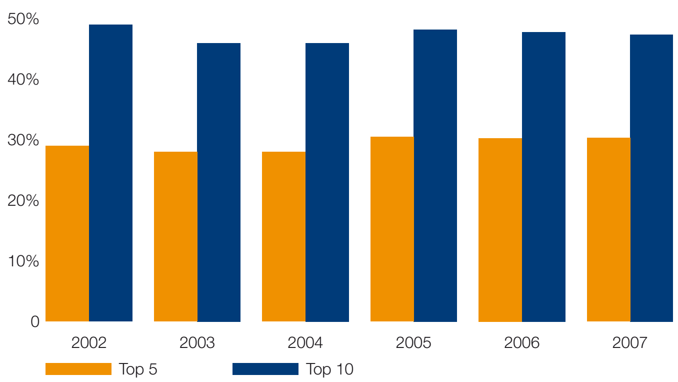


Chart 6 shows UK and global assets under management for the ten largest firms in the UK as at December 2007. With respect to these firms, a number of further points can be made:

- The top three are characterised by their leading place in the indexing market, both domestically and internationally.
- There is a marked contrast between the more domestically-focused firms and those that are part of major international operations. This is illustrated by the global assets under management data within Chart 6.
- Bank and insurance-owned firms remain highly significant players (see Table 3).

Chart 6: Assets Managed in the UK and Globally –
Ten Largest Firms by UK AUM (December 2007, £bn)[12]

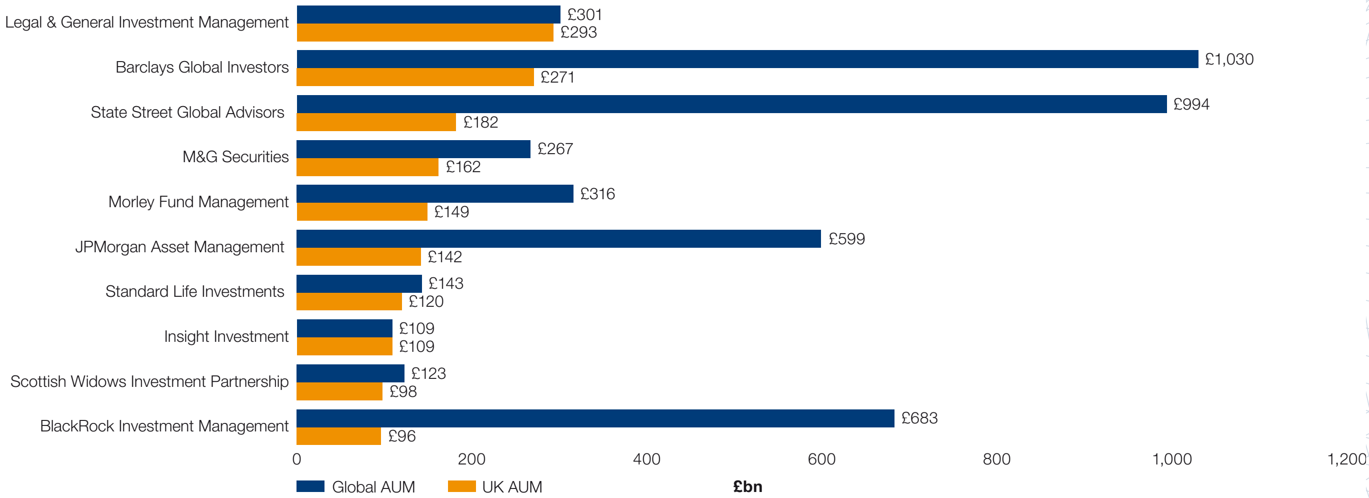


Table 3: Parent Groups of Largest Firms (by UK AUM)

Asset Management Firm	Parent
Legal & General Investment Management	Legal and General Group PLC
Barclays Global Investors	Barclays PLC
State Street Global Advisors	State Street Corporation
M&G Securities	Prudential PLC
Morley Fund Management	Aviva PLC
JPMorgan Asset Management	JPM Chase & Co.
Standard Life Investments	Standard Life PLC
Insight Investment	HBOS PLC
Scottish Widows Investment Partnership	Lloyds TSB Group PLC
BlackRock Investment Management	BlackRock

[12] The global number includes assets under management by parent group.

Obstacles To Consolidation

The past year has again seen few signs of a developing consolidation momentum in the UK asset management industry, although the passive market has become more concentrated (see p.36). There is still a view that further consolidation will take place if market conditions deteriorate substantially. In this scenario, trends in both the retail and institutional market place are felt to be pushing inexorably towards a position where weaker performers in the active management market will not be able to survive.

However, a number of respondents continue to emphasise how difficult it is to make consolidation work in the asset management industry:

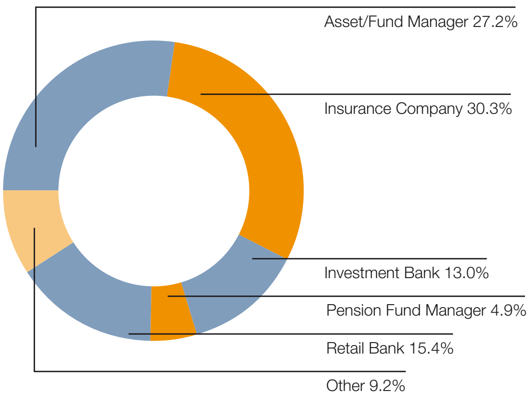
'All of the top line logic about why this industry should be ripe for consolidation always sounds good, but when you test the real life case studies, it's harder and harder to make the numbers stack up. The main area where it can work is not where you are looking to consolidate to take out costs, but actually where you are just looking to bolt on the capability that you simply haven't got.'

This approach of 'bolting on' capability also sits more comfortably with both the trend towards specialisation and the intellectual capital component of the asset management industry, which makes it challenging to undertake merger and acquisition activity with the kind of synergies that can be achieved in other industries less dependent on a comparatively small pool of individual talent. The implications of specialisation are also discussed in more detail in Part Two.

Ownership Patterns And Corporate Relationships

In terms of current ownership patterns, insurance-owned asset managers remain the largest single group, with 30% of assets under management. Asset/fund managers are the second largest group (27%). For more detail, see Chart 7.

Chart 7: Assets Managed in the UK – Ownership of Firms



While it is still useful to produce a parent classification according to the dominant business within the parent, we have noted in recent IMA surveys that ownership categories are becoming less meaningful. First, cross-sector consolidation and expansion is tending to create a growing number of global diversified financial services firms, which will often combine a wide range of services to retail and institutional clients. Second, the business realities for the asset management subsidiaries are often quite different than the ownership structure might suggest:

- Some firms within larger groups have a longstanding emphasis on external business as a defining element, as opposed to the more usual relationships which see strong internal commercial ties.

- A number of firms which would previously have been defined by their in-house relationships are increasingly significant players in the institutional asset management arena. Conversely, there is an emerging trend for mandates related to life company balance sheets and products (as opposed to access via open or guided architecture) to be outsourced to external asset management companies (see p.32).

- Open architecture in the insurance and banking sectors, and the rise of fund platforms, means that the notion of a bank-owned or insurance-owned asset manager is less relevant for retail distribution than it may have been in the past.

These changing structures also mean that relationships between firms in the asset management and distribution arena are increasingly complicated. For example, an insurance-owned manager might be distributing through both a parent group's distribution network and that of other insurers via open architecture or a fund of funds/ multi-manager product. As one interviewee put it, this also reflects a whole series of new realities across the financial sector as a whole:

'Firms used to be very vertically integrated. They tended not to outsource much and to say that if something was worth doing, they would do it themselves. Over the last decade or so, the financial services industry generally has moved to a position where firms are much more willing to partner with third parties, including their competitors, to get things done and the nature of the inter-relationships is very complex. It's all about the principle of comparative advantage: people doing things they are best at and not being precious about things they are not.'

6. Overall Asset Allocation

With respect to the overall question of what is being managed in the UK, respondents were asked to provide total assets under management based on asset classes and geographical areas. Chart 8 shows total assets under management in the UK broken down into equities, bonds, cash/money market, property and other (excluding hedge funds).

Chart 8: Assets Managed in the UK – Asset Allocation

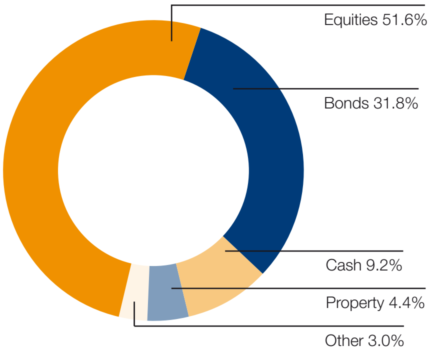


Table 4: Asset Allocation – Headline Data and Matched Samples

	Equity	Bonds	Cash	Property	Other
Headline Data					
Dec-07	51.6%	31.8%	9.2%	4.4%	3.0%
Dec-06	52.4%	31.7%	8.7%	4.8%	2.4%
Matched Sample					
Dec-07	50.7%	31.7%	10.1%	4.5%	3.0%
Dec-06	53.0%	31.7%	8.8%	4.9%	1.6%

In comparison with the December 2006 figures, the relative proportion of equities (51.6% from 52.4%) and bonds (31.8% from 31.7%) has not greatly changed (see Table 4). However, using matched samples from firms who replied in both 2006 and 2007, the proportion of equities shows a moderate fall. Market movements over this period (see Table 5) would tend to confirm an ongoing movement out of equities.

Table 5: Returns on Selected Indices (December 2006 – December 2007)

	Capital Return	Total Return
Equities		
FTSE All-Share Index	2.0%	5.3%
FTSE World (ex UK)	7.4%	9.7%
Fixed Income		
iBoxx Sterling Gilts Overall	0.0%	5.2%
iBoxx Sterling Non-Gilts Overall	-3.8%	1.8%
Lehman Global Aggregate Bond	-0.4%	9.5%

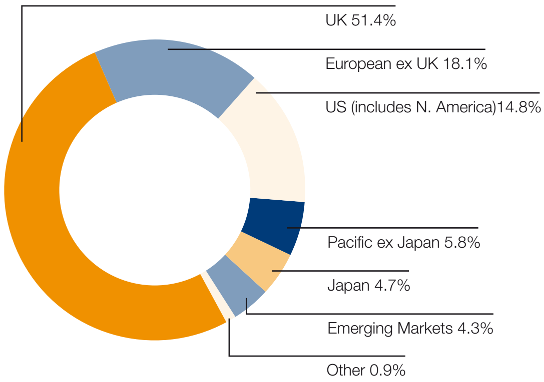
Source: Lipper Hindsight

Looking in more detail at equity allocation by region, the equity split using a regional breakdown is outlined in Chart 9. UK equities remain predominant, with European and US equities the second and third largest components respectively. However, there has been a sharp fall in UK equities (to 51% from 59%). Matched samples show a marked fall, but not of the same magnitude (to 54% from 59%).

Given that comparative performance only accounts for a small part of this movement, we would look elsewhere for an explanation. The change in both the relative weight of equities and other asset classes, and of UK and overseas equities, appears once again to be influenced substantially by the behaviour of pension funds and other institutional investors. This is discussed in more detail in the next section.

In terms of UK equity holdings as a proportion of total UK domestic market capitalisation, this year's survey suggests that IMA members manage some 44% of the total as at December 2007 (from 47% a year earlier). As we note above, the scale of the year-on-year fall is mitigated when taking into account sampling effects. Nonetheless, the moves out of UK equity are clearly having a downward impact on the total holdings of the UK asset management industry.

Chart 9: Assets Managed in the UK – Equity Allocation by Region



2. Institutional Market

Key Findings

1. Client Type

- Within the institutional market, corporate pension funds (38%) and insurance companies (33%) were the largest client components in the sample, followed by local authorities (9%).

- Within the insurance component, 20% of mandates are accounted for by third party asset management firms.

2. Assets Under Management

- The overall equity (44%) and bond (37%) exposure of institutional clients continues to move in favour of bonds.

- Within the equity component, UK equity mandates are markedly falling out of favour, particularly among UK pension funds.

- While overall volumes remain comparatively low within firms, IMA members detect a greater interest in alternative asset classes and products.

3. Separation of Alpha and Beta

- Although there is no significant increase in assets managed passively in the UK (just over a fifth of total institutional assets), the polarisation between beta and alpha continues. At the active end of the spectrum, there is increased emphasis on high alpha, unconstrained and, particularly, absolute return approaches.

- While 130/30 funds have been a high profile product trend of the last 12 months, overall assets under management in the UK remain modest so far at an estimated £6bn.

4. Specialisation… but increased talk of new balanced

- The trend towards specialisation is stabilising. Survey responses indicate that specialist mandates account for 74% of total institutional assets managed in the UK (excluding in-house corporate pension fund assets). This figure rises to 84% for all third party business, broadly unchanged from last year.

- A number of firms suggested that new balanced or diversified growth approaches were likely to increase in popularity.

5. Segregated Mandates and Pooled Funds

- The survey data suggests that in terms of total third party institutional business, the proportion of assets in segregated funds is 62% compared to 38% in pooled funds.

- The survey also confirms our other previous findings about the dominance of larger scale players in the pooled market. Concentration in the third-party passive market is increasing.

6. Outlook for DB Pension Funds

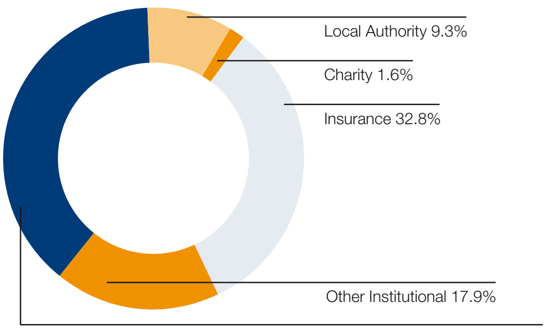
- Firms were gloomy about the overall outlook for DB schemes, particularly in the light of proposed accounting reforms. While LDI was once again identified as an increasingly important trend, the buyout market is also clearly expanding, albeit with capacity constraints.

2. Institutional Market

1. Client Type

Respondents were asked to provide mandate information for institutional investment based on assets managed in the UK on behalf of both UK and overseas-domiciled clients. A number of firms manage sizeable mandates in the UK for a wide international institutional client base.

Chart 10: Institutional Assets Managed in the UK – Client Type



Institutional mandates split by client type are shown in Chart 10:

- Corporate pension funds (38%) and insurance companies (33%) are the largest clients, followed by local authorities. While most of the local authority assets relate to pension funds (and do include some overseas local government mandates), some of the mandates are not pension-related and pertain to cash management.

- A large majority of insurance client assets (80%) are still in-house funds (managed by asset management subsidiaries on behalf of parent groups that are insurance companies or have a large insurance component within the group).

- The 'other institutional' category contains a wide range of clients, which broadly fall into three main groups: corporate clients; government agencies (incl. central banks and sovereign wealth funds); and financial services industry (sub-advisory services to other fund management firms; banks; private client stockbrokers etc.). Here, there is also a sizeable cash management component (illustrated in Chart 12). Additionally, some money included here may also ultimately be retail, but unidentifiable behind an institutional mandate from another asset manager or an asset gatherer. This reflects the way in which many firms see themselves as wholesalers to asset gatherers both in the UK and overseas, and is part of the wider trend towards the blurring of the retail and institutional markets.

As noted in the last two surveys, the dynamics of the insurance market are changing. External asset managers now account for 20% of total insurance assets. Although this is not showing a significant year-on-year increase from 2006 to 2007, it is consistent with broader, if slowly developing, trends in the international asset management industry. Third party managers are increasingly looking to insurance companies (including pension fund buyout firms, see p.42) as a source of institutional business as the latter seek to outsource a range of investment functions. As a US study last year pointed out, this is not confined to small and medium-sized companies, but extends more widely.[13]

One increasing driver of change is perceived to be regulatory scrutiny and the extent to which regulators are placing increasing emphasis on governance structures in captive funds. As one in-house investment firm put it:

'More often than not, we are having to demonstrate better than best. Captive firms have to show the regulator and their own in-house teams that it is justifiable for them to have the mandates.'

[13] See Patpatia & Associates, Inc. (2007), 'Insurance Asset Management Investment Approach & Manager Dynamics'.

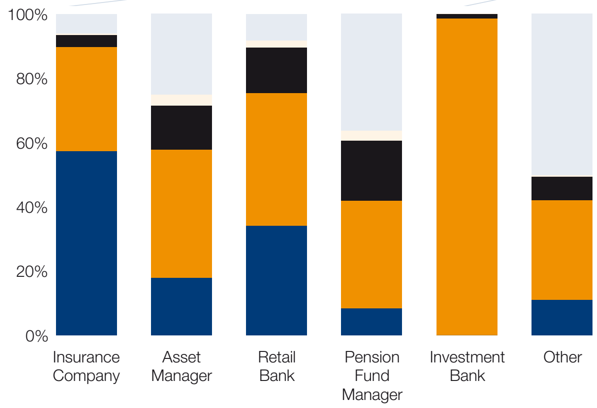
However, firms interviewed tend to remain cautious about the speed and scale of the change:

'Greater third party business is an inevitability. There are advantages to in-house managers, especially in the sharing of ideas, so it is likely to be a slow process.'

This change is also seeing different fee relationships between in-house managers and their groups, with greater use of market-referenced charges.

At the same time, a number of larger insurer-owned asset managers are increasingly building up sizeable third party institutional and retail business from outside their group. Chart 11 shows the extent to which a number of insurance-owned asset managers are particularly significant players in the pension fund part of the institutional market: 35% of institutional business for insurance-owned asset managers comes from corporate pension funds and local authorities.[14]

Chart 11: Institutional Assets Managed in the UK – Asset Manager Parent Type by Client Type

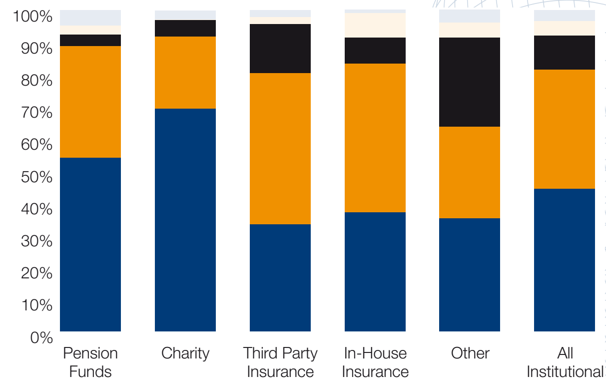


	Insurance Company	Asset Manager	Retail Bank	Pension Fund Manager	Investment Bank	Other
Insurance	57.3%	17.8%	34.0%	8.4%	0.0%	11.0%
Corporate Pension Fund	32.4%	40.0%	41.3%	33.5%	98.5%	30.9%
Local Authority	3.7%	13.7%	14.2%	18.7%	1.5%	7.4%
Charity	0.5%	3.3%	2.1%	3.2%	0.0%	0.5%
Other Institutional	6.2%	25.3%	8.3%	36.3%	0.0%	50.2%

2. Assets Under Management

In terms of overall assets under management, Chart 12 provides a general overview across the main asset classes and across institutional client types. The data and interview responses support two dominant themes: a continued movement out of equities by pension fund clients, and a growing interest in alternatives.

