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**In focus**

# Mutual funds are in decline: what comes next?

**February 2023**

## For almost a century mutual funds have provided a simple and effective solution for investing: delegation to professionals, diversification through pooling of client assets, and security through a regulated legal structure. But times are changing, and so is the way people want to invest.


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At the same time as investments into mutual funds have been growing exponentially, technology has been making incredible advancements in areas such as electric aviation, AI and the cloud. Meanwhile, the needs of the human population and - more specifically - asset owners and wealth managers have also evolved dramatically; becoming more diverse, complex, and challenging.


As these needs and the technological environment have evolved, it seems hard to believe that mutual funds have broadly stayed the same yet still remain so relevant. Can they continue to meet the needs of the modern day, or are we at an inflexion point, where we have seen the peak of mutual funds? Could they even become extinct?

With advancements in technology, alternative options available to asset owners and wealth managers, and generational differences in how people like to invest, mutual funds' dominant market share will continue to decline. This decline is likely to be significantly more rapid in the US and globally the rate of decline will likely increase as we see significant advancements in tokenisation.

**Questions this paper addresses**

1. **What are the benefits and limitations of mutual funds?**
2. **What are the other options available today and in the future?**
   - a. ETFs
   - b. Models
   - c. SMA/Direct Indexing
   - d. Tokenisation
3. **Why are we seeing this shift? – from a client perspective**

Schroders

## Executive Summary

### Comparison to mutual funds

| Option | Tokenisation | Direct indexing | SMA | Models (Asset allocation) | ETF |
|---|---|---|---|---|---|
| **Client need** | | | | | |
| Customisation | Low | High | High | Medium | Medium |
| Access/fractional ownership | High | Low | Low | Low | Low |
| Transparency | High | High | High | Medium | Medium |
| Lower cost | High | High | High | High | Medium |
| Tax efficiency (specific markets) | Low | High | High | Medium | Medium |
| Passive/Active investing | Passive and Active | Passive and Active | Active | Active | Passive and Active |

**Comparative advantage to mutual funds**
High  Medium  Low

**Tokenisation** uses distributed ledger technology (or Blockchain technology) to automate the operating model of a traditional fund. Ownership is recorded in the form of a digital token which represents the underlying assets. Benefits include fractional ownership, transparency of holdings, potential cost efficiencies, and secondary trading. Tokenisation can be used for both active and passive investments.

**Separately Managed Accounts (SMAs)** are a portfolio of direct securities held by investors, they provide investors transparency, direct ownership of underlying securities, tax advantages in some regions (e.g. US/Australia), and the flexibility to make custom decisions such as inclusion or exclusion of individual securities or entire industries from their portfolios. These have become particularly popular in the US. **Direct Indexing** is a form of SMA that uses technology to automate tax management. Direct Indexing and SMA increasingly rely on fractional ownership to increase diversification for lower wealth clients, and trading through this mechanism is growing in popularity in the US.

**Models (asset allocation)**. Model portfolios are a cost-effective way of accessing a diversified and actively managed portfolio of investments. They allow for an element of customisation through high-level asset allocation. While models typical use pooled investments rather than  direct investments as building blocks, they can provide a flexible approach for some personalisation.

**ETFs**, trade on an exchange like stocks and bonds, allowing investors to buy and sell them at any point throughout the day. ETFs are closest in structure to mutual funds, (and in Europe are typically UCITS) but in some instances can be cheaper, provide transparency and provide some tax benefits, again particularly in the US.

## 1 What are the benefits and limitations of mutual funds?

Mutual funds remain the largest fund type, with global assets under management of $54.6 trn[1]. They continue to have many advantages for investors, including delegation to specialists who perform extensive research to select the constituent securities and providing optionality; from asset classes, themes, risk tolerances, outcomes, time horizons and geography. Mutual funds continue to afford investors diversification, the pooled nature of capital provides access to a broader cross section of assets, and allows for holdings in assets that would otherwise be unattainable to many individuals.

Inevitably, these advantages don't come without some disadvantages. The running of mutual funds requires multiple participants, e.g. the advisor, depository, fund accountant, custodian, transfer agent and AFM. This means a layer of costs for the administration of funds.

