START-UPS IN UK ASSET MANAGEMENT

A Study of Barriers to Entry & Success

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Contents

CFA UK is grateful to the following members of the Competition working Group for their input into this paper: Jason Baran, CFA, Alex Bogdanovskij, CFA, Andy Burton, Dario Maglione, CFA, Brishni Mukhopadhyay, CFA, Esther Perkins, CFA, Scott Tindle, CFA, Bixuan Xu and Joy Yang, CFA (Chair). Views expressed are those of CFA UK and not necessarily those of the working group. The working group members are acting in a personal capacity.

Foreword from The Chief Executive

In the past few years, CFA UK has worked with and responded to the FCA in its Asset Management Market Study and the various consultations that have flowed from that as the FCA proposed remedies to the study's conclusions. We welcomed the study as we thought that many of its findings (and the steps that the FCA planned to take) would help to protect consumers and to promote competition. However, we also noted the FCA's comment that 'Analysing competition in investment markets is a complex task'. While we agreed with the finding that price competition does not always work well across the market, we suggested that 'price clustering in active equity funds should not be taken as evidence that there is a lack of competition in active investment management'.

Following the FCA's study, we remained interested in understanding better the competitive nature of the market for investment management. We believe strongly that investment management is a competitive activity - and should always be competitive so that providers are conscious of the need to work in their clients' best interests.

This report - on barriers to entry and barriers to success in investment management - is the product of our continuing interest in this field. The report, researched and written by CFA UK members with expertise in these specific areas, focuses on start-ups in business areas related to the retail investment market.

In common with the FCA's study, we find that barriers to entry are low, but, unlike the FCA's work, we go beyond that observation and find that barriers to success are high. While it is not too time-consuming or expensive to set up a new investment management business - whether an ETF provider, a DFM, an investment platform or a UCITS provider - it is extremely difficult to gather the assets or flows that you need to succeed.

Our report is written from a supply-side perspective. What if this experience is matched on the demand side? What if consumers find choosing an ETF, a DFM, a platform or a fund time-consuming and challenging? Perhaps then the relative inefficiency of price competition in the market for investment management products and services becomes easier to understand.

In this kind of world, perhaps competition policy should focus more on ways to overcome inertia and to help consumers understand the potential costs and value of switching. Perhaps 'pounds and pence' comparisons would suggest that there might be sufficient compensation for the hard work of finding new partners. Perhaps, too, even more could be done to promote the kinds of technological innovations that would allow consumers and suppliers to find each other faster and cheaper.

We hope that you enjoy this report and welcome your comments and suggestions.

Will Goodhart
Chief Executive, CFA UK

Executive Summary

Across most of the sub-sectors of the UK investment sector which we reviewed we found relatively low barriers to entry. With over 1,000 start-ups being authorised by the FCA over the last 5 years and with a failure rate* amongst that cohort of c.7% (as at April 2019), the UK commercial and regulatory environment would appear conducive for start-up businesses. We note, however, that 2018 stands out as a weaker year with only 47 new start-ups authorised and the rolling 5-year failure rate jumping from c.2% (ending 2017) to c.5% (ending 2018).

At the same time, however, we found significant barriers to success. We identified that the main barrier to success is client acquisition, asset growth and establishing brand recognition. Most retail and institutional asset owners require evidence of a successful institutional track-record as a pre-requisite to awarding their investment business. Start-ups by definition lack this, so they often must have either the institutional relationships and/or the capital backing from the start to see them through a period of sustained losses in the early years.

Start-ups instead compete with innovation and fresh approaches. Many customers welcome this, but many more wish to stick with the familiar and tried-and-tested. Even those customers seeking to embrace innovation for better investment outcomes, probably rightly prize 'trust' more highly. Yet trust is generally only won over the longer-term and so to remain relevant, start-ups must continually innovate and diversify to improve their offering to maintain their unique selling point.