Chart 12: Asset Allocation (Institutional Assets)



	Pension Funds	Charity	Third Party Insurance	In-House Insurance	Other	All Institutional
Equities	54.0%	69.3%	33.3%	37.0%	35.2%	44.3%
Bonds	34.8%	22.4%	47.0%	46.4%	28.5%	37.2%
Cash	3.5%	5.1%	15.4%	8.0%	27.7%	10.5%
Property	2.9%	0.3%	2.1%	7.7%	4.7%	4.6%
Other	4.7%	2.8%	2.2%	1.0%	4.0%	3.4%

[14] The large insurance component of retail bank-owned asset managers reflects the existence of siginificant insurance business within several retail banking groups.

Equity Exposure

The largest set of institutional clients, pension funds, continue to move both out of equities in general, but also out of UK equity into non-UK equity exposure, with a particular current emphasis on global mandates:

'Generally, the old bias towards UK equities has died. There is less demand in the pensions world for Europe, Asia, North America per se because they have gone straight from UK to global for the asset class as a whole.'

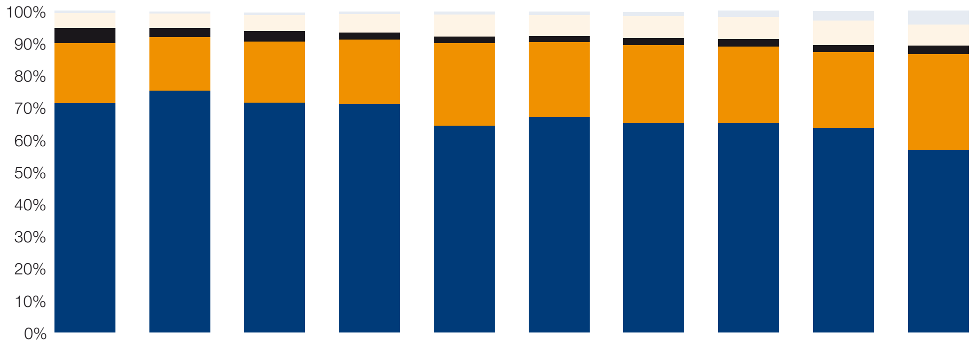
'People seem to be increasingly looking at the UK as a specialist area that is almost a satellite of the core, and they are going down the unconstrained route in UK equities to get away from this benchmark bias and use it as a source of added value over and above equity returns.'

To the extent that the IMA survey captures both overseas pension fund assets managed in the UK and does not capture UK client money managed overseas, our asset allocation figures cannot be taken as a firm indication of the specific behaviour of UK pension fund (or other institutional) clients. However, other data points to similar developments:

- WM Performance Services estimates that UK pension funds saw their holding change from 63% equities in 2006 to 57% (see Chart 13). Within this, UK equity mandates declined from 32% to 25%, halving over the last ten years (see Chart 14).[15]

- UK Office for National Statistics data on beneficial ownership of UK shares demonstrate that pension fund holdings have steadily fallen from a peak of 32% of the total in 1992 to only 13% in 2006.[16]

Chart 13: UK Pension Fund Asset Allocation (1998-2007)

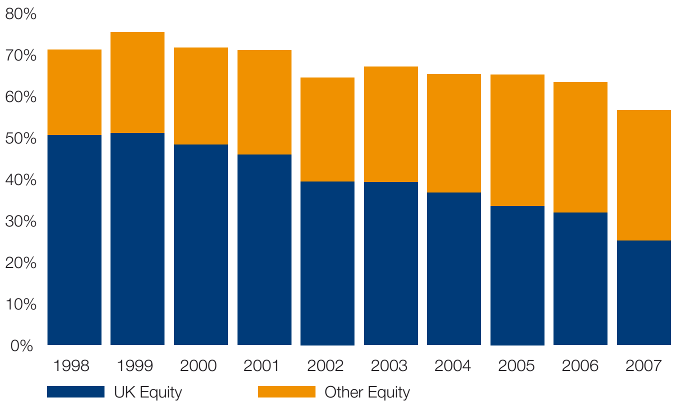


	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Equities	71.2%	75.2%	71.4%	71.0%	64.3%	66.9%	65.1%	65.1%	63.4%	56.6%
Bonds	18.7%	16.7%	19.1%	20.0%	25.7%	23.5%	24.2%	23.8%	23.8%	30.0%
Cash	4.7%	2.8%	3.2%	2.2%	2.0%	1.8%	2.2%	2.4%	2.2%	2.5%
Property	4.7%	4.4%	5.0%	5.8%	6.9%	6.4%	7.0%	6.8%	7.5%	6.6%
Alternatives	0.8%	0.7%	0.8%	0.8%	0.9%	1.1%	1.2%	2.0%	3.0%	4.5%

Source: WM Performance Services: UK Pension Funds Annual Review 2007

[15] For more details on the behaviour of UK pension funds, see 'WM Annual Review: UK Pension Funds 2007' (WM Company) and 'Pension Fund Indicators 2007' (UBS).
[16] See ONS, 'Share Ownership' (2006). Over the same time period (1992-2006), insurance company holdings have also fallen sharply, although less dramatically, from 19.5% to 14.7%

Chart 14: UK Pension Fund Equity Asset Allocation (1998-2007)



Source: WM Performance Services: UK Pension Funds Annual Review 2007

The explanation for this change centres on several key issues, including concerns about the concentration of the UK stock market, greater correlation with international indices and the attractiveness of a wider global opportunities set. The suggestion was also made that the 'home bias' previously seen in a number of markets is also diminishing elsewhere, creating other opportunities for firms offering global strategies.

'There is a natural move to global among UK clients. The UK equity market has become very concentrated, which causes concern that you have a market dominated by one or two sectors. The diversification benefit of being in equities is therefore reduced. Why limit yourself to one market when there is a whole world out there you can invest in and get the benefits from diversification?'

'A major ongoing trend is the internationalisation of portfolios. We have a US client who is now about 65% international. This was ahead of his peer group, but it is representative of what UK funds have also done, avoiding or allocating away from the home market towards international. It's happening everywhere else too.'

'Why limit yourself to one market when there is a whole world out there you can invest in and get the benefits from diversification?'

Moves Into Alternatives

'The underlining theme is pursuit of low correlation. People just don't want to be loaded up with market risk.'

Once again, alternative asset classes and products are attracting wide interest among institutional clients:

- While survey data shows that private equity (0.3%), commodities (0.1%) and infrastructure funds (0.1%) remain a comparatively small proportion of total institutional assets under management in the UK, their usage is increasing and is expected to increase further.
- Although hedge funds represent only 1% of total assets under management, almost one half of survey respondents indicated that they now operate hedge funds.

In this area, several respondents commented on the popularity of fund of funds approaches, which can diversify both manager and asset class:

'The number one trend is the continuous shift into alternatives which incorporates both hedge funds and private equity – hedge funds defined more by funds of hedge funds than by direct exposure.'

'Alternatives remain very attractive with clients, particularly funds of alternatives. Funds that combine private equity, infrastructure, hedge funds within a single wrapper is an area of interest because a number of funds are too small to do those type of investments direct but see the benefit of diversification.'

While pension funds do appear willing to diversify into alternative asset classes and products, one interviewee drew what he felt was a sharp contrast between the behaviour of pension funds and endowments:

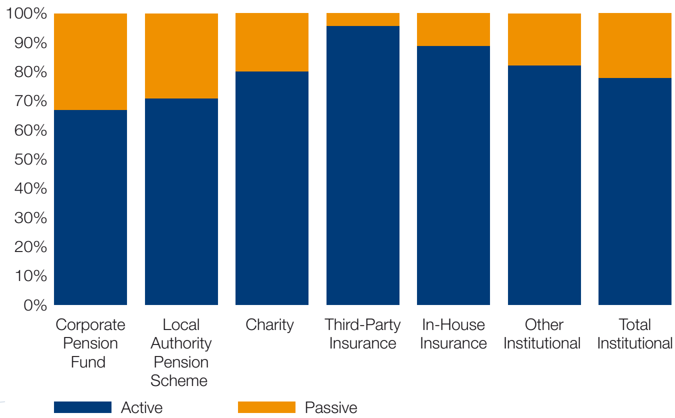
'Endowments continue to be more open to a wider range of asset classes, and seem at times more likely to pull the trigger and make a decision to go into new asset classes than trustees of pension plans. In the pension space, there is a growing interest and willingness to consider it, but they haven't yet taken the plunge.'

'The underlining theme is pursuit of low correlation. People just don't want to be loaded up with market risk.'

3. Separation of Alpha and Beta

There has been a trend in asset management over the past few years to make a clearer separation between alpha (value-added by active management) and beta (market return). This continues to be a major feature of the institutional market, and is also associated with the trend towards specialisation (see following section).

Chart 15: Use of Active and Passive Management (Institutional Assets)



As in previous surveys, we asked again this year about the use of passive management and Chart 15 illustrates the results across institutional client type.[17] The data suggests little substantial change in total institutional assets managed in the UK on a passive basis which account for just over 20% of the total. Within the passive market, however, there are signs of increasing concentration, largely due to the exit of one player last year. The largest three firms account for 93% of third party passive assets under management in the UK we have been able to identify.

In the active space, there are a number of ongoing developments, related both to specialist alpha based on a proven ability to significantly outperform and more innovative use of that alpha. This translates into:

- Demand for high alpha products relative to index benchmark.
- Increasing demand for index unconstrained strategies, for example, based on a ‘best ideas’ approach.
- Increasing demand for absolute return strategies.

Those we interviewed put particular emphasis upon absolute return as a key feature of the current institutional market. Many also saw absolute return as likely to be increasingly important in the retail market (see Part Three).

The other significant product story of the last year has been the gradual introduction of 130/30 funds (or equivalent), combining long and short trading positions and illustrative of the way in which the boundaries between the ‘long only’ and alternative parts of the asset management industry are blurring.[18] Survey results show that only around a fifth of respondents operate 130/30 funds, which represent around £6bn of assets under management in the UK. Most of this is institutional money and survey interviewees expect it to take some time before the new funds take off in a more substantial way, not least because of the lack of track record for the new funds and the unpropitious timing of their launch:

‘As an active manager, we think that 130/30 is probably just a much better way to run a portfolio because we can short the stocks we don’t like and leverage the stocks we really like. It’s a better way to really put the conviction into our process, but it’s been a tough time to show convictions.’

[17] Defined as non-discretionary stock and securities selection (excluding enhanced index products).
[18] 130/30 funds, and variations thereon, refer to an approach whereby 100% long exposure in a portfolio of stocks could be combined with 30% of short selling, with the proceeds of the short selling reinvested in long exposure.

Of firms that are not offering 130/30 funds, the general reason is a concern that there is a mismatch of skill sets whereby they do not have the expertise to short:

'The 130/30 thing has been incredibly fashionable. We had quite a significant internal conversation but decided for lots of reasons not to do it. I think most concluded that doing the 30 bit of the 130 requires a set of skills that are actually not that obvious and knowing what you want to buy is not the same as what you want to short.'

Looking ahead, in the context of the credit crisis (see later discussion), several interviewees we spoke to thought that there might be a reaction on the part of institutional investors against more complex products. While it remains to be seen how this will play out, some firms believe that one consequence will be the separation of 'true' alpha generators from those only able to achieve strong performance through the use of substantial leverage:

' I think what we have seen is quite a significant acceleration of the blending of the traditional long only and alternative/hedge fund space. What seems to have helped that acceleration is obviously the dislocation we've seen in financial markets and the negative effects of leverage unwinding on people who were confusing leverage with alpha.'

With respect to the broader consequences for clients of a more polarised environment, which sees pure passive at one end and high performance active mandates at the other, there are (unsurprisingly) different views from within the industry. These reflect longstanding differences of philosophy over the use of passive vs active management:

'The situation is unsustainable because they should not drive the core allocation on a passive basis. In five years time, you will see that the price of over-prudence is just as powerful as the price of imprudence. Pension sponsors don't want the volatility. However, a pension fund is actually well-placed to experience volatility because they are supposed to be investing for a 15-25 year horizon. Instead, you are going to end up with sub-optimal returns.'

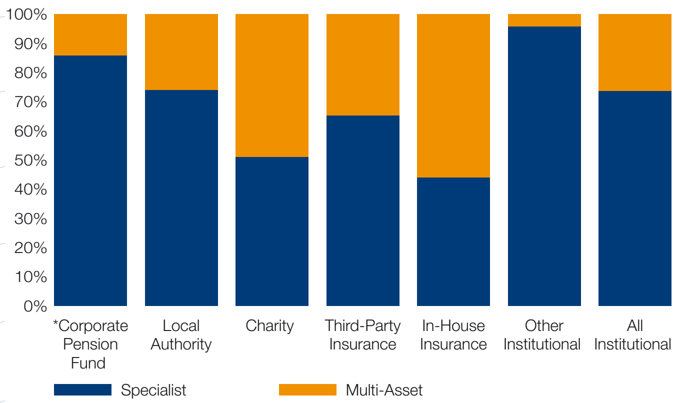
'The core-satellite is bound to disappoint. If you talk to active managers, I think there is a case of hope springs eternal. You have to believe that you can add that alpha consistently over a period of time. The alpha business is always going to have a degree of cyclicality. Even the best people have periods in which they don't do so well.'

4. Specialisation…but increasing talk of New Balanced

Within the overall institutional space, survey responses indicate that specialist mandates account for 74% of total institutional assets managed in the UK (excluding in-house corporate pension fund assets). This figure rises to 84% for all third party business, but is broadly unchanged from last year. The responses are analysed across client type in Chart 16.

This move towards specialist mandates has contributed to the growing fragmentation of the institutional market, which is creating a range of opportunities as well as adjustment challenges for asset managers. As we noted last year, one feature of this change is that a number of firms who have previously been concentrated on the retail market and found it difficult to win significant institutional mandates are finding that there is greater interest in managers and products that would in the past have been seen as predominantly 'retail' oriented. At the same time, players from outside the traditional 'long only' industry have also found opportunities to win business.

Chart 16: Use of Specialist and Multi-Asset/Balanced Mandates (Institutional Assets)



*Excl. in-house corporate pension fund assets

New Balanced Mandates

'The point about old balanced is that it wasn't very balanced. It was substantially weighted towards equities. Consistent with the idea of diversification and low correlation, you will see a different pattern emerge.'

At the same time, more interviewees this year raised the prospect of an increase in 'new balanced' or diversified growth business, particularly in the context of liability driven investment, but also in the context of greater general interest in absolute or total return products. The new balanced approach can differ from the 'traditional' balanced mandate in several key respects:

- **Benchmark**. In new balanced mandates, the portfolio is likely to be run against a cash or inflation benchmark.
- **Portfolio composition**. While balanced mandates would previously have been focused on a limited number of conventional asset classes, there is a greater tendency to include a wider spread of asset classes, such as commodities.

While this may appeal to a range of institutional investors, a number of firms we spoke to emphasised the new balanced approach as an important part of LDI mandates, where the manager is providing a strategy for long term out-performance alongside a solution to deal with inflation/interest rate risk. In this arena, small and medium-sized corporate pension funds are particularly significant:

'It is about providing a pot of assets that delivers a return characteristic for a given volatility that maps the risks contained in a client's own liability profile. It isn't just about what LDI was seen as 3 or 4 years ago (bond immunisation and putting swaps over and providing a cash stream). People are finally coming to that point of recognising that you cannot really hedge and diversify away mortality risk, so if that's the only risk in your pension fund, you're still left with a need for long-term active management.

'And that's particularly important for smaller to medium size pension funds. It is much more economic for them to put the immunisation in, take down their risk budget and then spend their active risk budget on this kind of new balanced product. If they can find a firm with an ability to deliver some kind of inflation plus, then it makes a good deal of sense.'

At the same time, there is still a perceived demand for multi-asset mandates from other kinds of clients, for example, local government pension funds, which are seen to be in a different place from many corporate schemes: for example, comparatively less pressure on funding, generally a larger number of active participants and more caution on fees. Like many small and medium-sized corporate pension funds, they may also not be geared up to handle the level of complexity that specialist mandates bring.

As Chart 16 demonstrates, while specialist mandates account for the majority of local government mandates identified in the survey (which also includes some overseas local authority business), there is much greater use of multi-asset approaches than in corporate pension funds. The charities sector also sees significant use of multi-asset mandates.

With respect to longer-term trends, while most interviewees felt that specialisation was set to continue, a number of firms do see limits and a possible move in another direction.

'The limits of specialisation are being tested, and people who are more adept at addressing asset allocation issues, particularly when mapped against liabilities, will be at a premium.'

'I think there is quite a lot of scepticism on the part of our clients about the fragmentation that the specialist approach brings and whether they are satisfied. They know that old balanced is out of fashion, so we are seeing greater interest in new balanced.'

'Interestingly, one of the things that happened in the US a few years ago was that specialisation went into reverse. It may be that this trend comes here too. I certainly don't see any signs of greater specialisation.'

5. Segregated Mandates And Pooled Funds

The survey data suggests that in terms of total third party institutional business (i.e. excluding in-house assets and those run by OPS firms), the proportion of assets in segregated funds is 62% compared to 38% in pooled funds, in line with our findings over the past two years. The survey also confirms our other previous findings about the dominance of larger scale players in the pooled market:

- Of 47 respondent firms, 42 managed third party pooled funds of £544bn. Of this group, only eight firms manage more than £10bn each, but account for almost 80% of the total.

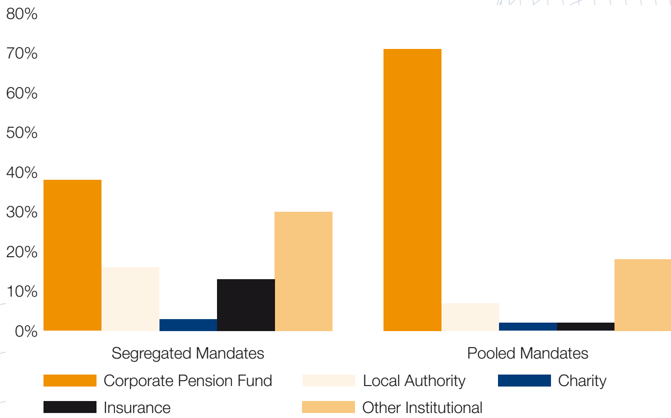
- The shape of the segregated market is rather different. Out of a total of 47 firms managing £903bn, the number of firms managing more than £10bn rises to 22.

Table 6: Distribution of Third Party Segregated and Pooled Mandates

	Segregated	Pooled
Number of Firms Managing > £10bn	22	8
% of Total Third Party Institutional AUM by these Firms	89%	79%
Number of Firms Managing > £5bn	31	17
% of Total Third Party Institutional AUM by these Firms	96%	93%
Sample size: 47 Firms		

Looking at the composition by client type of segregated and pooled third party business identified in the survey, corporate pension funds have a particular tendency towards the use of pooled funds (see Chart 17). As we have noted before, this in considerable part reflects the presence of very large pooled indexing vehicles. For reasons mainly relating to tax, these vehicles tend to operate within a life fund structure.

Chart 17: Client Composition of Segregated and Pooled Third Party Institutional Business



6. Outlook for DB Pension Funds

'We are concerned about the seeming inevitability of the death of DB. I think that society is sleepwalking into sacrificing what has been an extraordinarily effective system.'

In membership terms, the momentum in the pensions market internationally is with DC. In the UK, it is expected to intensify as the Government introduces auto-enrolment from 2012. Nonetheless, as a proportion of total pension assets, the stock of DB assets dwarfs DC and is likely to continue to do so for some time. For asset managers, therefore, this is still a very important part of their business and a substantial preoccupation.