With the multiple layers involved in their running and trading, the cost of mutual funds is regularly criticised. Cost continues to be addressed by the industry and mutual fund fees have continued to fall (down ~35% in fixed income, multi-asset and equity mutual funds over the last five years[2]). It is estimated that ~66% of the decline has come from passive fund fees and ~34% from active fund fees[3].  Alongside the inefficiencies that translate into layers of cost, mutual funds cannot be individually managed to a clients specific tax situation, cannot be customised to specific client requirements and are only traded once a day. For some the lack of intra-day pricing could be viewed as a challenge in the increasingly personalised and on-demand digital environment of today. However, for the vast majority of investors, holdings are for the long term and therefore this should be less of a concern.

A number of mutual fund challenges can be solved in SMAs or direct index accounts (which are a type of individual separate account explained in more detail below).

1 Source: Schroders, Broadridge data – as at Dec 2021.
2 Source: Morningstar Global Fund Investor Experience Study 2017 and 2022, UK domiciled funds.
3 Morningstar; Fund fees, continued decline is a win for investors.

## What are the other options available today and in the future?

### ETFs

Considered a hybrid between a share and a mutual fund, exchange-traded funds (ETFs) in the 90s were considered an industry-disrupting innovation. Today this innovation has ~$10.2trn of assets under management globally, of which the US dominates flows with~74% share[4].

ETFs trade on an exchange like stocks and bonds (unlike mutual funds, where transactions occur directly with the fund), allowing investors to buy and sell them at any point throughout the day. As the buying and selling occurs on an exchange, operating and administration costs are cheaper as the underlying fund is not impacted by redemptions and transaction costs like a mutual fund would be. Although administration and operating costs can be higher for a mutual fund, ETFs may come with broker commissions and therefore the ongoing costs associated with either option needs to be considered depending on individual circumstances.

In addition to the reduced administration and operating costs, trading on an exchange provides secondary liquidity and has the potential to provide tax efficiencies (trades can be matched on the secondary market rather than having to sell securities from the underlying fund which could result in capital gains). In some markets like the US, the tax benefits can go further and flush out securities with large gains to the market maker (specific to the US), so can largely eliminate the distribution of capital gains from the ETF which cannot be done in a mutual fund.

ETFs are overwhelmingly passively managed against indices. Although there is a small active ETF market, an issue with active ETFs is the disclosure of holdings on a daily basis. This transparency can be a positive for investors, but for many active managers this transparency can lead to concerns about their strategy being front-run and also of the overall portfolio strategy being copied as a way to avoid active management fees.

In 2019 regulation allowed for the introduction of semi-transparent ETFs. Rather than providing daily disclosure of holdings, this disclosure could be provided with a time lag or at regular intervals, such as quarterly or monthly. The semi-transparent ETF addresses some of the concerns for active managers; however it comes with its own set of concerns, e.g. bid/ask spreads can be wider due to the risk of valuation being incorrect.

In addition, the universe in which a semi-transparent ETF can be launched is currently limited to US stocks and to American Depositary Receipts and Global Depositary Receipts of foreign companies.

Other potential concerns when thinking about investing via ETFs (transparent or semi-transparent) can include capacity. When a mutual fund attracts assets to a level that a fund manager believes starts to limit potential investment options that align with the conviction of the fund, it can be soft-closed or even closed to new investors to maintain the fund's characteristics and investment philosophy. With ETFs, due to the way in which they are traded, there is no ability to close access to these funds. In some cases this can lead to a broadening of the investment holdings, which has the potential to change risk/return characteristics and dilute the investment philosophy. In addition to potential capacity issues, investors need to be aware that the share price of an ETF can fluctuate during the day, and price may trade above (premium) or below (discount) the net asset value of the fund and this could be exaggerated during times of market stress.

For example, during the Covid crisis in March 2020 the five largest S&P 500 ETFs experienced a widening of their bid/ask spreads to ~10 basis points at the peak[5].

### Model Portfolio Service (MPS)

Model portfolios are a cost-effective way of accessing a diversified and actively-managed portfolio of investments, and allow for an element of customisation through asset allocation. While still pooled investments rather than individual direct investment, they provide a degree of personalisation.

Almost half (46%) of UK wealth managers expect to use model portfolios more extensively over the next 12 to 24 months, compared to just 2% that plan to decrease their use over the period.

In the US, 72% of advisers use asset allocation models in some capacity. The number of advisers using models has been stable over the last several years, fluctuating between 71% and 75% since 2016[6].