Investment products and services, increasingly manufactured and delivered through technology are highly scalable. Whilst there will always be room for value-added, bespoke investment products and advice, this is relevant and affordable for only a small proportion of the population. Start-up companies are, by definition, pre-revenue and often monoline and can least afford to build-out a complete back- and middle-office infrastructure. So, they must rely on technology and outsourcing processing functions to third party service-providers to access economies of scale and to do this well requires a COO that can co-ordinate all these different external pieces and systems and deliver seamless client service.

Meanwhile, a confluence of factors combine to provide the perfect storm for the asset management sector. A persistently low-yield environment (which spotlights the portion of client investment returns eaten by fees); the aggressive growth of low-cost, passive fund management and sharper, pro-consumer regulation are three forces combining to make the sector arguably less attractive to enter and the hardest to survive in living memory.

Regulators and policy-makers today face two particular challenges:

- First, they need to be live to the fact that often the implementation costs associated with new regulations hit small and start-up firms disproportionately.
- Second, they need to keep up with the technological innovation in order to protect consumers. As machines replace humans at an increasing number of the stages in the investment value-chain, regulators and policy-makers now must regulate machines as well as humans!

Our survey of the CFA UK membership showed a good awareness of the competitive landscape for start-ups in the UK investment sector, with those polled accurately identifying both the level of start-up activity and the failure rate. They also agreed with the findings of our work in citing (i) an increasing regulatory burden (39%) and (ii) building a brand (27%) as the biggest barriers to success, whilst interestingly (iii) attracting talent, (iv) Brexit or (v) the complexity of technology attracted low or even nil responses.

There was a slight under-appreciation of the relative percentage of investment firms newly authorised by the FCA and hence the relative importance of the FCA in Europe. Also, members displayed a low level of awareness of the existence, role and purpose of the FCA's relatively new Asset Management Authorisation Hub launched in 2017 to facilitate the authorisation process for new investment firms.

* Failure rate is the number of inactive companies over total number of companies authorised as identified by the ESMA register.

Introduction

Over the last five years, between January 2014 and December 2018, the FCA authorised 1,063 investment firms as logged by European Securities and Markets Authority (ESMA) Registers[i]. Of those investment firms, 986 remain active and 77 (7%) were logged as inactive as of April 2019. A more detailed review of those new entrants reveals 646 (58%) were genuine start-ups, so neither re-registrations or new initiatives actually launched by existing incumbents.

Start-up activity is important to the UK asset management industry. Start-ups influence competition and innovation within the industry and ultimately help drive the value produced by the industry for consumers. A truly competitive industry will challenge existing incumbents to improve products and services. An innovative start-up culture will attract new ideas and talent to the industry.

Our study looks at the barriers to entry and, more importantly, barriers to success for start-up companies[ii] in the sectors of the UK asset management industry which directly face the consumer and how that influences competition. For the purposes of this paper, we have defined a start-up investment company as one with less than 6 years of trading that is not associated with, sponsored by, partially or wholly-owned by an incumbent.

To gain a well-rounded view, we drew on the experience of a range of stakeholders: CFA UK members, start-up company management teams, regulators, trade associations, research providers and consultants. These conversations gave us a better understanding of the key issues.

The purpose of this paper is to understand how easily start-ups can establish profitable and successful operations in the UK asset management sector.

Within the UK asset management sector, we have chosen to review start-up company activity in the following sub-sectors:

- Pooled Fund Companies
- ETF Companies
- Discretionary Fund Managers
- Investment Platforms
- Robo-Advice Companies

In addition, we decided to review the UK insurance sector to enable a comparison of start-up activity and barriers to success in another sector in UK financial services.