Growth of LDI

Within the DB side of the pensions industry, the dominant theme continues to be the question of how schemes can be better assured of meeting future liabilities. In this respect, liability driven investment (LDI) is rising in importance. This year's survey suggests that approaches specifically marketed as LDI strategies account for around 8% of total pension fund assets under management. Given that parts of LDI strategies will be implemented across a number of asset managers, this headline number is likely to understate the full extent of usage.[19]

The increase on the 6% recorded last year accords with comments made in interviews that LDI – if still a small part of the overall market – is now making progress far more clearly as a distinct product offering. However, there is still some degree of caution about whether the current iteration of products is going to deliver in line with current expectations, with some scepticism expressed about whether the various components will actually satisfy the expectations that now exist.

At the same time, the broader outlook for DB has not improved. One particular current issue concerns proposed changes to accounting standards, which might result in the discount rate used to report pension liabilities under FRS 17 being changed to a risk-free rate. The objection often stems less from a rejection of the technical justification on which they are based, but the substantial anticipated public policy consequences:

'Anything that lowers the discount rate reduces the survival rate of DB schemes. Whether that is an intended or unintended consequence is almost irrelevant. At a time when so much of the world's investor base is moving into a range of asset classes in order to achieve a greater return for the same amount of risk, it seems unreasonable that the accounting profession would be forcing an asset allocation into risk-free instruments.'

'I would just step back and ask "what are we trying to do with pension schemes?" Quite clearly, they are beneficial to the employee and I would have thought it was in the Government's interest to try and protect that. The authorities ought to be pressing the Accounting Standards Board to be sensible.'

This mirrors wider evidence about corporate concerns with respect to the sustainability of DB schemes. When asked in a recent Economist Intelligence Unit survey to rank the most significant risks, 48% of board-level executives cited regulatory changes affecting pension funding (the next highest ranking criterion was mortality assumption: 47%, followed by equity risk: 40%).[20]

[19] To measure the true extent of LDI usage, it would also be necessary to survey investment banks, which provide competition for the asset management industry in this area.
[20] See Economist Intelligence Unit, 'A Way Through the Maze: The Challenges of Managing UK pension schemes' (2008).

Emergence of Buyout Market

'Pension buyouts were a marketing idea a short time ago with very few deals other than the normal insurance package small end of the market. Now, we are seeing some really quite substantial deals, very aggressive pricing'.

In such an environment, the potential attractiveness of scheme buyout is a theme mentioned by a number of asset managers we interviewed. While there was an acceptance of the inevitability of this market developing further, several expressed concerns that buyout might be seen as a short-term panacea, with unforeseen longer-term issues, relating to credit or counterparty risk.

'How can we be worried about corporate bond spreads over Treasury spreads and be very happy and content that a start-up operation is going to guarantee the livelihood of thousands of pensioners 20 years from now. I'm not saying they won't. I'm just saying that the company wants to do it to get rid of the problem. But it doesn't get rid of the problem from the pensioners' point of view.'

'Are you storing up a problem? That's a distinct possibility. The difficulty is that you won't see the problem for a long time. It is better for the regulator to look into it now rather than have issues ten years down the line.'

At the same time, a number of interviewees also felt that capacity issues within the buyout market meant that a substantial increase in demand could lead to capacity issues that would impact on price and potential popularity. In such a context, it was also suggested that if asset management firms could actually manage to remove a significant proportion of the volatility facing pension sponsor balance sheets for a competitive price, then this could prove attractive to schemes:

'There is the issue of how much longevity risk any group can take on and who is the natural buyer of longevity risk? If the whole of the DB market moves towards annuities, someone has a lot of longevity risk and that has got to be offset.'

'The buyout market will be something to be reckoned with in the long run, but capacity is still very limited. I think that if demand picks up, you are likely to see the pricing structure change. This will limit growth to an extent; it will always be an issue of price. The buyout market is at one end of a spectrum of solutions. There are other risk mitigating solutions, such as liability-based management, which offer a different cost/risk trade off.'

'We are concerned about the seeming inevitability of the death of DB. I think that society is sleepwalking into sacrificing what has been an extraordinarily effective system.'

7. Broader Implications of Current Trends

The trends already outlined collectively add up to a set of opportunities, but also considerable challenges for the asset management industry (see summary in Figure 6).

For active managers, it is clear that the UK pension fund market has changed substantially as a result of alpha/ beta polarisation, the growth of LDI and, to a lesser extent, the growing buyout market. Taken together, these developments leave such firms competing for a smaller proportion of assets, often with less time to prove their worth. However, with the focus shifting to performance, higher fees are available to those who can deliver. Some see this as a major opportunity and are relaxed about the commercial implications:

'Our experience is that where you have got both alpha and innovation, clients are willing to pay for that. So if you are successful in garnering a share of the smaller pot, then actually it's very profitable. If you haven't, I think you're going to get commercially squeezed, which is quite right; let the market work.'

'You may pick up a smaller slice of the pie, but people are happy to pay more for it, much more. I've been delighted with the hedge fund industry because what it has done is to inure a whole generation of fund selectors and decision-makers to understand the difference between price and value. So now the discussion is shifting more towards one of value.'

Others see greater headwinds and a need for a change of focus as institutional demand itself changes:

'The clear trend is one of the continuing decline of the fee cake for UK pension funds as more goes into indexed, more gets transferred into bonds, and some disappears into buyout. So you just see the fee cake getting smaller at the same time as we all know sovereign wealth is exploding. If you looked ten years ago at the pecking order of fee cakes internationally, UK pension funds came in second to the US. The business is just disappearing now and a day's marketing may better be spent elsewhere than the UK.'

With respect to the position of buyout firms, the position is quite complicated. In one respect, they are clearly direct competitors to asset management firms in the pension fund market. At the same time though, the tendency to outsource asset management functions also creates opportunities, particularly for companies with fixed income capabilities. The key question though is how profitable some of this business will be, with a number of firms expressing doubts about the commercial attractiveness of outsourced mandates from the buyout industry:

'They are competitors in a way, but they are also clients of the industry. We manage assets for buyout companies. Somebody still has to be the underlying manager. Few of the buyout companies have set up their own internal asset management capabilities.'

'[Buyout] is not great news for us. What typically happens is that where we've got a mandate from a medium-sized pension fund, we suddenly get a call and that's gone. And, unlike the balanced to specialist argument where we would hope to retain some of the book, this is lost to us and the industry. We are then left with the prospect of working with [Buyout Company X] at a much lower fee if we get lucky enough to be one of the scale managers on their roster.'

Figure 6: Key Trends in UK Institutional Market

Trend	Features
Diversification of sources of beta	Rising general interest in alternative asset classes, such as infrastructure and commodities.
Separation between beta and alpha	At one end of the spectrum, beta is becoming increasingly inexpensive. At the other, there is an expanding range of products, including 130/30 absolute return and unconstrained strategies seeking to satisfy investor demand for innovative and higher performance active management.
Pension fund emphasis on fixed income portfolios and growing focus on LDI	DB pension funds are increasingly preoccupied with liability matching and corporate balance sheet impact. This has seen a substantial move out of equities into fixed income, but also wider use of LDI solutions. While LDI is often associated with immunised bond portfolios it also encompasses some of the specialist and innovative alpha products.
Emergence of pension buyout companies	A number of DB sponsors are increasingly considering transferring plan liabilities to insurance companies, with specialist (buyout) firms established in recent years.

'Our experience is that where you have got both alpha and innovation, clients are willing to pay for that.'

A Different Role for Asset Managers?

The changing nature of pension fund preoccupations is also seeing some changes in the dynamics of distribution within the institutional market. As we noted last year, a number of asset management firms perceive opportunities to play a wider role in the provision of services to clients. Responses from interviewees this year confirm that there is indeed increasing consideration now of a somewhat different tactic, which could see firms offering approaches encompassing areas such as asset liability modelling, strategic asset allocation and manager selection. This is also reflected in the market place, with several firms associated with fiduciary services overseas now appearing in the UK:

'There is desire by many of our pension fund clients, both here and internationally, to have someone who's thinking about the whole scheme day-to-day as opposed to a consultant who sets up a strategic benchmark, hires managers and does not address that benchmark other than a tri-annual review. It's of course always a debate that emerges when you get volatility in markets.'

'At the one extreme, you have got the way we did things in the past, which was pure assets and no liability consideration. At the other extreme, you have the buyout market where you remove all of the risk. And then you've got a fiduciary model and asset management solutions which span a new space.'

It is not just the case that asset management firms are seeking to re-position themselves. There are signs that some of the major consultants are developing solution-based approaches, which would see them taking greater responsibilities. At the same time, within the LDI space, investment banks are also present. In other words, the division of labour in this market place is becoming less clear, with different actors moving in different directions:

'We now have actuaries and former consultants on our staff. But you also see consultants wanting to do implemented consulting, which is a stride in our direction.'

Despite all of these changes, there remains a high degree of caution about how fast and how far this trend will develop. For now at least, it seems that fiduciary approaches of the kind seen in The Netherlands are unlikely to take off rapidly due to the way in which the market is currently intermediated:

'It's a bit of a grey area. You have a lot of dancing and posturing. I'm not sure if there is a lot of activity yet, but it is something that will be an important component in the future'

'Partly because of the longevity of some of the relationships, we have been able to have conversations with clients and get involved, although I still find the consultants are by and large not terribly comfortable with this.'

'The way it has manifested itself here is there are a few clients that want to do it, but not for the whole portfolio. A client may say: "We want some of our assets to try and target this sort of return. We know we are only going to get those characteristics from alternatives, but we don't want to be worrying about the allocation decision between the hedge fund, the hedge fund of funds and a private equity account."'

As one participant put it, there is also a need to take account of the local context in the debate about any extension of the fiduciary approach. In his view, fiduciary management in The Netherlands was a response to a particular set of circumstances and problems:

'The fiduciary management product offering was a very well timed service to an industry with large pools of assets that were about to make the transition from balanced with one provider to specialist with multiple providers. It was a good response to a specific local situation which is unlikely to be repeated here.'

Furthermore, if a firm is to offer a set of services across the spectrum from liability modelling through to actually managing assets, there is also a set of requirements in terms of expertise that are concentrated in a relatively small number of large groups.

An additional issue that is clearly important if asset managers move more into a space that was previously the domain of consultants (and equally, if consultants and banks find themselves moving into asset management territory) is that of conflicts of interest:

‘Our competitors have recruited actuaries, taking the raw material from the pension fund trustees and working out what the overall LDI strategy should be. I am a little dubious. You are stepping very much on the ground of consultants, which in this intermediated market is a difficult path to tread.’

‘We can clearly help clients discuss these subjects. The question becomes should we be their adviser? I think we see ourselves as a sounding board and source of information. I don’t think we are seeking to leverage ourselves into an advisory position. It is a huge conflict of interest.’

‘Obviously, there’s a question about whether asset managers will be most interested in pushing the solutions which would be most profitable for them. On the other hand, they’ve got the best knowledge of the underlying asset classes, they know the way the assets combine and indeed, from an operational point of view, how best to manage switches between one asset and another.’

For now, what does seem to be taking place is a greater level of discussion between the key components of the process (corporate sponsors, trustees, consultants and asset managers):

‘What we are trying to do is make sure we have contact not just with trustees but with corporate sponsors. You’ve got to a situation where everyone has a stake in the solution. Before, we were a box that had to fit somewhere. Now we are part of the solution, so there is greater discussion and consultation. But the direct contact we have is also very much one of education – how does it work, what does it mean?’

‘When clients are looking at the structure of their pension fund, we are able to offer a second pair of eyes and to work with them, perhaps looking at things in a slightly different way. There is an increasing realisation that consultants are not the sole part of creating what is a sensible pension structure. LDI has reminded clients that there is expertise within the asset management world to actually look at both sides of the balance sheet, and perhaps marry the two in a way that they probably hadn’t thought that we were able to do before.’

3. Funds Market

Key Findings

1. Funds managed in the UK

- Total investment funds – including both UK and overseas domiciled funds – managed in the UK are estimated at over £1trn.
- Assets managed in the UK on behalf of retail clients (including both UK and overseas domiciled funds) are estimated to account for some £770bn of this total.
- In terms of asset allocation, there is a heavy weighting towards equities, which accounted for nearly 75% of total retail assets under management.

2. UK domiciled unit trust and OEIC market

- UK domiciled funds totalled £468bn at December 2007. Within the European investment fund market (UCITS and non-UCITS), the UK is the fifth largest in net asset terms with a 10% market share.
- The overall number of fund operators has fallen substantially over the last decade. However, while the market share of the top ten firms has increased to 45% during this period, it has been stable over the past few years and the funds industry as a whole remains unconcentrated.
- Equities account for the largest proportion of assets under management at 70% with bonds at 18%. Property funds represented less than 3% of total funds under management in investment funds.
- There has been a significant shift over the last 10-15 years, which has seen a sharp fall in the proportion of total funds accounted for by equities (from 86% in 1997 and over 90% in 1992).

3. Retail sales

- Gross retail sales of UK domiciled investment funds were the highest on record during 2007 at £66.5bn. Net retail sales were £9.5bn over the same period but this was characterised by a strong first half of the year and weaker second half.

- While the number of funds has risen by around a quarter over the last ten years, retail sales data shows that the proportion of firms recording positive net sales has fallen to 55%.

- Although property sales fell back during the second half of 2007, property and commodity fund sales made the Specialist sector the best selling over the year as a whole, at £3.2bn.

- Funds under management of ethical funds grew strongly to £5.9bn during 2007 with both annual gross and net retail sales at record levels.

- Although ISA funds under management increased to £54bn during 2007 compared to £51bn at end 2006, net sales were disappointing and just above the low seen in 2005. Changes to the ISA regime came into effect at the start of the 2008/09 tax year and it is hoped that these will have a favourable impact.

4. Distribution Dynamics and their Implications

- The intermediary channel in 2007 continued to add to its already dominant position in terms of gross sales of retail funds. This has been driven by the increasing influence and popularity of fund platforms.

- Firms continue to be watchful regarding margin pressure as a result of the current changes in distribution, but this is not generally causing undue concern. However, there are other commercial implications that are becoming increasingly apparent: notably concentration pressures and fund flow volatility.

3. Funds Market

1. Funds Managed in the UK

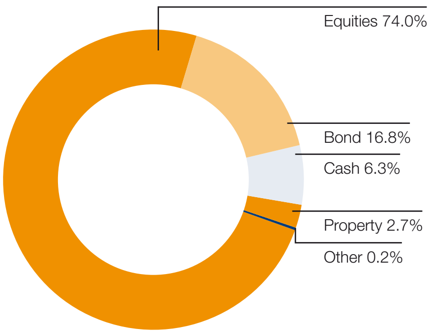
As we showed in Part One, investment funds managed in the UK broadly comprise:

- UK domiciled investment funds (unit trusts, OEICs) with total assets under management of £468bn at December 2007[21]; and
- UK managed funds domiciled outside the UK (e.g. Luxembourg SICAVs, Dublin OEICs, and ETFs), with total assets under management estimated at £540bn (rising to around £570bn if hedge funds are included). A substantial component of this £540bn – an estimated £160bn – is accounted for by Luxembourg and Dublin-registered AAA-rated money market funds.[22]

These UK managed investment funds, totalling just over £1trn of assets under management, are sold to a range of retail and institutional clients. Indeed, a number of firms may run funds which are available only to institutional investors or used purely for internal purposes. Retail investors cannot gain access to these funds directly.

From survey returns, we estimate total assets under management for retail clients (in both UK domiciled and offshore funds) at just under 23% of total overall assets under management in the UK (£3.4.trn), equating to £770bn. However, the increasing blur between institutional and retail business suggests that caution should be used about inferring the balance of business within UK managed investment funds on the basis of these findings.

Chart 18: Retail Assets (UK and Non-UK Domiciled Funds) Managed in the UK – Asset Allocation



In terms of asset allocation, a striking feature of the retail market is the high level of exposure to equities (see Chart 18). While this is in marked contrast to trends seen in the institutional market in recent years, fund holdings are an imperfect illustration of individual portfolios. Firstly, retail investors may directly own equities and bonds. More importantly, they will often be directly holding other assets outside funds, notably cash and property.

Non-UK Domiciled Funds Distributed in the UK

Of the investment funds domiciled outside the UK, a number are FSA recognised and sold into the UK with distributor status. The majority of assets are thought to be managed in the UK. IMA has collected data on these funds since July 2006:

- The number of funds has risen from 506 at end 2006 to 615 by the end of 2007 and represents data from 24 firms. Total funds under management for UK investors in these funds were £18bn.
- Retail investors invested about £400mn net into these funds during 2007, whilst gross sales were over £7bn.

The low level of assets in non-domiciled funds sold to investors in the UK contrasts strongly with the sizeable proportion of non-domiciled funds whose assets are managed here.

[21] The position is actually more complex in that not all of the £468bn may be managed in the UK. Although the IMA does not specifically collect this information, we believe that the majority of UK domiciled funds are also UK managed.
[22] Dublin and Luxembourg domiciled AAA-rated money-market funds totalled £250bn as at December 2007. While a considerable proportion of these is accounted for by dollar-denominated funds that are managed out of the United States, we estimate that around two thirds of the total is managed in London.

2. UK Domiciled Unit Trust and OEIC Market

This section of the survey focuses on highlighting current trends and developments within the UK domiciled unit trust and OEIC market, referred to as 'funds' within this section. Although often thought of as primarily 'retail' vehicles, these funds are used both by retail and institutional investors.

Total funds under management at the end of December 2007 were £468bn, a 14% increase from 2006, and up 141% over the five years from December 2002 when funds under management totalled £195bn. As Chart 19 shows, this was the fifth consecutive annual rise, despite global equity and bond markets experiencing a high level of volatility, particularly in the second half of the year. However, a proportion of the increase in 2007 can be attributed to the collection and inclusion of additional institutional funds within IMA statistics from January 2007 onwards. Total funds under management at December 2007 excluding these funds would have been £439bn – an increase of over 7% compared to 2006.