A move among advisers to focus on the value they can add is one of the main drivers of increasing adoption of model portfolios in the UK wealth management space, with advice firms turning to external solutions that enable them to focus on "core" financial planning (e.g. tax & estate planning, retirement planning and family finances) rather than investment management[7]. Model portfolios to some extent are complementary to mutual funds. Key characteristics of an MPS include asset allocation and manager selection, but the execution of the overarching asset allocation is through building blocks, and can include mutual funds, ETFs, or can be executed through direct holdings of securities in a separate account.

In addition to the cost benefits, efficiency from outsourcing and some element of customisation are also benefits of this approach. **Model portfolios can also be built as solutions directly for an adviser firm, white-labelled and customised to represent the house view of the firm**.

4 Source: Schroders, Broadridge data as at December 2021.
5 Investment company institute, Experiences of US exchange-Traded Funds During the COVID-19 Crisis (October 2020)
6 Fuse research
7 Demand for Model Portfolios Is Set To Continue Growing in...| Cerulli (as at 6 June 2022)

## SMA and direct indexing

Historically SMAs were largely reserved for institutional and high net worth investors. SMAs are a portfolio of direct securities held by investors, which provide investors transparency of holdings, direct ownership of underlying securities, tax advantages (e.g. in US/Australia), and the flexibility to customise investments such as inclusion or exclusion of individual securities or entire industries from their portfolios. In the US SMAs are one of the fastest-growing segments of the wealth management market, but are still generally reserved for fairly wealthy clients due to the high costs of acquiring whole portions of underlying assets and the wealth required to build a diversified portfolio.

Within SMAs, there has been a recent increase in the popularity of direct indexing. The first direct indexing portfolio was actually available in the 90s. Back then, the cost of creating these portfolios remained prohibitive to retail channels but today, as technology has significantly developed, many asset managers now have technology platforms to launch index SMAs. The primary objective of direct indexing is to provide clients with an index exposure that can then be customised and improve outcomes through providing tax efficiencies, factor tilts, and thematic investing to represent individual preferences. Unlike mutual funds or ETFs, individuals are provided with control over tax and security level decisions while maintaining their individual preferred risk exposures.

In the US the primary benefit of direct indexing is the tax management and optimisation via automation. In a survey carried out by Cerulli Associates, ~84% of respondents thought the main advantage of direct indexing to be tax optimisation or management, with the remaining 16% saying it was the ability to screen for ESG factors[8]. (With the proliferation of ETFs and mutual funds with ESG, sustainability and impact criteria now embedded within their process and value proposition, to some degree this preference can also be accommodated through these structures).

In North America direct indexing is expected to grow at an annualised rate of over 12% over the next five years, faster than traditional financial products, such as mutual funds, ETFs, and separate accounts[9] (albeit starting from a significantly lower base). A large reason for this being the specific tax benefits available. Direct indexing is thought to be heavily entrenched within passive management due to its starting point of index replication, but the technology available can use any reference portfolio as its starting point and make adjustments for client preferences as it would for a starting passive index.

In Europe SMAs continue to be used for institutions and high net worth investors. The use of direct indexing is less prevalent, in the main due to its main advantage (automated tax management) not being as applicable and client demand not as considerable.

As asset managers continue to acquire and build their capability across direct indexing and scalable SMAs in the US, it is feasible that it may start to come to Europe in a more meaningful way, potentially through industry push rather than demand-side pull.

Just as tax optimisation has been critical to the growth of SMAs in the US, tax benefits could also help drive adoption of SMAs in other countries where tax losses or tax deferral can be used to reduce an investor's overall tax liability.[10]

