RETAIL FUND MARKET

Investors seek panacea for past performance

A nose-dive in Italian equity performance has seen many savers place their money in fixed income vehicles. However, the introduction of 'fondi flessibili' may offer them an alternative that could make up for past losses, writes Furio Pietribiasi, general manager responsible for product development and manager selection at Mediolanum

Italy can be considered leading and innovative in a number of businesses, such as fashion, food and wine where they have built one of the strongest franchises. On the other hand, Italians have never been considered pioneers in the financial products industry.

This situation might change with the introduction of 'fondi flessibili'. Here we look at what the key drivers of the success of these funds have been so far and if the trend is set to last and develop, or if it is just a short-term Italian phenomenon.

We should start from the most recent past, analysing how investors' appetite has changed, but mainly how distributors tackled some historical events.

INDUSTRY DEVELOPMENTS

The 'fondi flessibili' are the result of a reaction by the distributors to a number of industry developments. The most important one was the 2000-2002 bear market, during which retail clients experienced huge losses on their savings. In fact, during this period, large portions of retail portfolios were exposed to equities, riding the bull market trend with the hope to gain higher returns than those of the Italian treasury bill – which no longer offered such attractive yields.

Unfortunately, after experiencing such losses, retail clients were forced to learn the meaning of volatility and, as a consequence, from 2001-2005 they avoided equities and switched to less risky asset classes such as bonds or capital protected products (from 2003-2006, the net inflows for Italian equity funds fell by €9.1bn).

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In many cases, this also had an important effect on the relationship with distributors, mainly with the traditional big banks. Clients felt the fiduciary relationship where banks were receiving a certain income generated by the management fee vis à vis uncertain returns for the clients was breached.

In addition, the experience with equity markets was so negative that it influenced the retail investors' perception on the real market results. In fact, according to SWG research, investors believed that the market return for 2005 for domestic equities was just around 1 per cent. The actual performance of the Mibtel Index was 37 per cent.

As a result, clients moved to safer investments. Today the fixed income and liquidity funds represent 56 per cent of the total assets in the Italian mutual fund market, with 25 per cent in equity funds. Safer investments offered lower management fees to different providers. Generally outside the traditional bank products (year-to-date in 2006, there was a net outflow from the Italian mutual fund industry for €2.2bn), this generated new distribution opportunities to third-party, big international providers and/or niche local players.

This trend has had an inevitable impact on the income of banks and the products offered. In fact, many banks had to restructure the existing equity funds range, either closing some of the funds or merging vehicles together, triggering the so-called product offer rationalisation trend.

This aimed to eliminate the funds that proliferate during the bull market years (e.g. sector, thematic and style equity funds), with the added benefit of sprucing up the performance track record of the product offerings.

TRADITIONAL SAVINGS

Today, clients have completely changed their expectations. From a generic savings approach, where the results were assessed at the time of which a need of cash may arise, retail had a wiser savings attitude by targeting objectives with specific time horizons, maintaining a solid and consolidated tradition of regular investments (71 per cent of Italian families invest perdiodically, of which 27 per cent have regular saving plans, the so called 'PAC' – Piani di accumulo).

The SWG research, which reported that the average time horizon to achieve their objective for Italian families is 9.25 years (e.g. typically a maximum target period of 10.4 years on average for a pension or a minimum target period of 6.8 years on average for the purchase of capital goods) and, more importantly, the average time horizon for the assessment of the results is 4.14 years.

In this environment, where retail investors remain adverse to market risks but are attracted by total return strategies which enable capital accumulation, the attention of distributors shifted to flexible funds.

These type of products were initially recognised by the Assogestioni (Italian Mutual Fund Association) in January 1999, when it established a new category containing the funds. They have total freedom in swinging their asset allocation between equities and cash from 0 per cent to 100 per cent. This type of fund appealed to clients immediately as it was based on the idea that managers could consistently limit the losses during bear markets and maximise returns during bull markets.

FROM BETA TO ALPHA

This turned out to be the first big product development shift from beta strategies to alpha strategies with no benchmark constraints and where the alpha was generated not only by stock picking, but also by asset allocation.

The other relevant change relating to these new products was the pricing, which would typically incorporate a performance fee based on the capital appreciation with a high water mark mechanism as well as a management fee. This new structure was aimed to align the interests of the managers with those of the inventors, which was again something new for industry.

The demand for these type of investments grew over the years and the big banks rushed to launch flexible funds which would have helped them to maintain the margins (though both the management and performance fee) and also regain some client trust.

As at the end of 1999, flexible funds already had 29 funds with €5.5bn under management, which is 1.15 per cent of the total assets of the Italian mutual fund industry.

Initially, the growth of flexible funds saw very little participation from the big international asset managers, probably because they felt that the flexible funds were mainly a commercial solution with very high risk of realisation and they didn't want to jeopardise their franchise in the local market. In fact, the Ucits I regulation was too restrictive (e.g. shorting was not permitted, and only hedging was allowed) to implement total return strategies with sustainable results at that time.

At the end of 2003, according to Assogestioni, only 14 of the flexible funds were promoted by international asset managers versus the 82 funds run by Italian asset managers (55 domiciled in Italy and 27 outside Italy).

It was only in late-2004, with the advent of Ucits III and the relevant clarifications of new regulation interpretation nuances eliminating the major investment limits, that the big international players entered the fray. The new players brought proprietary total return strategies, which have proven successful over the years.

Thanks to this additional development, the number of flexible funds available on the market grew from 96 funds at the end of 2003 to 143 (of which 41 promoted by international asset managers) at the end of 2004.

As at the end of May 2006, the number of flexible funds was 162 with €46bn of assets under management, which represents 7.3 per cent of the total assets of the mutual fund industry in Italy (€601bn).

This figure is even more impressive if we consider that year-to-date the net inflows has been nearly €17bn for flexible funds, in comparison to flat flows for equity (€964m) and negative for fixed income (-€13bn).

INTERNATIONAL APPEAL

By attracting big international asset managers, it could be suggested that flexible funds should not be just a considered local story based on a marketing idea, but rather that they have the potential to become a solid investment solution containing innovative investment engines.

Having said that, there is always the risk that the 'fondi flessibili' phenomenon could turn to be a bubble for the Italian market, and become the next lesson for retail investors. If the results of the funds fall short in more volatile financial markets (these products typically have a two to three-year track record) and if distributors will not sell these category of funds to their clients, flexible funds may become just another brick for a successful long-term investment saving plan rather than the panacea to make up for past mistakes.