Chart 19: Funds Under Management (1998-2007)

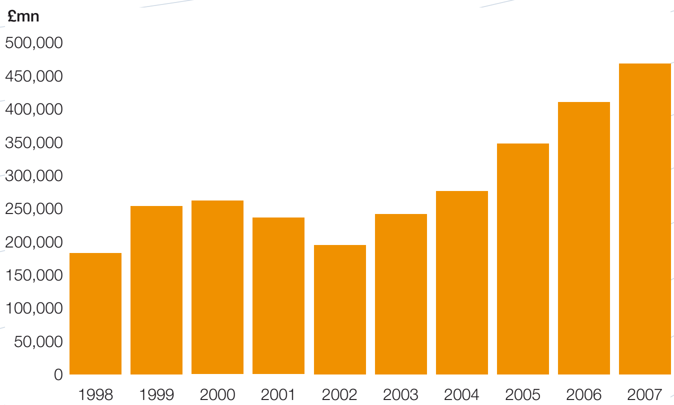
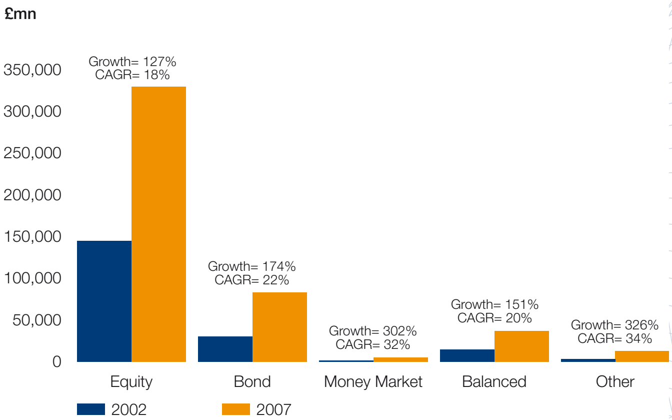


Chart 20: Funds Under Management by Asset Type (December 2002 vs December 2007)



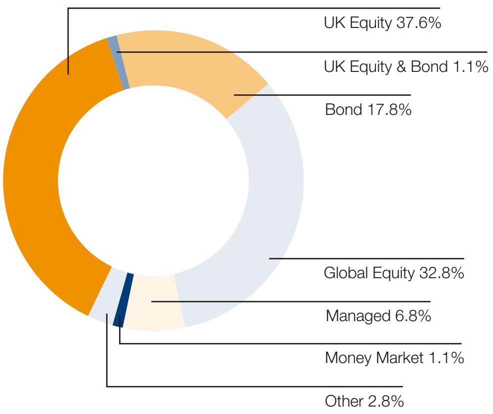
Over five years to December 2007, the compound annual growth rate in funds under management was 32% for money market funds, 22% for bond funds and 20% for balanced funds (see Chart 20). The rate for equities (18%) was the lowest of the main asset classes, which is somewhat surprising given the stock market movements over this period: in terms of UK equities, the FTSE-All Share compound annual growth rate was 12% for capital return and 15% for total return. This comparatively low growth in funds under management may be due to the fact that the UK industry has traditionally always had a high equity weighting. However, given that retail sales in equity funds have been strong (see p.58), a waning interest on the part of institutional investors may be a partial explanation. Total net retail sales over the five years to end 2007 for equity funds were £22.2bn compared to net institutional outflows of £9.9bn.

The overall asset mix of UK funds at December 2007 can be seen in Chart 21:

- Equities accounted for the largest proportion of assets under management at 70% (75% in 2006) and UK equities contribute 38% of the overall total (from 42% in 2006). The proportion of assets invested in global equities is little changed from 2006 at 33%.

- In contrast, bonds have risen to 18%, from 14% a year earlier. This is above the previous peak value of 16% seen at the end of 2003 and reverses the decline observed since. At first sight, this would appear strange given that bond funds in 2007 saw the lowest net retail inflows on record and that bond fund returns have been somewhat depressed. The increase has been caused primarily by the fact that from January 2007 onwards, IMA started to include data on a number of additional institutional funds. This has had the effect of increasing the proportion of assets invested in bonds at the expense of some other asset classes.

Chart 21: Funds Under Management by Asset Type (December 2007)

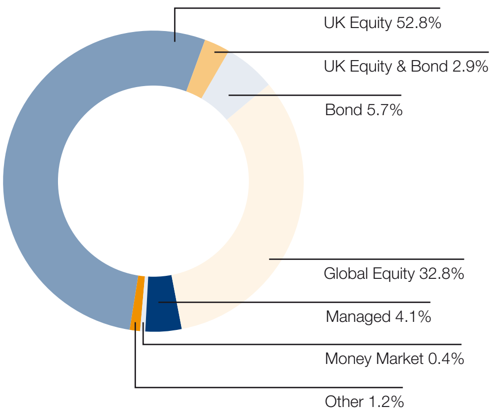


This current asset mix picture is markedly different to the one seen in the 1990s:

- Looking back ten years to 1997 (see Chart 22), the weighting in bonds was just 6%, with equity funds accounting for nearly 86%. UK equities alone contributed 53% to total assets under management.

- Looking back even further to 1992, the proportion of assets managed within bond funds was even lower (less than 3%), whilst the proportion managed in equities stood at over 90%.

Chart 22: Funds Under Management by Asset Type (December 1997)



UK Market in Context

In a comparative context, the combined net assets of the investment fund market in Europe (i.e. the market for UCITS and non-UCITS) stood at €7,925bn at year end 2007, a 5% increase on 2006[23]. UCITS assets made up 78% of total. Figure 7 shows the market share of the top ten European nations by fund domicile:

- The UK is the fifth largest with a market share of 10%, double that of Italy (4%), but behind France (19%) and Germany (13%).

- Luxembourg with assets of over €2,000bn accounts for more than 25% of the European investment fund market and confirms its continued importance, together with Ireland (10%) as a key administration and distribution centre within Europe. As we note earlier, a significant proportion of funds whose assets are managed in the UK have overseas domicile, the majority in Luxembourg and Dublin.

Compared to the UK fund growth rate, a mixed picture emerges:

- Asset growth in emerging Central/Eastern European countries was particularly strong in 2007; assets in Poland grew by 43% and in Hungary by around 25%. Norway (28%), Lichtenstein (37%) and Turkey (35%) also saw assets grow well above the average observed in Europe.

- Declines in assets under management were seen in a number of European countries in 2007: the most notable of these were Italy (11%), Netherlands (11%) and Greece (8%).

Figure 7: Market Share of Investment Fund Assets by Country of Domicile (Largest Ten, December 2007)

	Countries	€mn	
1	Luxembourg	2,059,395	26.0%
2	France	1,508,300	19.0%
3	Germany	1,040,937	13.1%
4	Ireland	806,768	10.2%
5	United Kingdom	796,954	10.1%
6	Italy	339,669	4.3%
7	Spain	278,796	3.5%
8	Austria	165,584	2.1%
9	Switzerland	159,853	2.0%
10	Sweden	139,380	1.8%

[23] This data is sourced from the European Fund and Asset Management Association (EFAMA).

However, when evaluating market share and regional asset growth, it should be noted that those countries which report in local currency rather than euro terms, such as the UK, can be impacted by exchange rate movements. During 2007, the euro strengthened by approximately 9% against Sterling meaning that in Euro terms, UK net assets increased by only 6% when compared with year end 2006.

Comparing European UCITS assets by fund category highlights some of the key differences between the market in the UK and that of Europe:

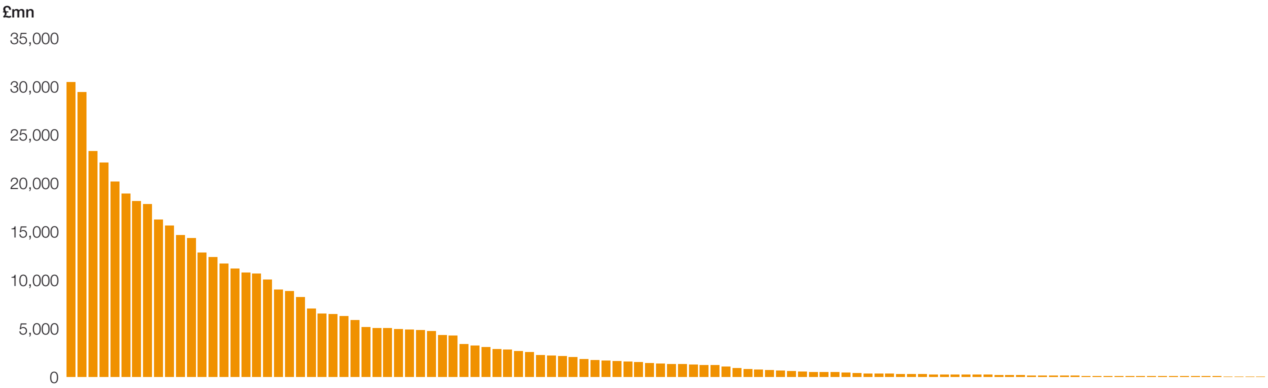
- In Europe as a whole, equity and balanced funds accounted for 55% of UCITS assets in 2007 whilst in the UK this figure is around 78%, with 70% invested in equities alone.
- Money market and bond funds are much more popular in Europe than in the UK with a weighting of 16% and 22% of total assets respectively – comparable figures for the UK are just 1% and 18%.

UK Industry Concentration and Structure

Industry concentration in the UK in terms of total (retail and institutional) funds under management by fund company (i.e. company branding the fund but not necessarily responsible for managing the assets) is illustrated in Chart 23. Comparable to Chart 5 looking at the wider asset management industry, the long tail indicates a large number of comparatively small firms. The median figure for funds under management is approximately £1.4bn and the simple average is £4.4bn – there are 76 fund companies with funds under management less than the average and only 34 in excess of this figure.

Chart 24 shows the top ten fund companies by total retail and institutional funds under management.[24] We also present the top ten fund companies in terms of retail assets managed – this is displayed in Chart 25.[25]

Chart 23: Fund Companies Ranked by Total Funds Under Management (December 2007)



[24] Appendix Two shows the largest fund operators consolidated by asset management firm.
[25] Retail in this context is calculated as funds which have a minimum lump sum investment less than or equal to £10,000 and over the preceding 3 years at least one third of gross sales were retail.

Chart 24: Top UK Fund Companies (December 2007)

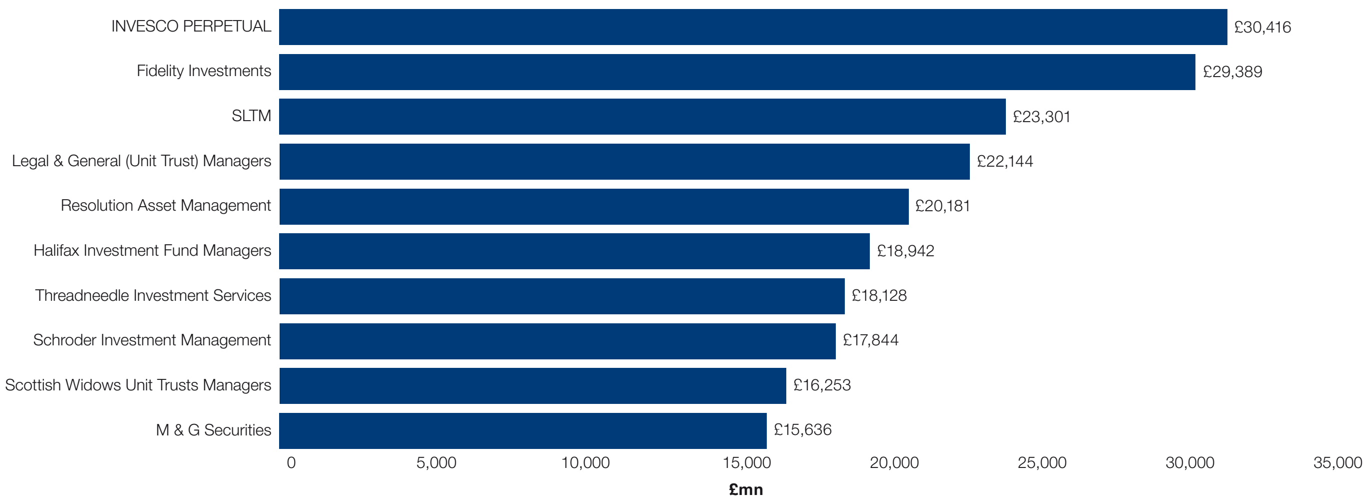
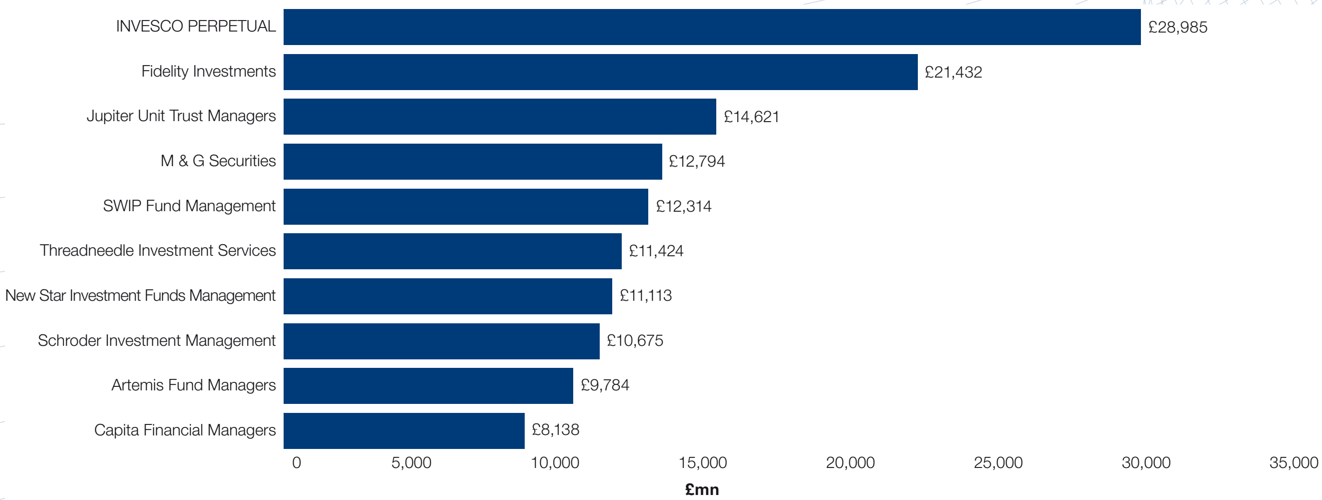


Chart 25: Top UK Retail Fund Companies (December 2007)



By year-end 2007, the top ten firms by total UK domiciled investment funds under management represented approximately 45% of total industry funds under management. While concentration increased somewhat in the period 2000-2003, after the end of the technology bubble, the share of the top five and top ten has never been particularly high and has remained relatively stable over the last five years.

Looking at the data over a longer period, the market share of the ten largest firms in 2007 (45.3%) is largely unchanged when directly compared to 1992 (45.6%) whilst the market share of the five largest firms is lower than that seen in 1992, both of which suggest that the industry remains competitive (see Chart 26). There was a period during the late 1990s when the concentration of the largest firms was eroded slightly, but this trend reversed between 2000 and 2003. At the same time, the number of companies decreased from 152 at the end of 2000 to 128 at the end of 2003 (see Table 7). The number of companies has continued to fall since.

Table 8 shows the mean and median fund values of the five largest IMA sectors by funds under management. In each case, the median fund value is about a third of the mean, indicating that the distribution of funds within sectors is skewed in much the same way as seen in the industry concentration chart: i.e. there are a small number of large funds in each sector with a long tail of many smaller funds.

In contrast, the total number of funds available has increased by 26% to 2,178. Looking at this in terms of asset classes, the effect on the fund offering during the stock market downturn of 2000-2003 was as would be expected – the number of equity funds declined year-on-year and it was only in 2005 that this trend reversed when the stock market recovery was already well underway. Since 2001/02, the number of funds available within bond, balanced and other asset classes have all increased and by a greater proportion than equity funds.

Chart 26: Market Share of Largest Fund Companies (% Total UK FUM, 1992-2007)

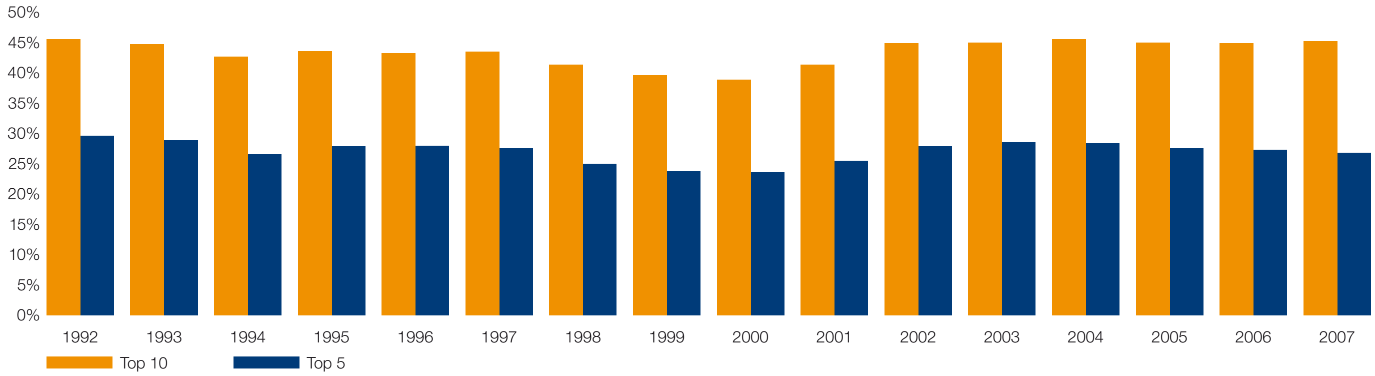


Table 7: Number of Companies & Funds (1998–2007)

Period	Number of Companies	Number of Funds					
		Total	Equity	Bond	Money Market	Balanced	Other
Dec-98	151	1,725	1,205	176	40	216	88
Dec-99	152	1,765	1,194	203	52	238	78
Dec-00	152	1,927	1,264	235	51	284	93
Dec-01	140	1,952	1,243	235	48	299	127
Dec-02	133	1,971	1,223	245	43	292	168
Dec-03	128	1,929	1,147	257	40	311	174
Dec-04	120	1,970	1,123	267	39	326	215
Dec-05	118	2,003	1,133	280	38	333	219
Dec-06	113	2,034	1,166	286	32	340	210
Dec-07	110	2,178	1,232	297	33	375	241

Table 8: Mean & Median Fund Size by IMA Sector (2007)

Sector Name	Mean Fund Value £mn	Median Fund Value £mn
UK All Companies	338	108
UK Equity Income	605	212
Europe Excluding UK	331	118
UK Corporate Bond	315	93
Global Growth	190	60

3. Retail Sales in UK Domiciled Fund Market

Gross retail sales of funds during 2007 were the highest on record at £66.5bn – a 15% increase year-on-year. This was not, however, reflected in net retail sales which, although again strong at £9.5bn, represented a 38% fall from the level seen in 2006 (see Chart 27).

Chart 27: Net Retail Sales (1998-2007)

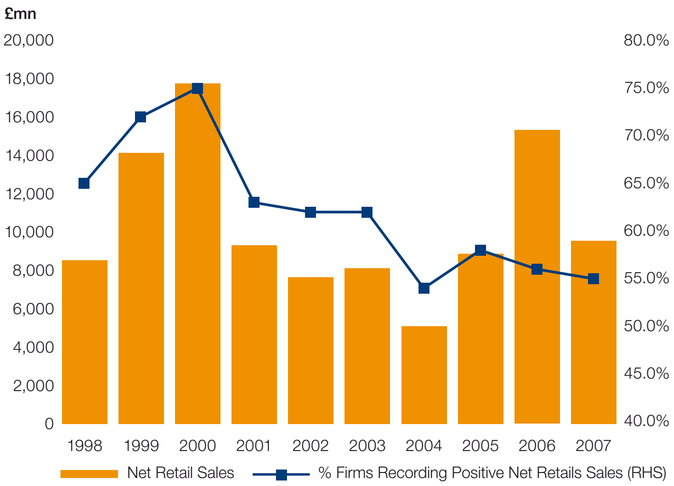
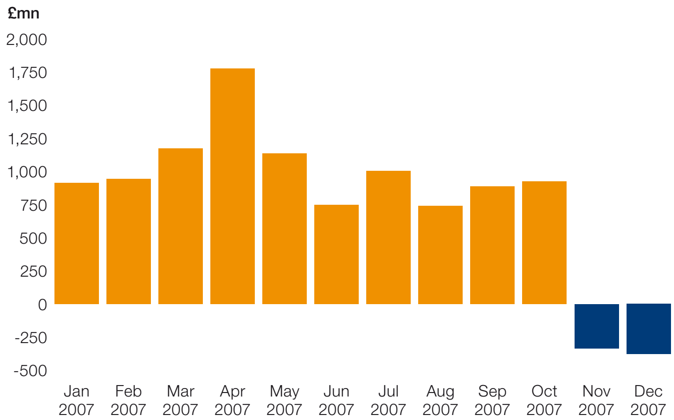


Chart 28: Monthly Net Retail Sales (2007)



The year started strongly with net retail sales of £6.7bn in the first half, but only £2.8bn net was invested in the second half when retail investors became more cautious as financial markets deteriorated (see Chart 28). However, net retail sales turned negative in both November (£334mn) and December (£378mn) – the first monthly retail outflows since July 1992 (£98mn). Despite this, 2007 was still the fourth best year on record in terms of net retail sales.