8 Improving client experience: customizing with Direct Indexing, Cerulli associates August 2021.

9 Improving client experience: customizing with Direct Indexing, Cerulli associates August 2021.

10 This is not tax advice.

11 BCG on chain asset tokenisation – September 2022.

## Tokenisation

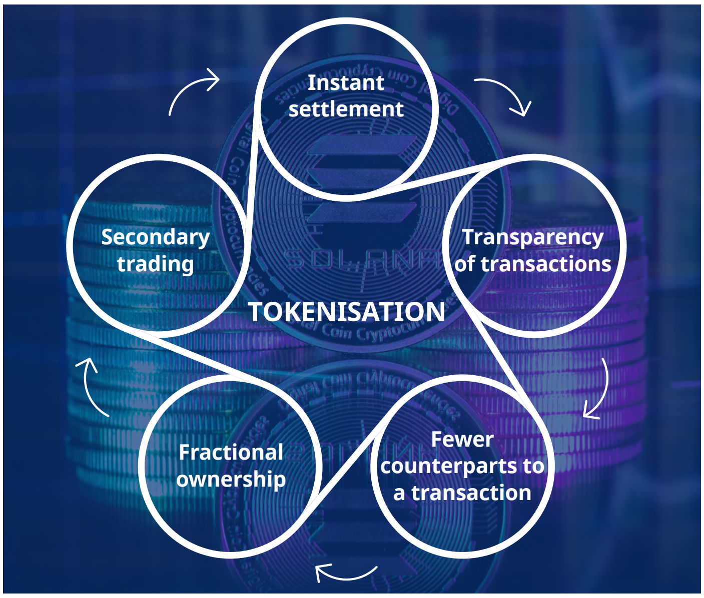
For almost a century there was very little innovation in the fund industry. However, over the past two decades the rate of change has exponentially increased, with the growth in ETFs, SMAs, direct indexing and most recently the use of tokenisation.

Tokenisation uses Blockchain and technology to automate the operating model of a traditional fund. Shares or units in a fund are digitally represented and recorded and traded on distributed ledger technology (DLT). From a client perspective, their experience of buying/selling shares of a fund would be very similar, but they would receive a token rather than a share.

Currently, tokens are not defined or regulated consistently across regions, we believe regulators will address this, and to some degree regulation will impact the speed at which change occurs.

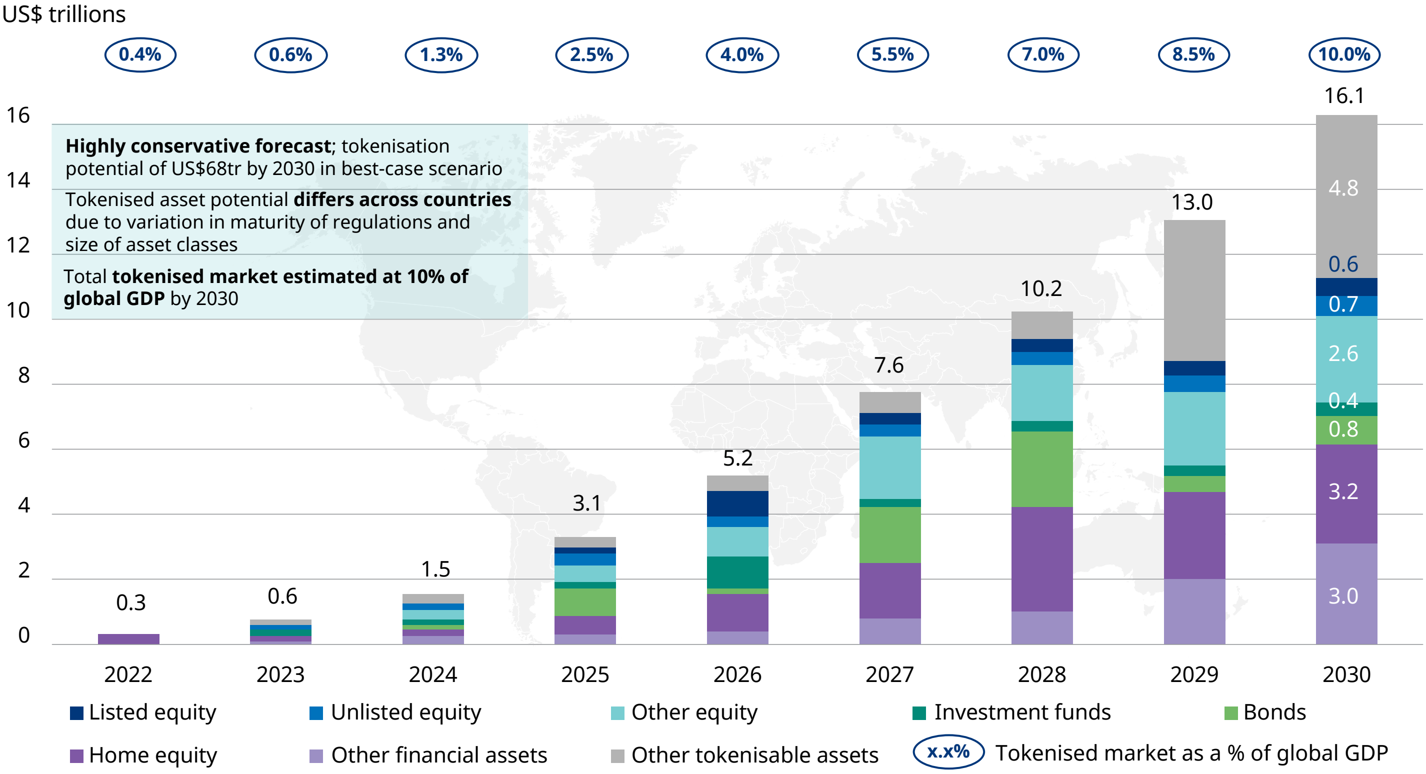
Tokenisation brings a number of advantages over mutual funds:

