Are Rachel Reeves' Initiatives fueling an Asset Management Oligopoly?

Pricing out smaller managers stifles innovation and destroys competition.

In her maiden Mansion House speech, Chancellor Rachel Reeves has proposed one of the most radical overhauls to the £400bn UK local authority pension system in a generation. The principal proposal is the creation of a small number of Mega Funds, with the critical mass to invest significantly in infrastructure projects in both the UK and abroad.

The rationale for these changes is essentially two-fold – to provide UK pensioners and stakeholders with access to larger scale infrastructure investments, while still maintaining adequate levels of diversification, but also to give the Mega Funds the scale and negotiating power to drive down fees, thereby improving net returns. These admirable ambitions make a great deal of sense and could undoubtedly drive domestic investment and therefore growth in the UK economy.

The other side of the debate is whether such significant consolidation and stipulating minimum investment levels in UK projects is ultimately in the best interests of pensioners and investors. Markets tend to function most efficiently without government intervention, does the UK Government really know best or are investors better able to identify value. The rise in popularity of private equity investments in pensions would seem to suggest the money will find its way, without legislation.

Feedback from some Local Government Pension Schemes, based on their experience of the current pooling mechanism, also raises questions around the benefits of large-scale pooling. While headline costs have undoubtedly been reduced, you get what you pay for and cheapest isn't always best. There are empirical reservations relating to the mass pooling of assets and consolidation of pension funds, which the Government may wish to take heed of.

Firstly, the reason that Mega Funds are able to negotiate fee concessions is that they have very large sums of capital to invest. However, as these sums of capital rise, the number of investment managers able to accommodate them falls. This is primarily due to liquidity limitations on the percentage of any manager's total assets that any single pension fund can invest. Eliminating a significant number of boutique, niche or just smaller managers from these mandates risks creating an effective oligopoly concentrated around a small number of Mega Managers. Oligopoly power rarely benefits the ultimate client in the long run.

Not only do these very large sums of capital put constraints on the managers that can service them, but also the underlying investments they can make. Most investments have some form of liquidity or capacity limitation. This balance between potential return and liquidity becomes an increasing issue the larger a fund becomes, for example, the due diligence requirements on a potential investment that could only be a fraction of a percent of the portfolio begin to outweigh the portfolio benefit, regardless of the potential returns. In practice this means that Mega Funds will not be able to access the same set of investment opportunities as existing LGPS.

While the scale theory behind reducing costs is obvious, the real-World results have varied. Experience shows that in order to win these very large, high-profile mandates, large, diversified managers will treat the mandate as a loss leader, reducing their headline fees to un-economic levels to price out competition, while expecting to make back these fees from cross selling other services, such as stock lending, advisory, hedging, reporting or other basic asset

management services. The ultimate price the client ends up paying may differ significantly from the headline fee.

Mega Managers are likely to experience the same type of economies or scale as Rachel Reeves' Mega Funds but, in this case, there is no guarantee that part, or any, of these savings will be passed through to the investors or pension funds that have effectively created them.

Researching and launching new innovative investment products is expensive and time consuming and, without competitive forces, both are likely to be under prioritised. A lack of competition almost always stifles innovation, restricts diversification and ultimately limits choice. One of the main criticisms of the existing CIV Pools has been the lack of suitable product and investment flexibility available to the underlying pension funds. Adopting a one-size fits all approach has its limitations and the danger is that the current proposals may exacerbate this.

Osmosis welcomes all initiatives to direct investment towards development in the UK economy and to reduce fees for pension holders. We also believe, however, that these new regulations must take care to protect investors and pensioners, as well as the economy, by safeguarding innovation, diversification of both products and thought, transparency and most of all competition in the UK asset management industry.

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