With respect to the annual data presented in Chart 27, it is striking that the percentage of firms which contribute positively to net retail sales each year has broadly trended downwards over the past ten years. While the overall data set on number of funds does not point to greater concentration, there is a somewhat different picture at the level of retail sales in UK domiciled funds specifically: retail consumers are investing with a smaller percentage of firms. The exact drivers behind this development are not yet fully clear. One factor likely to be playing a part is the change in distribution structures, where two interlinking factors are significant: increased emphasis on performance driving fund flows towards a smaller number of funds, and the accelerating use of guided architecture:

'Whether it's in the retail arena or in DC or on platforms, the business has become much more binary: you either have a successful product or you don't. Ten years ago, if you had mid-second quartile performance with a product, you were probably adding assets. Today you're definitely losing assets.'

The longer-term consequence may be a consolidation at fund level. As we show earlier (see p.25), there are still substantial obstacles to wide-scale consolidation at firm level.

Equity funds were the best selling asset class in terms of net retail sales for the fourth successive year at £5.2bn, down 35% on the 2006 investment level (see Chart 29) – this comes despite retail investors being net sellers of equity funds in the fourth quarter as sentiment weakened. Money market, balanced and "other" funds all saw record annual net inflows whilst flows into bond funds slumped to the lowest on record with net retail sales of just £137mn – less than 2% of the total.

Chart 29: Net Retail Sales by Asset Category (1998-2007)

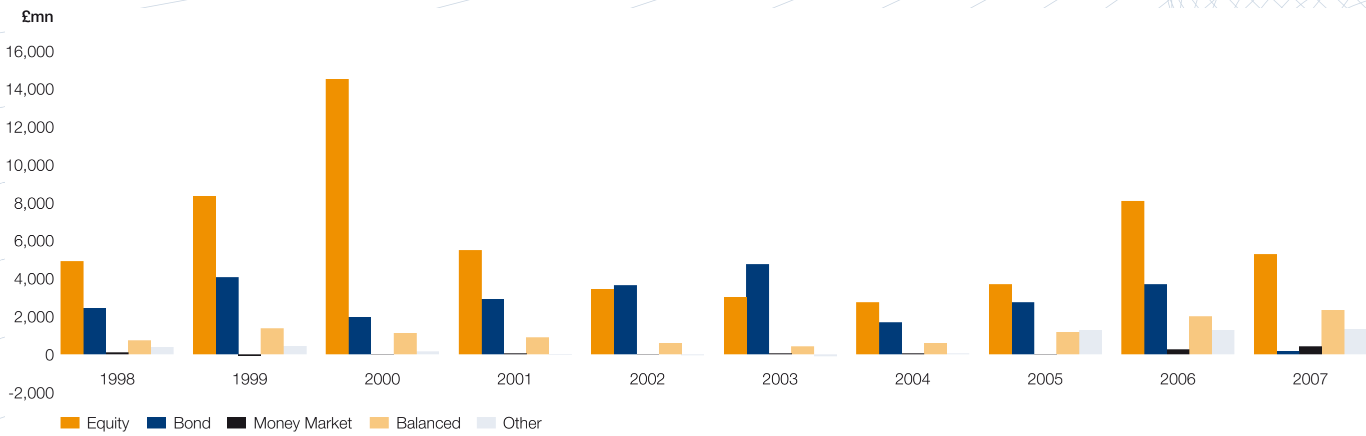
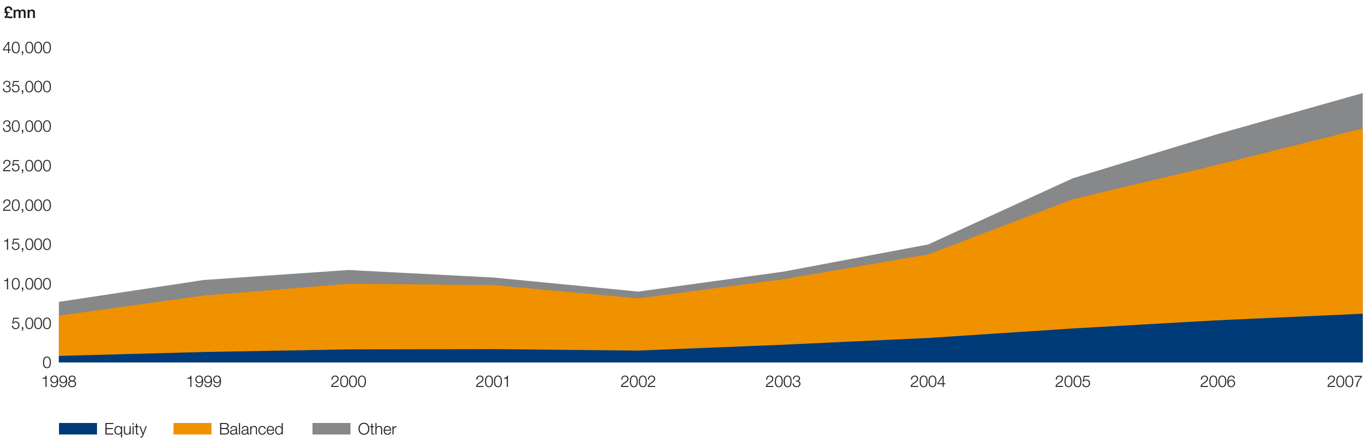


Table 9 illustrates both the best and worst selling sectors in 2007 in terms of net retail sales. The Specialist sector was, as in 2006, the most popular sector in 2007 taking in more than £3.2bn – property funds accounting for just under £2.1bn, with commodity funds making up a further £640m of the total. The second and third best selling net retail sectors were Cautious Managed and UK Equity Income. The worst selling sector was UK Corporate Bond with net outflows of £1.4bn.

Table 9: Best/Worst Selling IMA Sectors (Net Retail – 2007)

	Net Retail Sales (£mn)	Total FUM (£mn)
Best Selling Sectors		
Specialist	3,235	24,638
Cautious Managed	1,989	13,447
UK Equity Income	1,476	54,980
Worst Selling Sectors		
UK Corporate Bond	-1,425	35,977
Europe Excluding UK	-563	37,566
UK Smaller Companies	-366	8,128

Chart 30: Funds of Funds Under Management (1998-2007)



Funds of Funds

Funds of funds under management grew to £34.2bn at year end 2007, compared to £29.0bn at the end of 2006. Chart 30 shows that balanced funds accounted for the majority of assets at £23.5bn, while equities totalled £6.2bn. Over the five year period to December 2007, the compound annual growth rate of total funds of funds assets was 31%. The highest compound annual growth rate over this period was seen in the 'Other' category (39%), which comprises bond, money market and 'other' funds. The equivalent figure was 33% for equity funds and 29% for balanced funds.

Chart 31: Funds of Funds Under Management by Fettered/Unfettered (1998-2007)

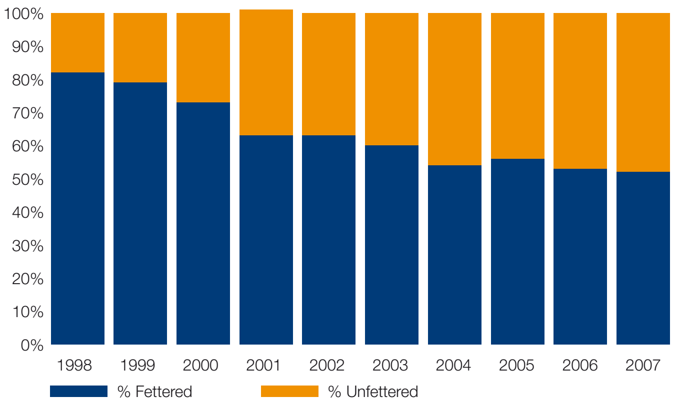


Chart 32: Funds of Funds Net Retail Sales (1998-2007)

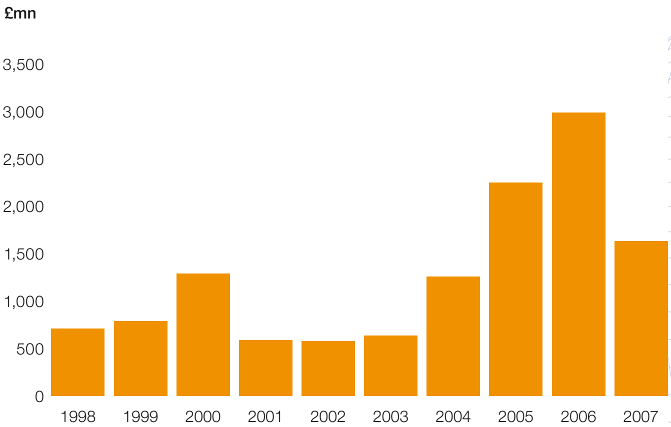


Chart 31 illustrates an interesting long-term trend observed within the split of funds under management between fettered and unfettered funds of funds. At the end of 1998, the proportion of total funds under management within fettered funds stood at 82% and has declined steadily over the period. By the end of 2007, this figure stood at 52%, demonstrating how the market is increasingly oriented towards those products looking to select external funds for their portfolios rather than just in-house. This is consistent with the broader shifts in the market associated with open architecture and the evolution of platform distribution.

Net retail sales of £1.6bn were recorded during 2007 for funds of funds, which represented a 45% decrease on 2006 (see Chart 32). The best selling sector in net retail terms was the Cautious Managed sector with net inflows of £1.2bn whilst the Global Growth sector was the worst selling with net outflows of £116mn during 2007.

Property Funds

Property funds have been the subject of much attention over the last couple of years, but it looks increasingly as if 2007 marked a turning point. By December 2007, funds under management in property stood at £12.5bn or 3% of total assets of UK investment funds. However, net retail sales of these funds fell to £2.1bn over 2007, compared to £3.6bn in 2006, a decrease of 43%. The movement observed over the course of the year was one of contrasting halves, in keeping with the experience of the wider funds industry (see Chart 33):

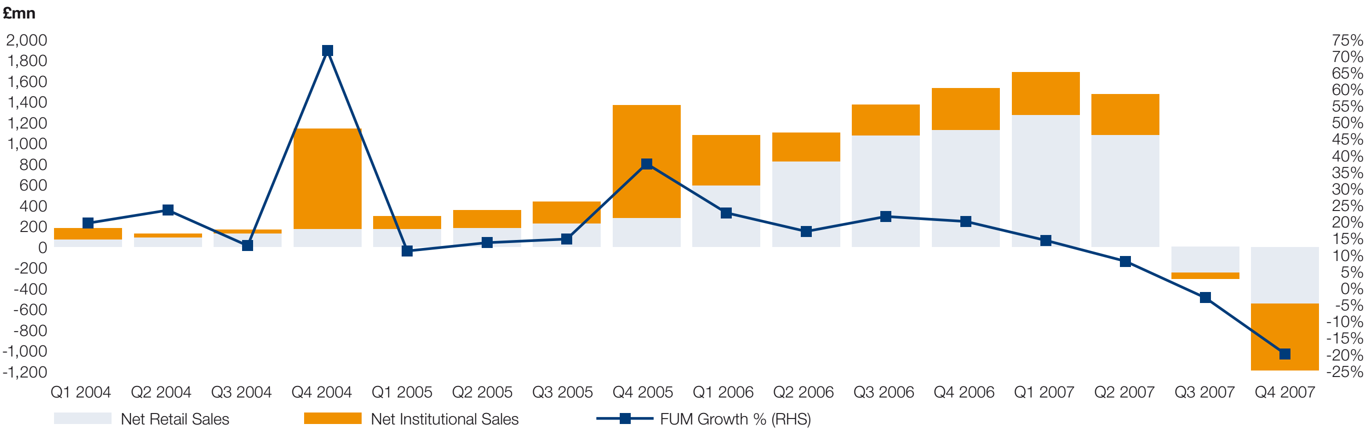
- The first quarter saw record net retail inflows into property funds of £1.27bn followed strongly by £1.07bn in the second quarter.

- The effects of the deterioration in the commercial property market which led to downward revisions in property valuations saw investors approach property funds with caution in the second half of the year. Net retail inflows in the third quarter remained positive but outflows were observed in each month of the fourth quarter totalling £543mn.

Despite the weakening of sales in 2007, property funds still accounted for more than a fifth of total net retail sales. The number of property funds offered to investors has also increased considerably over the last few years. From only five in December 2003, there were 23 by December 2006 and 34 by the end of 2007.

Quarterly growth in funds under management of property funds for the period 2004-2007 is also shown in Chart 33. This highlights the impressive growth seen in these funds over recent years due to the combination of fund performance and net inflows. This chart also clearly shows the effect of the weakening conditions seen in the commercial property market in 2007 which caused year on year asset growth to turn negative.

Chart 33: Quarterly Net Property Sales and FUM Growth (Q1 2004-Q4 2007)



Certainly, there is an element here of retail investors buying at the peak of the market, which has been a feature of previous cycles, including the tech bubble of the late 1990s:

'The ultimate test of when this industry will be at peace with itself is when we get the consumer buying cycle to match the investment cycle, i.e. consumers buy at the bottom, sell at the top. Right now, they are not doing that.'

In this context, a number of interviewees we spoke to pointed to the need for responsibility on the part of the industry to ensure that there was not too much of a focus on 'faddish' asset classes or products. At the same time though, several firms detect – albeit in different ways – a more sophisticated approach among some retail investors and their advisers:

'We're seeing a flight to quality and a de-risking, but also at the same time, people taking some very considered bets. Now that may sound completely contradictory but if I look at the flows and where they come from, we are not seeing everyone put all their assets into what's hot. We are seeing people buy things in quite a mature thoughtful way to create a more diversified risk adjusted portfolio.'

'Our gut feeling is that 10-15% of investors stayed engaged in the market in 2000-2003 in terms of buying active equity products. Now we think it's around 30%. So we do think we are seeing customers understanding the fact that actually market volatility should be a buying opportunity.'

Ethical Funds

While still a very small part of overall funds under management (a little over 1%), ethical funds exhibited strong growth during 2007, increasing by around 19% to £5.9bn:

- Both gross and net retail sales of ethical funds hit record levels in 2007. Gross sales more than doubled compared to 2006 at £880mn, while net sales of £473mn were much higher than the £137mn registered during 2006.
- The number of ethical funds available increased from 46 at the end of 2006 to 53 at the end of 2007.

A greater interest in and awareness of climate change as well as shifts in consumer attitudes towards organic, fair trade and similar products are clear drivers behind these recent trends as is of course fund performance. Furthermore, the interest is seen not just among retail investors, but in the private client and institutional markets:

'We've been in this market now for 20 years, and had been pushing at doors that were firmly closed. Something has changed. There is definitely increased demand, both in the UK and internationally. The question is whether that will be sustained during a market downturn.'

In a wider context, initial research conducted on individuals' attitudes to forthcoming UK pension reforms introducing auto-enrolment and Personal Accounts found that of those who would choose how their money was invested, 23% were interested in ethical investment options regardless of the level of return. If the survey accurately reflects wider consumer attitudes, this would suggest that ethical funds will play an important future role in the fund universe for many investors and that demand for these funds will be strong.[26]

[26] Smith, P. et al., 'Individuals' Attitudes and Likely Reactions to the Personal Account Reforms 2007: A Qualitative Survey' (Initial Findings, Department of Work and Pensions, 2007).

Tracker Funds

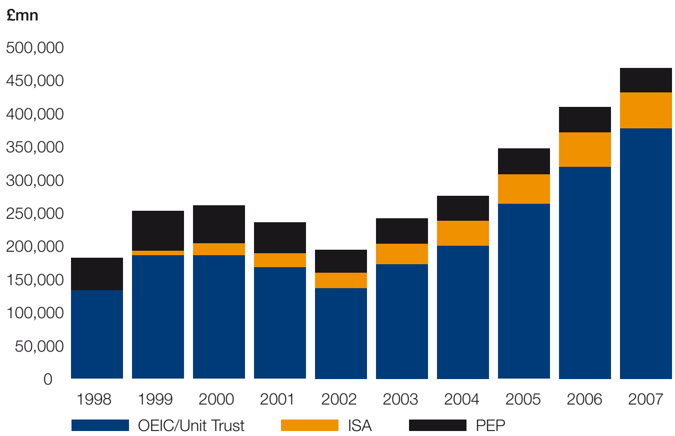
Figures for tracker funds show that funds under management increased by 6% over the level seen in 2006 to reach £27.1bn at the end of 2007. The number of tracker funds was largely unchanged compared to 2006 at 63 and such funds continue to make up only around 5% of the fund market. For the third consecutive year, tracker funds saw net retail outflows, although the total outflow for 2007 was only £110mn, around half the amount seen in the previous year.

In order to measure the broader use of index tracking vehicles, one would also need to include the market in Exchange-Traded Funds (ETFs), which has expanded rapidly in recent years. ETFs are an increasingly accepted form of gaining exposure to a variety of asset classes and geographical markets. The IMA does not currently collect regular monthly data in this area. While ETFs appear to be proving popular with retail investors buying direct through execution only platforms, the pattern of usage by IFAs in the UK market is less clear.

Wrapped Products

ISA funds under management grew by £2.9bn from December 2006 to December 2007 to stand at £54.3bn (6% year-on-year increase), but the contribution to total funds under management was 12% (see Chart 34). At December 2007, PEPs accounted for 8% of total funds under management meaning that tax wrappers as a total contributed around 20%. This figure has trended steadily downwards since 2002 when tax wrappers made up 30% of funds under management.

Chart 34: Funds Under Management by Product Type (1998-2007)

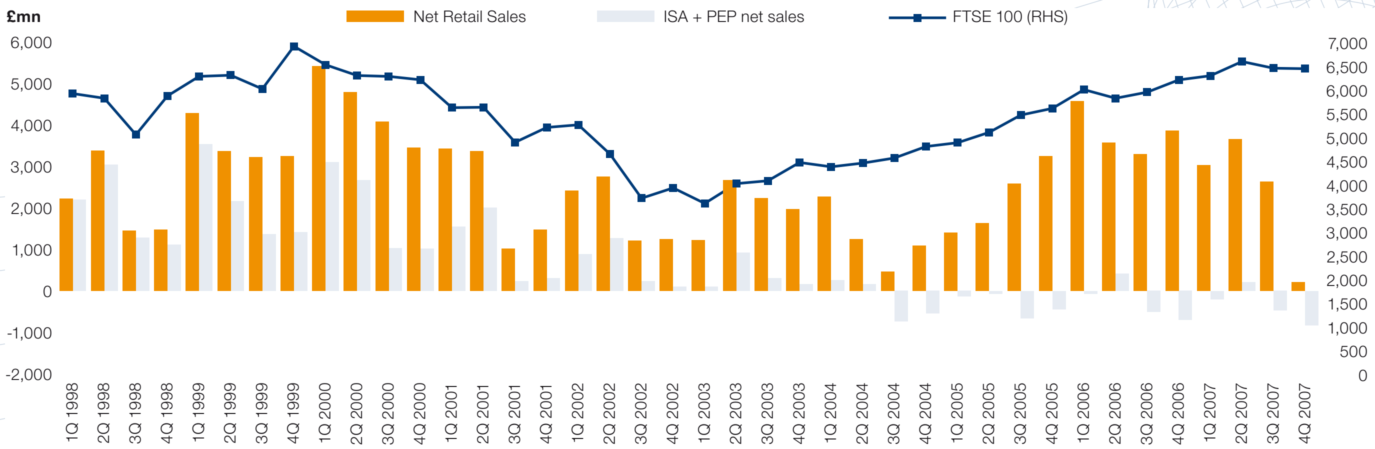


After staging something of a recovery in 2006, net ISA sales performed rather poorly again in 2007, falling by 25% to £1.88bn, which was just above the low of £1.81bn seen in 2005. Chart 35 shows that tax wrapped business as a whole in 2007 saw net outflows of £1.3bn, fuelled by PEP redemptions. This compares to tax wrapped outflows of £863mn in 2006, a rise of nearly 50% year on year. (Re-registrations, where an investor re-registers their holding from a firm to a fund supermarket may cause distortions in the data as some of the data may be lost).