| Costs efficiencies | Fractional ownership | Secondary trading |
|---|---|---|
| As a result of a streamlined back office operations and fewer transactional costs, there is the potential of active management at reduced costs, the value of this is yet to be determined | would provide access to additional asset classes, tangible and intangible (e.g. direct holdings in private assets), enabling increased diversification | would provide the ability to trade assets that would have not otherwise been tradeable on secondary markets, e.g. tokens in illiquid private asset holdings |




Fractional ownership and secondary liquidity are of particular importance when thinking about access to illiquid assets. Until recently only ultra high net worth investors have had access to private investments. This is for many reasons, but partly due to ticket sizes ranging from £250k–£5m+ and an inability to fractionalise this. And partly due to there being no secondary liquidity solutions for such assets. With the introduction of tokenisation it is expected that access to illiquid assets will open up. It is predicted that the tokenisation of global illiquid assets could be a $16trn business opportunity by 2030[11]. We are less convinced that tokenisation of liquid assets will grow rapidly without a strong regulatory framework.

**Tokenisation of global illiquid assets estimated to be a US$16 trillion business opportunity by 2030**[12]




As with most things, these benefits do not come without challenges.

It is yet to be seen if the technology used in DLT is scalable to the volumes of trades that take place across the financial markets. To achieve scale and connectivity across the industry it is also unknown if the numerous networks across countries, regions and companies can operate together in a unified manner. Similarly, it remains unclear how such tokens, which may span multiple regions would be regulated. Other operational risks such as network stability, cyber risk, and the business risks of migration to a DLT-enabled environment also need to be considered.

The industry has started to think through the digitisation and use of tokenisation; however, we assume the initial pace of change may be slow. The mutual fund industry and its many participants are vast, the scale of assets held across global funds is immense and overhauling an entire industry will not happen overnight. The pace of change we assume will be different not only across regions, but also from one country to another. Regulation will have a large part to play in the speed of change along with the standardisation and co-ordination between market participants.

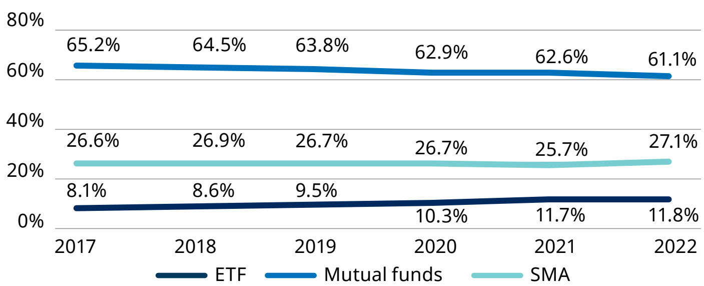
12 BCG on chain asset tokenisation – September 2022.

13 Sources: Broadridge as at Nov 2022. Forecast future AUM; PWC, ETFs 2026 the next big leap, PWC AWM revolution 2020, Schroders analysis.

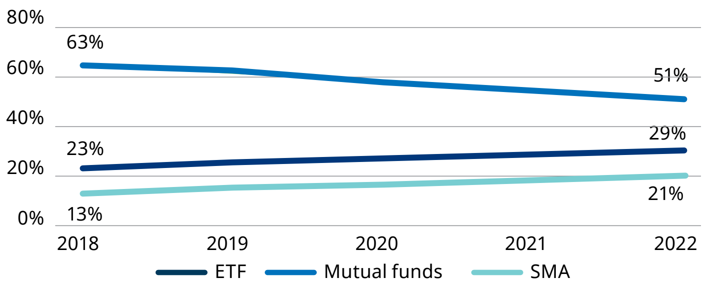
14 FUSE, Morningstar, MMI/Cerulli. Note: Wealth management channels include wirehouse, regional, IBD, independent/dually-registered RIAs, bank B-D, and insurance B-D.