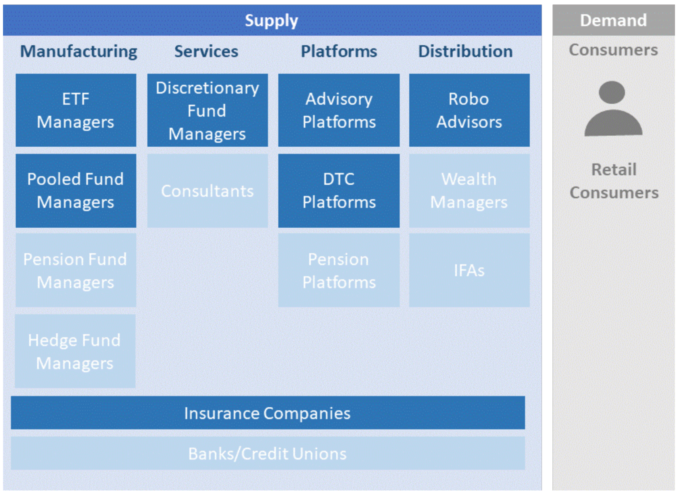
The above groupings do not cover the entire asset management value chain, but rather focus on those sectors that have seen interesting recent new entrant activity.

As part of our research outreach, we decided to canvass CFA UK members for their perception of new entrant activity (and its success) and compared their responses to the empirical data **we** obtained from the FCA and ESMA in our research. The results of the survey are detailed in Appendix: II CFA UK MEMBERSHIP SURVEY RESULTS.

Financial Services Sector Review

Retail investors access investment products and services in a number of different ways. We chose to review start-up firms and start-up activity within different parts of the value chain regulated by the Financial Conduct Authority (FCA). These investment firms fall into the following categories: manufacturing, services, platforms and distribution. Those we have reviewed are highlighted in dark blue in Exhibit A below:

Exhibit A: Pictorial overview of the Asset Management Value Chain



We reviewed barriers to success for start-ups in the following sub-sectors which directly face the retail consumer:

1. **Pooled Fund Companies:** Companies that pool money from many investors and invest money across multiple asset classes to deliver a solution in a fund wrapper.

2. **Exchange Traded Fund (ETF) Companies:** Companies that pool money from many investors and invest money across multiple asset classes to deliver a solution in an investment wrapper that trades on an exchange like a common stock.

3. **Discretionary Fund Managers (DFM):** Companies that offer an investment service to retail clients either via Financial Advisers or directly. Typically, the DFM has discretion over the investment decisions within defined risk parameters and utilizes either/both in-house or external funds to implement its investment process.

4. **Investment Platforms:** Companies providing on-line investment platform services, either Direct to Consumer (D2C) or on an Advised basis, i.e. via a financial advisor. The focus of our review was on those companies providing access to MIFID-eligible investments only, so we ignored niche areas like crowd-funding and peer-to-peer lending which have seen more recent new entrant activity.

5. **Robo-Advice Companies:** Companies that provide online portfolio management solutions that aim to invest client assets via automation of the advisory function.

6. **Insurance Companies:** Companies registered with and authorised by the PRA registration for either/both Life and General insurance business lines.

We recognize that firms can provide services across multiple sectors and that the sectors themselves overlap across the value chain. Where regulation permits it, many operators are also vertically integrated. By reviewing start-up activity within each sector, however, we seek to ensure we identify the incumbents that most influence barriers to entry.

In our conclusion, we attempt to aggregate our analysis into one coherent picture to provide an overall assessment of the barriers to success for start-up companies throughout the UK asset management value chain.

The CFA UK Team's Methodology

To analyse each sector, we apply a framework which enables a comparison of the competitive landscape across the asset management sector. We have also put the UK Insurance sector under the same lens for comparison purposes.

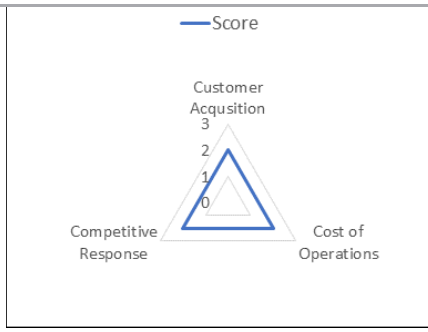
The framework (based on OECD material[iii]) considers 3 broad components of barriers to success:

1. **Cost of operations:** the expenses and barriers involved in setting up the daily operations of a business, including the pre and post-launch regulatory requirements.
2. **Customer acquisition:** the expenses and barriers related to acquiring new consumers and maintaining existing consumers, including establishing customer loyalty and trust.
3. **Competitive responses:** the expenses and barriers related to dealing with competition. This category may include: marketing, predatory pricing, mergers and acquisition, and consolidation in the asset management sector.