From the start of the 2008/09 tax year, a reform package came into effect. Among other changes, it sees PEPs consolidated into stocks and shares ISAs. It is hoped that this simplification along with other positive aspects of the reforms will have a beneficial impact on tax wrapped business going forward. These other changes include:

- Removing uncertainty by making ISAs permanent beyond 2010;
- Raising the annual ISA investment limit to £7,200; and
- Allowing transfers from the cash to stocks and shares component of ISAs.

Chart 35: Quarterly Net Retail Sales and Net ISA/PEP Sales vs. FTSE 100 (1998-2007)



4. Distribution Dynamics and their Implications

In terms of the distribution of investment funds to retail clients in the UK, the intermediary channel continued to increase its share to more than 85% of all gross retail sales compared to a figure of 81% for 2006 and around 65% in 2003. All other channels (direct, sales force/tied agent and private client) lost market share compared to 2006 with direct taking 6% of business and sales force/tied agent taking 6.% (see Chart 36).

The driver behind this trend is fund platforms, which are continuing to grow in popularity:

'The platforms continue to gather the lion's share of business, and are becoming the only way we do business.'

'I think we have defined our business very clearly as we are asset managers. A large amount of our business is going through both fund and life company platforms. It's a true commercial reality now.'

In order to better see the role fund platforms are playing in retail fund distribution, Chart 37 shows gross ISA sales by distribution channel, as fund platform data can be disaggregated from the intermediary channel for ISAs. In the tax year 2007, fund platforms were again the leading distribution channel as in 2006, and accounted for 42% of gross ISA sales which is an increase of 3% when compared to 2006. The sales force/tied agent channel, which only a few years ago was the dominant ISA sales channel, had a market share of around 30%.

Chart 36: Gross Retail Sales by Distribution Channel (2003-2007)

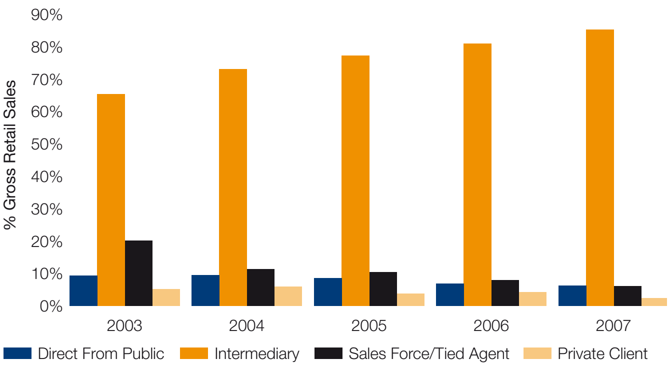
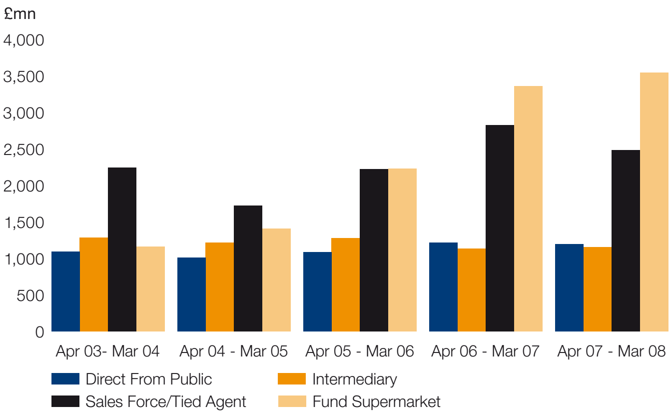


Chart 37: Tax Year Gross ISA Sales by Distribution Channel (2003-2007)



'The platforms continue to gather the lion's share of business, and are becoming the only way we do business.'

We mentioned earlier in this chapter that evolving distribution dynamics are starting to result in significant changes in business patterns for fund operators, and these changes are being seen internationally, not just in the UK. Alongside ongoing watchfulness regarding potential margin compression, two particular challenges were identified by those we spoke to:

- **The need for strong performance**. Just as weaker performers are starting to be more exposed in the traditional institutional market, the same thing is expected to occur in the retail distribution space.
- **Reduction in loyalty/rise in volatility**. Linked to this emphasis on performance, even firms with powerful retail brands are seeing very quick changes in flows in certain markets as a consequence of decisions made by professional buyers, particularly if these decisions are made on relatively short time horizons.

These challenges remain as strong this year, if not stronger:

'People talk about fees and margins. There are other huge pressures and especially this binary outcome where you either have a successful product or you don't, and may just not have any assets. It's concentration pressure.'

'If you look at last year, gross sales were up, net sales were down, so huge turnover. It's a real challenge for the industry now because the institutionalisation of the retail market through wholesale platforms and professional gate keeping services is creating much more volatility in terms of the retail product.'

'We cannot deliver performance year in year out from a particular asset class and from an individual manager. It cannot be done. However, I am confident that if you give us 3-5 years, we will deliver. So I would be careful on this thing about performance because what we are not trying to sell to anybody is the idea of one year or six months.'

Nonetheless, firms remain reasonably reconciled to the 'new distribution order'. Some feel that the skills of asset management and distribution are so different that it is neither particularly straightforward nor desirable to try to do both:

'We have seen ourselves moving towards becoming purely wholesalers. The people that run investments very well are rarely the people who run distribution very well and vice versa. It is a different culture, it's a different structure. People who become too distribution minded lose their investment edge. What it does mean is you are much more dependent on the delivery of very high quality products and innovative solutions.'

Others feel that the asset management industry missed an opportunity, and now had to live with a different kind of value chain:

'Platforms have continued to sweep forward. That's the way it is and very little product is bought directly. This industry on the manufacturing side failed to find a way to distribute direct to the public and failed to find a way to do their administration properly. It was left to others, such as the supermarket platforms, to provide the ability to switch assets between funds. We've lost a bit of the value chain and it's our own fault.'

However, the wholesale model is not universally accepted and one leading UK firm has chosen strategically to build both manufacturing and distributing capability, partly in order to address the persistency/volatility issues that we mentioned earlier:

'Everybody is basically saying: "Look, going to the end consumer costs a lot of money, it means having large back office record keeping operations, it means spending money on brands, so what we will do is shrink back to what we think is our core business, which is managing money, and we will do that through cost effective channels of wholesale/institutional." Our view is that will lead to volatility of earnings which we just don't want.'

In terms of the operational challenges that partnerships with third party distributors bring, although there will always be some tension, interviewees were generally relaxed:

'We do not find it difficult working with our partners to understand the clients. Distributors seem open to this. Clearly, they want to protect their relationship with the client, but we can work with them to serve that client. But it's also a function of how you approach the relationship.'

'The retailer will be fairly interested in product development, so you find a pretty spirited discussion about next stage products. They tend to be on the hunt for doing things and have the infrastructure to be close to the public.'

Once again, the comment was also made that the new distribution order meant that firms had to be prudent about diversification across channels:

'The one thing I've learnt from this business is not to rely on one channel. It kills you when things go wrong. When things go wrong, you lose assets whatever happens, but if you're in different channels, then you lose them at slightly different times. I think that's very important to a business model.'

'You try and pull all the different levers. You've got to make sure that you've got all the bases covered, so we will distribute our funds across a wide range of platforms and companies, some of whom we would have been reluctant to do business with a few years ago as they were classed as direct competitors.'

5. Outlook for 2008/09

The developments observed in financial markets and the economy during 2007, especially the second half of the year, would point to retail investors displaying a degree of caution in 2008, particularly while there is still significant uncertainty in the outlook.

In fact, by the end of the first quarter 2008, declines in global stock markets caused total funds under management to drop by nearly 8% when compared to December 2007. First quarter 2008 net retail sales registered only a very modest inflow of £191mn, lower than the £213mn figure for the fourth quarter of 2007 and down 94% when compared to the same period in 2007. After seeing further retail outflows in January 2008, it was an encouraging development to see some confidence return to the market in February and March when net retail sales turned positive once more.

As might be expected, equity funds were hardest hit with net retail outflows of £862mn in the first quarter, which along with poor market performance, caused negative asset growth of 10% compared to December 2007. Retail demand for equity funds is likely to remain weak in 2008, but other asset classes are showing signs of the benefit. Bond funds saw net retail investment of £554mn in the first quarter which were the highest inflows into this asset class since the fourth quarter 2006. Money market and balanced funds also saw positive investment:

'The risk appetite from the retail investor is usually a lagging function of the market environment. I think people get overly gloomy and rather focused on the delivery of equity products. I suspect what we've got is a retreat into less risky more conservative investment type products.'

At the same time, retail outflows from property funds slowed noticeably during the first quarter of 2008, to £63mn compared to the £543mn in the last quarter of 2007 – although there were actually net inflows in March of £21mn, the first retail inflows since September 2007. Looking forward, the appetite for property funds will be primarily determined by the short to medium term outlook for the commercial property market as investors reassess the risks associated with this asset class.

Given the current uncertainty in market conditions, several firms we spoke to also expect increasing demand from retail investors for absolute return products:

'In the current climate, there actually isn't a massive appetite out there for taking on concentrated chunks of investment and equity risk. It strikes me that a well diversified absolute return vehicle with very low volatility characteristics is much more what the market is about at the moment.'

'Absolute return is the single biggest untapped market for the mutual funds industry. I think that right around the world consumers have a preference for product with some degree of protection.'

'Absolute return in the past used to be for the super rich but I think today it is being identified and recognised by a much broader audience. Is it short-term fashion or a longer term trend? We can't predict the future but my instinct is that demand for absolute return strategies will increase.'

However, a number of respondents were concerned to ensure that absolute return products were both deliverable and fully understood by end investors and their advisers. The risk, in their view, was of creating – or failing to dampen – potentially unrealistic expectations, particularly at a time when retail investors are becoming more risk averse:

'If you want to call it absolute return, then you need to be able to be clear that a consistently positive outcome is a reasonable expectation from your investment process. That's one hurdle I don't think everybody's got their heads around.'

'If we can find products with asset engineering and structuring that deliver the protection [that consumers want], this will be the next stage of big growth. However, it is quite challenging to do it."

Certainly, the statistics suggest considerable recent asset growth in absolute return funds. In the first quarter of 2008, the IMA Absolute Return sector (which includes both onshore and offshore domiciled funds) saw net retail sales of £348mn. This compares to total net retail outflows of £274mn for the whole IMA universe of onshore and offshore funds over the same period, which highlights strong demand for absolute return while funds within the more traditional asset classes are seeing outflows against the backdrop of the increasingly uncertain economic climate.

Key Findings

1. Underlying Causes

- Interviewees identified a number of causes of the credit crisis, many of which are interlinked. At the core, the availability of cheap money facilitated a wave of imprudent lending. The impact was exacerbated by the way in which the 'originate and distribute' model was evolving, in combination with the use of high levels of leverage.

- Other causes cited included inadequate risk controls in investment banks, the failure of credit rating agencies to adequately assess the risk level of financial products, and insufficient scrutiny along the value chain. In this regard, one factor singled out was the overly complex packaging of products, which were sometimes little understood both by people selling them and those who bought them.

2. Impact on the Asset Management Industry

- While there have been problems in certain products, in comparative terms the UK asset management industry and its clients have emerged relatively unscathed from this recent crisis.

- Nonetheless, those we spoke to felt that the asset management sector will need to learn lessons from recent events. In particular, firms will have to reassess their approaches to risk analysis and management, as well as the design of products.

- More cautious investor behaviour may well have significant consequences for parts of the industry. Looking more broadly, falling fund flows and revenue are an obvious risk for the entire industry if the real economy falters.

- Not all of the consequences are felt to be negative: in the institutional market, proven alpha generators may benefit after a period in which returns generated by high degrees of leverage may sometimes be confused with genuine alpha.

3. Wider Lessons

- Regulation of the financial services industry did not prove effective. There is a need for better, more focused regulation, not more regulation.

- In the UK specifically, the current tripartite system is not felt to have functioned effectively in response to aspects of the current credit market crisis. In particular, it was felt that the role of the Bank of England in facilitating financial stability should be strengthened.

- A more coordinated international approach may be needed to cope with the domino effect that a crisis in one country can have on other economies worldwide as a result of globalisation. However, interviewees were cautious about how easily this could be achieved.

4. Credit Market Crisis

We asked interviewees a series of questions about the causes of the recent crisis in the credit markets and its consequences for the asset management industry. We also solicited their views on what kind of policy response might now be effective in preventing a similar crisis in the future.

1. Underyling Causes

Looking at the recent past, the primary catalyst of the crisis was poor underwriting practice, seen principally in imprudent lending in the US. With such activity facilitated by very permissive underlying credit conditions, it was not a surprise to see the issue of 'cheap money' singled out by many interviewees:

'That [cheap money] is all this is. It's a sustained lower interest rate which the world wasn't used to. Now we're getting a ghastly reverse flip.'

'It's just a cycle. Credit becomes very cheap, then credit becomes dear. There are about six basic plots in history and the credit cycle is one of them.'

'If you sit in your car and you rev at 8,000 rpm, at some point something is going to go bang. What will be really interesting is what people think of Greenspan in 10-20 years.'

Respondents emphasised that the combination of two other factors played a key part in determining the shape of what has taken place: the way in which the 'originate and distribute' model evolved (particularly with respect to incentive structures and agency risks) and the application of excessive leverage, both explicit and unseen. For some we spoke to, leverage was the defining feature:

'When the gods of greed meet the lords of leverage, you get a big problem. Greed is not new. Reckless lending is not new. Imprudent borrowing is not new. But reckless lending and imprudent borrowing in combination with astounding levels of unregulated leverage is new.'

'The primary cause is no more than excess leverage, absolutely eye watering leverage. What exposes leverage of course is underlying default. Suddenly in the US, you had the realistic possibility – now come to pass – of default and I don't think it's any more complicated than that.'

In this environment, the following factors also played a part in bringing about the crisis:

- Inadequate risk controls inside investment banks.
- A range of failings within credit-rating agencies.
- Insufficient scrutiny all the way along the value chain.

'When the gods of greed meet the lords of leverage, you get a big problem.'

On this last point, several firms we spoke to commented about the role of those at the purchasing end, with institutional investors engaged in a 'search for yield' that would create a market for the highly leveraged products which would ultimately be at the heart of the current crisis:

'There was an extraordinary appetite around the world to buy these products as 'risk free'. We have to look at the cultural issues of what happened. Everyone knew the problems and it is amazing that they carried on.'

'Whether it was the issuer, packager, distributor or purchaser, I think everyone expected that the person they bought from had taken advice or had done the underlying due diligence. And the reality was that each party in the chain looked at it in the context of what they were doing, but didn't look at it in the context of what its overall attributes and fundamentals were.'

An important sub-theme here was not just the incentive structures in the 'originate and distribute' model, but the sheer complexity of what was being packaged and sold. This presented challenges for those on both the buy-side and sell-side in terms of understanding the product and appreciating the implications:

'A lot of the structures were not understood or even understandable.'

'Some of the structures were totally flawed. If you look at what everyone was trying to do in terms of enhanced yield for low risk, then a lot of these products just seemed too good to be true.'

In this respect, the distinction was made between the underlying vehicles, such as CDOs and CLOs, and the way they were used:

'There is nothing wrong with the vehicles that were created. It was the way in which they were used that was fundamentally wrong, particularly the leverage that has been put into them. That is where they came unstuck'

Several respondents were also keen to separate underlying causes from the reality of what happened last summer, which they viewed fundamentally as a crisis of liquidity, rather than a credit crisis. In that sense, the appropriateness of the term 'credit crunch' was questioned:

'What we have been through is a liquidity crisis. A credit crisis is where there is demand for credit which cannot be supplied or will not be supplied and that is very often associated with the impairment of the bank's balance sheet. There is no evidence as yet that the economy has become credit constrained. What has happened is there has been a liquidity lock-up whereby assets that have been bought and held in a variety of portfolios have become untradeable and illiquid. There is every danger that the liquidity crisis could result in a credit crisis, but as yet there is limited evidence of a credit crisis.'

2. Impact on the Asset Management Industry

Respondents tended to make a distinction between two kinds of consequence for the industry: the immediate and the longer term.

For many firms in the UK, a key short-term problem has been one of trading in certain fixed income markets, where conditions over the period since August 2007 have been exceptionally fraught at times. While some funds did have exposure to instruments that suffered losses, overall the UK industry (and its clients) have not experienced anything like the kinds of difficulties endured by the banking sector. This is in part due to the different kinds of commercial relationships. In contrast to the sell-side, who are principals and put proprietary capital at risk, asset managers act as agents for their underlying clients and have a different set of fiduciary and incentive structures.

Looking beyond the immediate term, interviewees felt that there were likely to be a number of wider implications for the asset management industry:

1. Dealing with risk. On the risk assessment and management side, the industry will need to learn lessons from the events that led up to the recent crisis:

'I think we have to improve the risk management culture in all firms, including asset management firms.'

'I think the lessons are for everybody. Fundamentally, we will need to look at risk in a different way. The role of liquidity in looking at risk is at the centre, and then leverage and de-leveraging – these are the areas that we thought about, talked about, modelled, but we didn't expect it to turn out the way it did.'

'Four long tail events in one afternoon. That just blows every model. I think people will be a lot more diligent in future about what they are buying and why they are buying it.'

2. Product design. The industry as a whole will need to be more careful about product design, particularly given the increasing convergence of the traditional and alternative space:

'I hope that the investment management industry has re-learned what has become the golden rule. The golden rule should be if you don't understand it, don't buy it and if your client cannot understand it don't sell it.'

'A longer term beneficial outcome is that it should force us to be a bit more diligent about product design. The easy money world permitted certain product structures to be delivered to market that were never going to deliver and I think ultimately that will be a salutary lesson that we should all learn.'

At the same time though, there is a view that the 'traditional' part of the asset management industry may benefit from greater suspicion of large-scale leverage:

People unfortunately have been looking for quick fixes and certainties that can't exist from an investment product. I'm hoping that there will be a 'back to basics' approach. It's a healthier discussion.'

'There was confusion about alpha and leverage. Those that didn't have much alpha, but were generating very strong above-average returns simply through the application of leverage, have clearly been caught. In a funny kind of way, demand for absolute return type products from the well known long-only fund management community has increased and some of the myths surrounding hedge funds have dissipated. There's a greater appetite amongst institutions to get alpha and the use of modern portfolio construction techniques from people with a fund management brand.'