## Global asset market share[13]

Based on the data available, the below data shows the percentage of global AuM represented by each structure. Database information on AuM held within SMAs is largely self-reported by managers, so it is likely that SMAs represent a higher proportion of current AuM and, in all likelihood, future AuM. However, what can be seen, even with an understated growth in SMA, mutual funds as a total share of AuM has been declining over the past five years.




In the US wealth management channel this decline is significantly more pronounced[14]:



## 3 Why are we seeing this shift? – from a client perspective

We've explored what the options available to clients look like, but to assess the speed and market penetration of these alternative options to mutual funds we really need to understand the why.

When it comes to investing, options range from full standardisation (mutual funds) to full customisation. The toolbox of options aims to enable the industry to build and respond to different cohorts of investors and their different ways of thinking.

If we start with the generational differences, it is reasonable that the way people think about investing will vary according to their ages. Some differences may come from the stage in their savings lifecycle but some may be more fundamental and provide insight about how a future generation may prefer to invest.

Globally 67% of millennials want computer-generated recommendations (robo) as part of their investment platform, compared to 30% of Gen X. And 66% of millennials prefer to manage all personal finance, including investments in the same app, compared to 35% of baby boomers[15]. **There is a preference for technology and a digital experience for those born after 1981. However, despite their love for all things digital, this tech savvy group will still require the human touch and nuanced advice a human adviser can give – particularly in more complex investing situations**[16].

42% of millennials believe they have advanced investment knowledge, compared to 23% of baby boomers, and younger investors are more reactive to volatility (82% of millennials made changes to their portfolio following a sharp drop in equity markets compared to 32% of the silent generation)[17]. **For some this could mean the younger generation are more active in their approach, and want to be involved in the decision making process. But it seems to suggest that the younger generation possibly suffer more from behavioural biases and even among a technology-driven generation there will continue to be a need for advisers and education.**

66% of millennials make investment choices based on ESG considerations compared to 32% of baby boomers[18] – **the younger generations want their preferences reflected in their investment choices**.

15 How Different Generations of Investors Think - Full size version (visualcapitalist.com)
16 Accenture millennials and money
17 How Different Generations of Investors Think - Full size version (visualcapitalist.com)
18 How Different Generations of Investors Think - Full size version (visualcapitalist.com)
19 King's Court Trust, "Passing on the Pounds: The Rise of the UK's Inheritance Economy."
20 How to navigate the 'great wealth transfer,' according to top advisors (cnbc.com)

A higher percentage of millennials are familiar with crypto currencies, compared to all older generations. **This familiarity of trading via tokenisation, is potentially also a sign that alternative types of investment could be interesting for the next generation**.

Over the next few decades, baby boomers are estimated to pass down £5.5 trillion in the UK to millennials and Gen Zers[19]. In the US this is significantly more at $68 trillion[20]. The data shows us that these younger clients believe they have stronger investment knowledge, are more technologically savvy, like to reflect their personal views in their investment choices and may have more interest in new and alternative asset classes. As we look at these differences it is possible that investors of the future will want more or complete customisation when making investment decisions and will also want access to non traditional asset classes. These characteristics point to an increased use of models, SMAs, direct indexing and tokenisation, all things that would support the assumption that we are probably at an inflexion point for mutual funds.

Having the ability to offer some customisation and access to non traditional assets will likely lead to more satisfied clients, as their views and thoughts will be reflected in their end product. If customisation is likely to increase clients' satisfaction, so too will access, reduced costs and an improved client journey through the use of tokenisation and a digital client experience. As we increase satisfaction, we also likely increase the share of client wallet we manage and the long-term loyalty of a client.

**The various alternatives to mutual funds in their current form are becoming more prevalent and more widely available to clients. This makes it increasingly important to build solutions using all the various tools available in order to meet clients' needs and increase their satisfaction.**

**Although we have outlined the reasons why it's likely that mutual funds have reached their peak globally, we think the rate of their declining market share will be significantly faster in the US. We also believe that the rate of decline will increase as we see the proliferation of tokenisation.**

**No one investor is the same. What we do know is that we need to provide flexibility of approach, and continue to drive product innovation to cater to the increasingly complex needs of clients.**

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**Appendix:**

- The Silent Generation: Born 1928–1945.
- Baby Boom Generation: Born 1946–1964.
- Generation X: Born 1965–1980.
- Millennial Generation or Generation Y: Born 1981–1996.
- Generation Z or iGen: Born 1997–2010.