While we realise that the framework may not be fully perfect, we found the delineation helpful. We rated each sector on a scale of 0 (nought) to 3 (three) as below and illustrated in Exhibit B:

0 = INSIGNIFICANT barriers
1 = LOW barriers
2 = AVERAGE barriers
3 = HIGH barriers

Exhibit B: Our Scoring System for Barriers to Success



European Securities Market Authority (ESMA) Register

ESMA has compiled a register of management companies, investment firms, alternative investment fund managers, regulated markets, multilateral trading facilities, SME Growth Markets, organised trading facilities, systematic internalisers and data reporting services providers authorised by the national competent authorities of the Member States. ESMA has compiled this list (including the information on the services and activities and published sanctions) on the basis of notifications made to it by the national competent authorities of the Member States of the EEA. [ESMA register.]

For this review, the CFA UK team used the following register criteria to filter the data: Entity type = Investment Firm; Competent authority = Financial Conduct Authority (FCA); Period = 2013-2018.

Source ESMA Registers

The team also reviewed the investment firms for inactive status both by authorisation year and year authorisation was withdrawn:

Year - Authorised	Count of Total Authorised	Count of Inactive Investment Firms Year - Authorisation Withdrawn 2013	2014	2015	2016	2017	2018	% Inactive
2013	238			3	2	6	15	11%
2014	291			4	3		13	7%
2015	230			1	3	1	11	7%
2016	303						14	7%
2017	192						4	2%
2018	47							0%
2013-17	1,254			8	8	7	N/A	2%
2014-18	1,063			5	6	1	42	5%

Source ESMA Registers

From the data we conclude:

- The cumulative failure rate increases the longer a firm is active in the 5-year period (above from 0% for companies less than 1-year old to 11% for companies 5 years old);
- 2018 saw a notable increase in the number of business which had their authorisation withdrawn compared to prior years (2013-17);
- The number of new authorisations has dropped significantly in recent months - by more than half from a mean average of 265 in 2013-16 to a mean average of 120 in 2017-18.

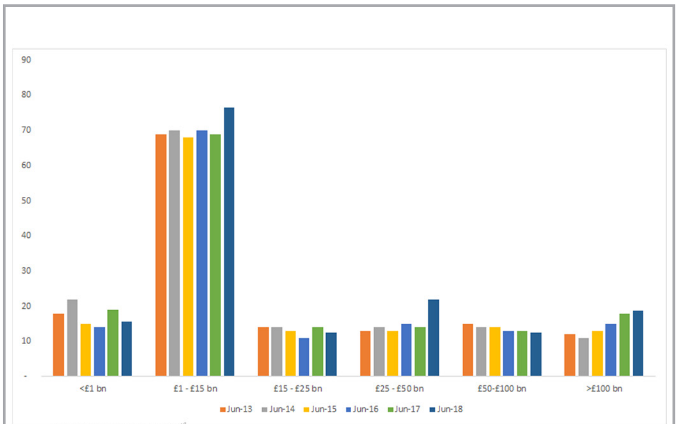
Pooled Fund Companies

Introduction

The concept of pooling resources to reduce risk and share rewards is far from new. Indeed, one of the oldest examples is the Foreign and Colonial Investment Trust, which is still in existence having launched in 1868[iv]. A hundred and fifty years later, the UK is home to the largest asset management sector in Europe with €8.7tn AuM managed by over 1,100 asset management companies, employing c.38,000 people[v].

The Investment Association (IA), a trade body that represents UK investment managers, shows the UK fund sector to be very fragmented with only a small number of very large firms (over £100bn AuM) and a long tail of medium to small-sized organizations (up to £15bn AuM)[vi] , refer to Exhibit C.