Nonetheless, there was also a suggestion that any post-crisis backlash might go wider than just leverage and extend to instruments widely used in the asset management industry, such as derivatives:

'We are seeing a deep suspicion among clients about leverage and also about many financial instruments that have been around for a long time which have proved in the past to be extremely effective but which have been fundamentally abused.'

3. Macro impact. Any fall in stock markets and/or greater reluctance among investors to commit new money (particularly on the retail side, where household balance sheets are already showing signs of distress in a number of countries) will clearly have an impact on the industry. A number of firms were cautious about the short-term outlook for UK household saving:

'People will be looking for more cautious products and I suspect we will have a period of sogflation – more likely soggy growth than stagflation. That is not a great environment for savings because people aren't going to be generating the wealth to put into funds. I would have thought it was going to be quite tough in our industry over the next five years and people are going to have to look increasingly [for business opportunities] offshore.'

3. Wider Lessons

By and large, the view of interviewees was that there would always be greed and excess in human economic behaviour. Therefore, there would be future bubbles and future busts. However, a range of conclusions were drawn about the implications for the government, central banking and regulatory community:

1. Regulate better, not more. All those we spoke to recognise that there will be strong pressure on regulators to act decisively and rapidly to address some of the perceived misdemeanours committed along various parts of the product chain. The message is that any regulatory response needs to be based as far as possible on principles-based regulation, and it should be carefully targeted where it can work effectively. Some areas, such as agency risk, are difficult to regulate. Others, such as remuneration structures, may need to be left to the market, with shareholders intervening to take responsibility. As one interviewee put it:

'Three factors lay behind the recent turmoil: the separation between origination and distribution of debt, leverage and the asymmetrical reward structure in banking. The regulator must address the first two; the shareholder the third.'

A number of questions also occur with respect to the way in which parts of the fixed income market have functioned or not been able to function since the crisis began last summer. Several firms we spoke to raised issues about underlying roles and responsibilities. As one interviewee put it:

'It isn't okay for the market maker to make markets and then decide they are not making the markets anymore. There used to be a role for the market maker through both good times and bad times.'

2. Domestic coordination and effectiveness. Another common observation was that the credit crisis had drawn attention to flaws in the UK tripartite regime, in particular the limited power of the Bank of England:

'The way in which the tripartite system is constructed meant that there was nobody with effective day-to-day, week-to-week responsibility for the functioning of financial markets and liquidity provision, and nobody who really understood how to read the signs and how to get the mechanisms in place. We need to give the Bank of England responsibility for day–to-day functioning of liquidity.'

'The current system is like driving your car with one person turning the steering wheel and the other person operating the clutch and brake. You can do it, but its not going to help you win a Grand Prix.'

'The problem with the tripartite system is that issues fell between the cracks. When things went wrong they were all looking in different directions.'

3. International coordination. One point that arose repeatedly was how contagion can spread fast and wide in a globalised financial environment. While this means that coordination is desirable, there is also a recognition of the difficulties involved, both in monetary policy and the wider regulatory domain:

'I don't think that they really understand just how liquid and connected these global systems are. Who would have thought that a bunch of poorly-written, badly-sold, over-leveraged credit products in the United States would have caused a problem here in the UK.'

'Globalisation has meant that it's really difficult for one central bank to solve problems so it has to be coordinated, but I don't see how you will ever achieve that because there's so many vested interests.'

'If you are a regulator in the UK with all the cross-border capital flows, it's a bit like sitting in the middle of a motorway in terms of the range of things that you cannot regulate.'

4. Policy paradigm. The question of the wider macro-policy environment also arises, with several interviewees raising the issue of the role of monetary policy globally in creating an environment in which the lending and leverage excesses could flourish. In short, was monetary policy too accommodating in the face of a clear asset bubble?

'The central banks need to understand the impact between asset prices and inflation in the economy. The big issue is whether you can recognise a bubble when it's inflating and what you do about it.'

'The big issue is whether you can recognise a bubble when it's inflating and what you do about it.'

5. Operational Issues

Key Findings

1. Revenue and Fee Structures

- Data from the survey suggests that weighted average profitability for UK asset management firms was 32% in 2007, from 31% in 2006. Revenue rose to £10.2bn from £8.8bn.

- The use of performance fees remains widespread with 84% of respondents to this question indicating usage. Although they are mainly found in the institutional environment, there are suggestions that performance fees will become more common in the retail arena.

2. Doing Business in the UK

- Respondents continue to view the UK comparatively positively. However, a range of tax issues have significantly clouded the views of those we spoke to.

- While the status of the UK as a domicile for asset management companies is probably not under immediate threat, a number of firms are flashing an ‘amber’ warning light.

- On the regulatory front, there was considerable criticism of the way in which the Treating Customers Fairly initiative is being handled.

3. Employment

- Total direct employment is estimated at 25,500, with numerous activities outsourced to third-party providers, the overall level of employment associated with the asset management industry is considerably higher.

4. Execution and Disclosure

- Firms are continuing to put commission sharing arrangements in place for at least part of their business. It is clear that the FSA's new 'Use of Dealing Commission' regime introduced in January 2006 has changed behaviour with regard to the way managers purchase services other than execution.

5. Operational Issues

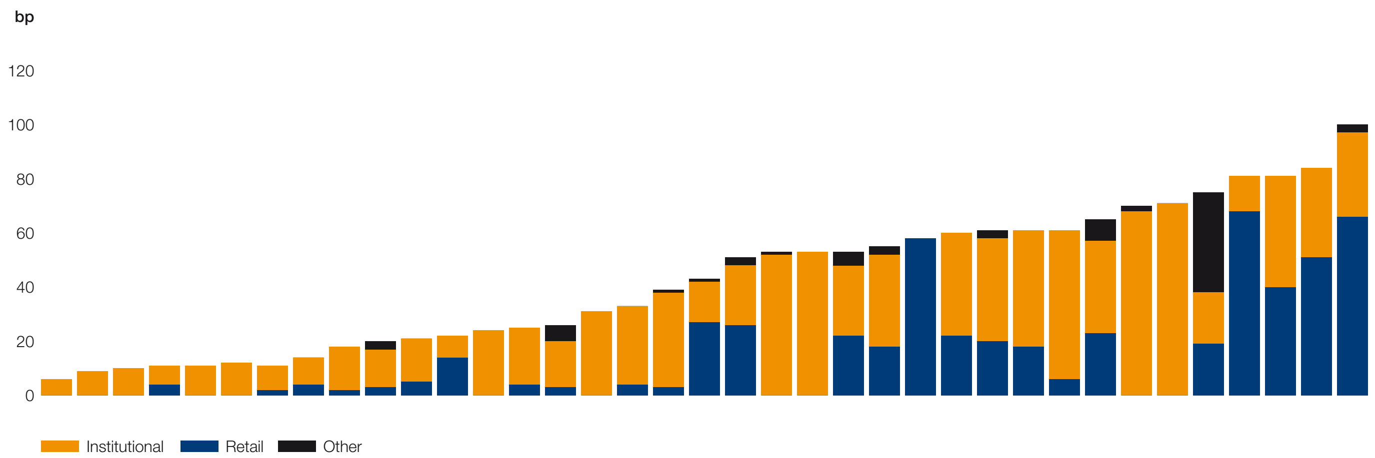
1. Revenue and Fee Structures

Firms were asked to report total cost and revenue numbers. The data presented below includes both in-house and third party activity:

- Overall revenue for UK-based asset management activity rose by 16% over the year to December 2007, while costs rose by 12%.[27]
- Based on a revised revenue estimate of £8.8bn last year, this suggests total industry revenue as a proportion of total assets under management of £10.2bn, translating into an asset management industry contribution to GDP during 2007 of about 0.6%.
- As a proportion of total assets under management, revenue represented 30 basis points and costs 19 basis points.
- Weighted average profitability increased to 32% from a revised 31% last year.[28]

Chart 38 shows revenue split by client type. Despite the increasing blur between institutional and retail business, it remains the case that many of the higher revenue firms have a large proportion of retail business. However, as we pointed out last year, it is also the case that a number of large businesses are running products capable of commanding a substantial fee base. The change in this fee base continues to be driven by the separation of alpha and beta, which is seeing an increasing focus by institutional clients on high alpha, unconstrained and absolute/total return mandates (see p.36). Strategically, as we discussed earlier in the survey (see p.43-44), that continues to create a challenge for some active managers, who are seeing a combination of factors making the operating environment very different to the past.

Chart 38: Revenue by Firm as a Proportion of Assets Under Management – Split by Client Type



[27] This is based on a matched sample of 31 firms managing a total of £2.3trn in the UK as at December 2007.
[28] Profitability is defined as the net of revenue and costs divided by revenue.

Performance Fees

With charging structures within the industry continuing to evolve, we also asked firms about the extent of the use of performance-related fees and about current trends in their usage:

- A total of 61 firms, managing £2.9trn, responded to the question, with 84% (51 firms) saying that they do use performance-related fees. A more detailed distribution is shown in Table 10. Usage continues to be concentrated in the institutional market.
- Among those respondents who do use performance fees, the weighted average proportion of total assets under management subject to performance-related fees was 22%, up from 20% last year.

Table 10: Use of Performance-Related Fees

Proportion of AUM Subject to Performance Fees (%)	Number of Firms	Total AUM by These Firms (£mn)
0%	10	63,356
1-25%	33	2,088,998
26-50%	9	281,856
51-75%	4	320,123
76-100%	5	117,245
Total	**61**	**2,871,578**

Where specific areas of usage were identified by survey respondents, the main product areas were hedge funds/alternatives and high alpha products, and is part of a trend whereby managers are looking to seek revenue commensurate with alpha generation. In this respect, a number of interviewees suggested that greater use of performance fees could in future be seen in the retail market, and might also be one way of resisting margin pressure from platforms:

'As the distributors get stronger, inevitably it is going to squeeze the manufacturer in general. One way around this is to use performance fees if you're allowed.'

2. Doing Business in the UK

Survey respondents have previously pointed to three key reasons why the UK – and London in particular – has been an attractive location for asset management firms in recent years:

- The depth of the available talent pool;
- A reasonably benign regulatory environment; and
- Geo-location (particularly time zone) and business connections.[29]

A number of these points were echoed again in interviews this year:

'The City is still a centre of excellence. There is an extraordinary collection of individuals and businesses, and the fact that you have integrated financial houses in such a short space of each other means that there is a huge pool of talent that you can call on. At the moment, there is nowhere to compare other than New York for dynamism and the positiveness that attracts young, enthusiastic people into the business.'

'If you think about it, what are the credible alternatives? The real competitors are the Far East and New York, but we still have key advantages. We have an installed base, English is the global language and then we have a favourable time zone. None of these things are going to change..'

Tax Environment

However, we detected a marked change of tone in comments in tax. These focused not on fund taxation, where specific positive advances for the industry were identified by a number of interviewees, but on the broader environment. Two areas attracted particular comment:

- Taxation of non-domiciled individuals working in the UK.
- Taxation of overseas profits.

With respect to the non-dom issue, there were a small number of forthright views that it did not matter for the UK asset management industry:

'It is a non-issue as far as I'm concerned. Non-doms should just pay their taxes like the rest of us. It is a just thing. They are not being asked to pay tax twice. They are just being asked to pay tax once. The industry is not about a few individuals. The real industry is about the nation's savings and pensions and long-term financing. There is plenty of talent coming through and the talent pool is fine. Don't worry about it.'

'Regarding non-doms, by and large, I don't know what the fuss is about. Many non-doms are paid a large amount of money and I should think they are delighted to get away with £30,000.'

[29] For more on general issues raised here, see 'The Competitive Position of London as a Global Financial Centre' (OXERA report for IMA/City of London, 2005).

In contrast, several firms felt strongly that the issue had been handled badly, to the detriment of the country's international image. In their view, the Government's policy stance was bordering on demonstrating open hostility to the very people they saw as critical to the ongoing success of the UK as an international financial centre:

'The UK is a very, very small place in terms of population and therefore has a relatively small talent pool. Being able to access the best in the world is all about your pull and being a great place to be. I think we are undermining it with cheap shots. I'm deeply worried about it.'

'International financiers working in the UK have lost all faith in this government's commitment to and understanding of international finance. London cannot thrive as an international financial centre without international talent.'

While there is no industry consensus view, it is generally true to say that there is a potential impact on remuneration planning in that the industry does employ some non-UK domiciled individuals. As a matter of pure economics, it may be that some of the cost of the changes is borne by the industry if the decision is taken to enhance remuneration packages to compensate affected employees in any way.

Looking more widely, almost all those we spoke to expressed varying degrees of unease about the wider tax environment. Taking the non-dom measures together with other tax changes over the past twelve months, the general perception was that a negative message was now being sent regarding the attractiveness of the UK:

'Whether it be the non-doms or the changes to capital gains, the level of volatility and uncertainty, coupled with a lack of explanation regarding the thinking, has made people more concerned about the UK as a domicile to operate from.'

'They've definitely spooked people. At the margin, it's definitely done some damage. It happened so suddenly and was so badly handled.'

'Some of the measures, such as CGT reform, were the right thing to do. But the problem is that they went about it the wrong way. They've just created the worst possible image for the UK as a tax domicile.'

In this context, one particular element that is worrying firms relates to the way that overseas corporate profits are taxed. Several interviewees suggested that unfavourable changes might well result in some degree of relocation outside the UK:

'I would have said this time last year that the tax regime was relatively benign. The moment they went down this route of trying to deal with so-called controlled foreign companies, that made it much less benign. Like every other company, we've looked at a range of options, from shifting our brand offshore and renting it to our UK subsidiaries to a full-scale shift of domicile. If the Government doesn't revert to where it was, I think a lot of people will take the more radical option.'

This negative view appears to have been fostered by the continuing lack of clarity on taxation of foreign profits, and may not have been so marked if HMT had made a clear statement of intent by now that some form of corporate tax exemption for foreign source dividends would be introduced.

The theme of potential relocation also links strongly to the notion expressed by a number of firms we spoke to that the asset management industry is highly human capital focused, intrinsically mobile and that relatively small individual changes in a given environment can easily disrupt an attractive external image:

'I don't think Whitehall understands just how nomadic and transportable this industry is.'

'My biggest concern is that there seems to be a total lack of recognition that the type of business we conduct in the City can just as easily be conducted from anywhere else. There is no intrinsic right for the City to be the place where assets are managed or where investment banks do their deals."

While none of this translates into an imminent move overseas by substantial parts of the asset management industry, it does represent a shift that many felt could develop further if unchecked:

'It's not like London has suddenly become an adverse place for business. But there only has to be something like a fluttering of the wings, a marginal change. If you had the choice of somewhere else, it might just tip the balance.'

'The danger is that you get complacent and in five years' time, there is a big exodus, and then it's difficult to get people back again.'

Regulatory Environment

With respect to regulation, there was also a change of tone. Certainly, the UK is seen, in a comparative context, as a good regulatory environment and some positive views were expressed about the direction taken in the current Retail Distribution Review (RDR). However, with respect to retail distribution, there is still much to do in making the fundamental changes envisaged by the review:

'It's fundamental that the RDR doesn't get diluted and it succeeds in its ambition to elevate the quality of the advisers. You're never going to get to the point where the private investor is going to be sophisticated and knowledgeable enough to handle all this. He relies on the adviser.'

Furthermore, a number of those we spoke to expressed irritation about the way in which the Treating Customers Fairly (TCF) initiative was being handled in the sector. The challenge for the asset management industry in delivering TCF is directly related to distributional changes, through the increased use of platforms for example, where the relationship between wholesale asset managers and retail end-clients is becoming increasingly distant. In the view of those we spoke to, both this year and last year, this makes it very difficult to know precisely who their clients are and how their funds were being used within individual portfolios:

'We only see the aggregate flows, so we don't know what the underlying client is doing. On a TCF basis, we try to provide the right materials and give a full and fair description of what it is we are up to.'

Initially, the guidance issued by the regulator did not seem to appreciate this distance in the relationship between the fund manager and client, and much time was spent seeking clarity on this point. Sector-specific was then issued, but seems still not to be fully understood.

Asset managers emphasised in interviews that they fully supported the principle of TCF and have expended considerable resource in setting up systems and procedures to demonstrate that they are doing so. Much effort is also expended in ensuring that the appropriate information is delivered to both advisers and clients. However, they felt very strongly that regulatory resource should also be focused on the right places along the distribution chain. This would mean a significant focus on intermediaries where client interaction takes place:

'It's the FSA's job to regulate the financial intermediaries. We do business with the right IFAs and making sure we only do business with those IFAs, but apart from that we can't be at every point of sale.'

'One analogy is the speed camera. If you took away every speed camera in this country, the average traffic speed would increase markedly. Basically what you have in the retail arena is no speed cameras, so just start putting some cameras up.'

3. Employment

Staff numbers were gathered from 70 firms representing around 87% of total UK assets under management. From this data, we estimate direct employment numbers for UK-based asset management activity at 25,500, from 25,000 last year. The overall distribution is summarised in Table 11.

The increase in headcount results from a number of factors, including business development and, in one case, the end of an outsourcing agreement for administration.

The data shows core asset management activities (fund management, research and dealing) continuing to account for just over a quarter of total direct employment, with marketing and client services representing the second largest segment of employment (22%).

Table 11: Distribution of Staff by Activity

Activity	Survey Findings	Estimated Employment
Marketing, Sales, Business Development and Client Services of which:	**22%**	**5,625**
Marketing, Sales, Business Development	68%	3,847
Client Services	32%	1,778
Fund Management of which:	**26%**	**6,561**
Fund Management (Strategic and Operational) *	68%	4,452
Research/Analysis	24%	1,545
Dealing	9%	565
Transaction Process of which:	**6%**	**1,480**
Transaction Processing, Settlement	89%	1,315
Custody	11%	164
Fund Accounting and Administration of which:	**11%**	**2,804**
Investment Accounting, Performance Measurement and Reporting	54%	1,503
Other Fund Administration (including CIS Administration)	46%	1,301
Compliance, Legal and Audit of which:	**5%**	**1,158**
Compliance	56%	646
Legal	36%	419
Audit	8%	93
Corporate Finance and Corporate Administration of which:	**12%**	**3,010**
Corporate Finance	37%	1,120
HR and Training	25%	752
Other Administration	38%	1,139
IT Systems	**13%**	**3,210**
Other	**6%**	**1,653**
Total	**100%**	**25,500**

* In some firms, the fund management and research roles are combined.

The personnel structure of the industry is complicated due to outsourcing of many aspects within the asset management value chain. The directly-employed staff numbers therefore significantly understate total employment generated by the sector in the UK:

- Many investment fund firms outsource a substantial amount of their other activities, notably fund administration and accounting. Such outsourcing extends to larger firms (particularly for the retail aspects of their operations). Outsourced administration is often undertaken by specialist third party administration firms. It may also be undertaken by other asset management firms who offer such services (staff numbers for the latter were excluded in this survey).

- In common with practices in other industries, other activities – notably IT – are widely outsourced.

Total sector employment is also understated due to employment overseas emanating from UK-based asset management activity:

- With many IMA firms operating at a global level, some assets are managed outside the UK on behalf of UK-based clients, whose accounts are run from the UK.

- With a number of firms domiciling funds outside the UK and selling their products across Europe, middle and back office employment is created in other centres, notably Dublin and Luxembourg.

An Environment Based On Boutique Culture?

With respect to the issue of staff retention and development, two interlinked trends over the last decade have put considerable pressure on the mainstream industry to adjust working cultures for asset managers:

- The rapid growth of the hedge fund community, offering both attractive remuneration and a different working environment.

- The fragmentation of the wider industry, particularly in the context of the move towards specialisation discussed earlier.

All of the firms we spoke to this year were acutely conscious of the operational challenges posed by the trend towards a 'boutique' culture:

'It is all about retaining your top talent because you have to be very careful that growth isn't counter-productive, and that the more you grow the less people want to work for you.'

'It is a way for the industry as it gets bigger to foster entrepreneurship and to keep talented managers who do not want to be a cog in a big machine. They want an element of being "masters of their own destiny" and of putting their own imprint on things.'

'Fund managers typically don't like working for big organisations, just a fact of life. They are not good at playing political games, they never like the bureaucracy and they don't like the restrictions that are placed on them typically by big firms. So somehow you've got to create an environment where the investment managers and investment department are not exactly insulated, but certainly protected from some of the things that go on.'

While many firms would not actively describe themselves as multi-boutique, there is recognition of the advantages in terms of retention and reward offered by an environment where there is more autonomy within individual investment teams:

'We are not a multi-boutique firm but we are increasingly running ourselves in a way that would look like a multi-boutique firm. So the fact that we recognise different franchises and treat them as franchises is akin to recognising them as a boutique and they definitely have different investment styles and approaches.'

However, the challenge for large firms is to create such autonomy, while also avoiding fragmentation of the overall business, or a Balkanisation that is also isolating:

'What people don't understand sometimes is that there is a requirement also for having the advantages of the boutique, which is the full accountability, the performance management and reward sharing that goes with this.'

'What you've got to be so careful about is that you don't create a Balkanisation and end up losing people because they feel they are not part of a team.'

At the same time, larger firms often feel that they can offer the best of all worlds, in combining greater freedom for their investment managers with an effective infrastructure:

'We recognise the benefit of clarity around investment styles and approaches, but with all the infrastructure that can support them in a way a boutique cannot: bigger dealing teams, bigger risk and portfolio analytical capabilities and much more in the way of structured distribution opportunities.'

Amid little sign of wider consolidation within the industry, these cultural/operational challenges are expected to continue.

4. Execution and Disclosure

The survey includes a number of questions on execution, disclosure and compliance arrangements, reflecting issues of ongoing regulatory interest. The following areas are surveyed:

- Extent of execution-only (i.e. without receiving other broker services) trades;
- Extent of commission sharing arrangements;
- Member uptake of the Pension Fund Disclosure Code;
- Number of brokers used to execute both UK trades and overseas trades;
- Use of transaction cost analysis;
- GIPS compliance; and
- Execution and disclosure.

Execution-only Trades

Respondents were asked what proportion of trading by value was completed on an execution-only basis (including through execution-only brokers, crossing networks and by direct market access (DMA)):

- Of 58 respondents, 20 managing £445bn (16% of total assets under management in the sample) do 100% of their business on an execution-only basis. See Table 12. This is a significantly larger number of firms than last year.
- Six managers with £554bn under management (20% of sample AUM) do 51-99% of their business on an execution-only basis.
- Thirty two firms managing £1.8trn (63% of total sample AUM) do up to 50% of their business on an execution-only basis, the same number as in the 2006/07 survey, managing a similar value of assets.

The results indicate that there continues to be a trend in the industry towards more execution-only trading strategies.

Table 12: Proportion of Business Directed on an Execution-Only Basis

	Number of Firms	Total AUM (£mn)
<1%	3	£60,849
1-25%	21	£1,363,240
26-50%	8	£334,236
51-75%	4	£364,722
76-99%	2	£189,605
100%	20	£444,625
Total	**58**	**£2,757,277**

Commission Sharing Arrangements

Respondents were asked whether they had set up commission sharing arrangements (CSAs) with their brokers and for what proportion of their trading:

- Of 59 respondents, 22 had not set up any such arrangements. See Table 13.
- Thirty-seven firms have put CSAs in place for at least a proportion of their business (29 out of 51 in 2006/07), with 19 firms using CSAs for over 20% of their business (12 in 2006/07).

Table 13: Proportion of Trade Through Brokers Subject to Commission Sharing

	Number of Firms	Total AUM (£mn)
0%	22	£540,970
1-20%	18	£1,138,632
>20%	19	£1,095,345
Total	**59**	**£2,774,947**

The trend towards increased use of CSAs continues as a result of the disclosure requirements in the FSA's 'Use of Dealing Commission' regime, introduced in 2006. The requirement to split the full service commission rate between what is paid for execution services and what is paid for research has facilitated the purchase of third party research and execution services from bundled commission, leading to increased scrutiny by managers of the quality of the services they are purchasing.

With reference to the previous section on execution-only business, the fact that 22 managers do not have a CSA in place is primarily explained by the fact that 20 managers transact 100% of their business on an execution-only basis and therefore have no need to establish CSAs.

IMA Pension Fund Disclosure Code

Out of 64 respondents, 56, accounting for 99% of assets under management in the sample, use the Pension Fund Disclosure Code. See Table 14. In 2006/07, 48 out of 53 respondents (98% of AUM in the sample) used the Code. It should be pointed out, however, that not all of those assets are subject to the FSA's disclosure regime.

Table 14: Use of the IMA Pension Fund Disclosure Code

Do You Use The IMA Pension Fund Disclosure Code?	Number of Firms	Total AUM (£mn)
Yes	56	£2,980,591
No	8	£26,822
Total	**64**	**£3,007,413**

Use of Brokers

The question is included in order to monitor changing trends in broker usage as a result of the 'Use of Dealing Commission' regime:

- UK equities. As Table 15 shows, out of 57 respondents, 23 use 5-10 brokers for the majority of trades in UK equities, a slightly higher proportion than 2006/07. A further 23 respondents use 11-20, down as a proportion from last year. Eight firms use over 20 brokers, again down as a proportion compared with 2006/07. Three firms use fewer than 5 brokers.

- Rest of the world. For the rest of the world, 15 respondents out of 50 use 5-10 brokers (down as a proportion compared to last year) and 20 use 11-20 (an increase over 2006/07). Twelve firms use over 20 brokers (down from 2006/07).

For UK equities, there appears to be a clear trend towards using fewer brokers. We believe that the increase in the usage of CSAs, in combination with the reviews required by MiFID (Markets in Financial Instruments Directive), has probably led to a reduction in broker numbers as managers are able to focus on those brokers who can provide best execution, while also being able to pay for research from third parties. With regard to the Rest of the World, the trend appears to be slightly in the opposite direction. The increasing diversification of client assets away from the UK may have led to an increase in broker relationships.

Table 15: Number of Brokers Used for the Majority of Trades

	UK	World
<5	3	3
5-10	23	15
11-20	23	20
>20	8	12
Total	**57**	**50**

Transaction Cost Analysis

Over two thirds of respondents (47 of 66), undertake internal transaction cost analysis, a higher proportion than last year. With the introduction of MiFID in November 2007 and the requirement under the Directive to provide best execution to clients, there has been an increase in managers subscribing to transaction cost analysis services in order to be able to demonstrate to clients compliance with the best execution obligation.

With respect to client requests, Table 16 details the responses for transaction cost analysis, 49 firms report that fewer than 25% of their clients require such analysis, a higher proportion than last year. Only 8 firms (11 in 2006/07) report that over 75% of clients request the analysis. While fewer clients appear to be requiring that managers provide them with transaction cost analysis, this is in some cases due to automatic provision by firms.

Table 16: Proportion of Clients Requiring Transaction Cost Analysis

	<25%	25-50%	50-75%	>75%	Total
Number of Respondents	49	4	0	8	61

Compliance with Global Investment Performance Standards

Out of 65 respondents, 49 firms report that they are compliant with the Global Investment Performance Standards (GIPS) and all of those have their results externally verified. In 2006/07, the comparable figures were 42 compliant firms out of 51 respondents, a higher proportion than this year, of which 41 were externally verified.

This year's sample has a higher number of respondents and includes several firms who do not have the same commercial requirement to become GIPS compliant, explaining the fall in the proportion of firms claiming compliance. As acceptance of the GIPS regime has become more global, in line with a more globalised asset management industry, uptake of the Standard is seen by many managers as a competitive advantage enabling cross-border comparison of investment returns.

The GIPS Executive Council has recently dropped the requirement, due to be introduced in 2010, that all firms who claim compliance should be independently verified. It will be interesting to see in the future therefore if firms begin to drop independent verification while continuing to claim compliance with the Standards.

Appendices

Appendix 1: Summary of Main Responses (Sample sizes vary between questions)

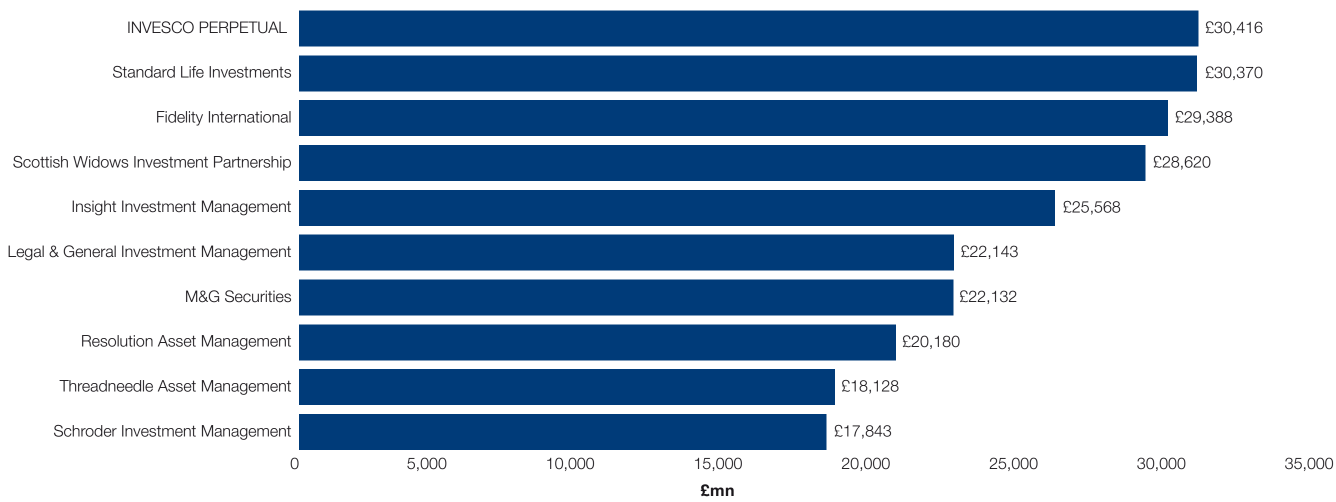
Client Type	TOTAL
Assets Under Management (£mn)	3,370,000
Segregated (directly invested) or Pooled Institutional Assets	
Assets directly invested on a segregated basis	
Managed on a pooled basis	
Multi-Asset or Specialist	
Multi-asset	25.0%
Single-asset / specialist	75.0%
Active or Passive	
Actively managed	81.2%
Passively managed	18.8%
Asset Allocation	
Equities of which:	51.6%
UK Equity	51.4%
European ex UK Equity	18.1%
US Equity (includes N.American Equity)	14.8%
Pacific ex Japan Equity	5.8%
Japan Equity	4.7%
Emerging Market Equity	4.3%
Other Equities	0.9%
Bonds	31.8%
Cash / Money Market	9.2%
Property	4.4%
Other	3.0%

* The data in the segregated/pooled and multi asset/specialist sections do not include responses from in-house pension managers

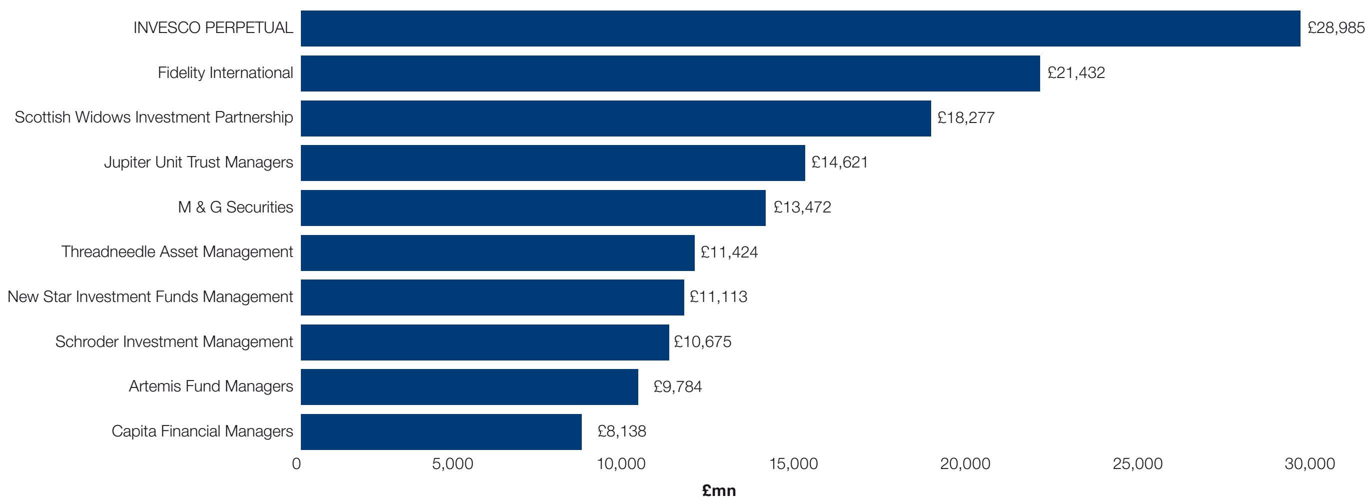
Institutional									
Corporate Pension Fund	Local Authority	Charity	Third Party Insurance	In-house Insurance	Other Institutional	Third Party Institutional	All Institutional	Retail	Private Client
979,322	237,922	41,451	172,207	666,249	458,320	1,782,833	2,555,471	769,034	45,158
29.1%	7.1%	1.2%	5.1%	19.8%	13.6%	52.9%	75.8%	22.8%	1.3%
47.2%	79.2%	74.1%	91.5%	86.7%	72.9%	62.4%	69.1%		
52.8%	20.8%	25.9%	8.5%	13.3%	27.1%	37.6%	30.9%		
14.2%	26.1%	49.0%	34.8%	56.0%	4.2%	15.6%	26.3%	19.6%	51.4%
85.8%	73.9%	51.0%	65.2%	44.0%	95.8%	84.4%	73.7%	80.4%	48.6%
66.8%	70.7%	79.9%	95.5%	88.8%	82.0%	71.2%	77.8%	6.7%	100.0%
33.2%	29.3%	20.1%	4.5%	11.2%	18.0%	28.8%	22.2%	93.3%	
49.3%	75.1%	69.3%	33.0%	37.0%	35.2%	48.1%	44.3%	74.0%	65.8%
38.1%	20.2%	22.4%	47.0%	46.4%	28.5%	32.6%	37.2%	16.8%	13.4%
4.0%	1.5%	5.1%	15.4%	8.0%	27.7%	12.1%	10.5%	6.3%	18.5%
3.2%	1.5%	0.3%	2.1%	7.7%	4.7%	2.8%	4.6%	2.7%	1.8%
5.4%	1.8%	2.8%	2.2%	1.0%	4.0%	4.4%	3.4%	0.2%	0.5%

Appendix 2: Largest Asset Managers For UK-Domiciled Investment Funds

Top Ten UK (Investment Fund) Asset Managers at December 2007



Top Ten UK Retail (Investment Fund) Asset Managers at December 2007



Appendix 3: Questionnaire Respondents

Note that data from firms has only been included in aggregate findings where they manage assets in the UK

Aberdeen Asset Management plc
Aberforth Partners LLP
Aerion Fund Management Ltd
ABN Amro Asset Management Ltd
AEGON Asset Management Ltd
AllianceBernstein Ltd
Allianz Global Investors (UK) Ltd
Artemis Fund Managers Ltd
AXA Framlington Investment Management Ltd
AXA Investment Managers UK Ltd
AXA Rosenberg Investment Management Ltd
British Airways Pension Investment Management Ltd
BAE Systems Pension Funds Investment Management Ltd
Baillie Gifford & Co. Ltd
Barclays Global Investors Ltd
Baring Asset Management Ltd
Belgrave Capital Management Ltd
BlackRock Investment Management (UK) Ltd
BNP Paribas Asset Management UK Ltd
BP Investment Management Ltd
B.S. Pension Fund Trustee Ltd
Canada Life Asset Management Ltd
Capital International Ltd
Cazenove Capital Management Ltd
CIS Unit Managers Ltd
Credit Suisse Asset Management Ltd
Dimensional Fund Advisors Ltd
Edinburgh Partners Ltd
F & C Asset Management plc
Family Assurance Friendly Society Ltd
Fidelity International Ltd
First State Investments Ltd
Franklin Templeton Investments
Gartmore Investment Management Ltd
Henderson Global Investors Ltd
Hermes Pensions Management
Insight Investment Management (Global) Ltd
INVESCO Asset Management Ltd
Investec Asset Management Ltd
JO Hambro Capital Management Ltd
JPMorgan Asset Management Ltd
Jupiter Asset Management Ltd
Lazard Asset Management Ltd
Legal & General Investment Management Ltd
Lehman Brothers Asset Management Ltd.
Lincoln Unit Trust Managers Ltd
Liontrust Investment Funds Ltd
M&G Securities Ltd
Marks and Spencer Unit Trust Management Ltd
Majedie Asset Management Ltd
Manek Investment Management Ltd
Martin Currie Ltd
MLC Trust Management Ltd
Morgan Stanley Investment Management Ltd
Morley Fund Management Ltd
Newton Investment Management Ltd
Nomura Asset Management U.K., Ltd.
Odey Asset Management LLP
Old Mutual Asset Managers (UK) Ltd
Pictet Asset Management Ltd
PIMCO Europe Ltd
Principal Global Investors (Europe) Ltd
Rathbone Unit Trust Management Ltd
RBS Asset Management Ltd
Reed Elsevier Pension Investment Management Ltd
Resolution Asset Management Ltd
Royal London Asset Management Ltd
Schroder Investment Management Ltd
The Share Centre (Investment Management) Ltd
T Rowe Price Global Investment Services Ltd
Standard Life Investments Ltd
State Street Global Advisers Ltd
Scottish Widows Investment Partnership
Threadneedle Asset Management Ltd
UBS Global Asset Management Ltd
Virgin Money Unit Trust Managers Ltd
Wellington Management International Ltd

Appendix 4: Firms Interviewed

Senior figures from the firms below were interviewed for the survey. With their agreement, selected quotations have been reproduced on an anonymous basis:

Barclays Global Investors Ltd
BlackRock Investment Management (UK) Ltd
Capital International Ltd
F & C Asset Management plc
Fidelity International Ltd
Henderson Global Investors Ltd
Insight Investment Management (Global) Ltd
INVESCO Asset Management Ltd
JPMorgan Asset Management Ltd
Jupiter Asset Management Ltd
Lazard Asset Management Ltd
Legal & General Investment Management Ltd
M&G Securities Ltd
Morley Fund Management Ltd
New Star Investment Management Ltd
Newton Investment Management Ltd
Odey Asset Management LLP
Schroder Investment Management Ltd
Standard Life Investments Ltd
Threadneedle Asset Management Ltd
UBS Global Asset Management Ltd

Designed by: **THE FOREST**
www.theforeststudio.co.uk

Investment Management Association
65 Kingsway
London WC2B 6TD
United Kingdom

Tel: +44 (0)20 7831 0898
Fax: +44 (0)207 831 9975

www.investmentuk.org

July 2008