Exhibit C: Number of UK IA member firms segmented by AuM bucketts

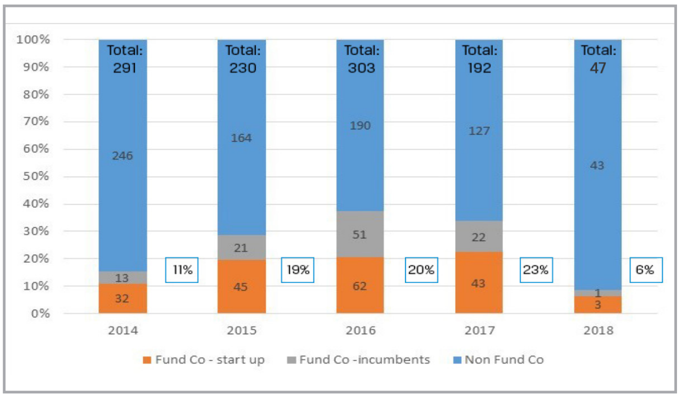


Source: Investment Association (IA)[vii]

The UK asset management sector offers a full range of investment products and asset classes governed under a panoply of different operating models ranging from large vertically-integrated firms to small, niche, specialist boutique managers. Although the sector overall remains relatively fragmented with the top five asset management firms managing only c.47% of AuM, the passive sector is highly concentrated with the top five asset management firms managing over 80% of AuM[viii]. On an asset-weighted basis, Morningstar found that the average fees for active and passive managed equity funds fell respectively by 18% and 28% since 2013[ix]. The heightened focus on costs and increasing rate of fee reduction for passive funds have led to a significant shift from active to passive funds.

Overall, the UK asset management sector continues to attract new entrants and start-ups. Taking a detailed look at the data logged by the European Securities and Markets Authority (ESMA) Registers, we found that the number of newly authorized investment firms approved by the FCA peaked in 2016 dropping sharply in 2017 and 2018. The proportion of genuine start-up Fund management companies (companies, not supported by or associated with existing incumbents), reflected a similar pattern as all investment firms, running at c.20% of the total until 2018, demonstrating the impact of Brexit, where it dropped significantly down to 6%, as represented by the orange boxes in Figure D.

Exhibit D: Count of Fund companies as a Percentage of Total Investment Firms approved by the FCA



Source: European Securities and Markets Authority, as of 2019, and CFA UK analysis.

Components of Barriers to Entry & Continued Barriers to Success

Cost of Operations

According to a study conducted by the IA, over the long term (2008-2017), operating costs for the asset management sector in aggregate have remained remarkably steady, increasing slightly, from 19 to 20bps of AuM[x]. However, the average profitability in any one year can mask a wider distribution in profitability across firms with different operating and business strategies. Unlike large incumbent asset managers, small firms and particularly start-ups are unable to defray significant middle- and back-office infrastructure costs across a substantial and diverse revenue stream. However, an increasing number and variety of third-party vendors, who provide a range of non-investment related middle and back office support services, are entering the industry to provide scalable outsourced services to start-up fund companies. This is crucial as it allows smaller firms to focus on differentiated core investment services and winning new business. The majority of start-ups need to have differentiated investment strategies or offer unique investment services focused on new customer acquisition.

Customer Acquisition

We believe that access to assets is the most significant barrier to entry for new start-ups. New start-ups need to build up a track record across a market cycle of three to five years, pass due diligence checks and other regulatory requirements to be incorporated into leading platforms for access to IFA networks and access to retail money or court institutional investment. Start-ups can find targeting distributors an expensive and often fruitless prospect during their formative stage. Although $100mn AuM is often cited as the breakeven point to cover operating costs for a single fund, the Financial Times reports that to attract new capital from institutional investors, investment firms need $500bn in aggregate AuM as a starting point with $1tn AuM now "generally considered a safe level"[xi]. Distribution and raising assets remain difficult.

Interviews: Market Participant Feedback

As part of our research, we approached four selected market participants to discuss their views on the UK Asset Management sector and the key barriers to success;

(SR) Start-up fund with a very short track record
(SI) Sub-scale fund with a long and successful track record
(BM) One of the largest multi-boutique asset managers globally
(NC) Private equity firm investing predominantly in asset management businesses

The following summarizes key findings from the interviews.

Raising assets is the highest barrier to success

All agreed that the hardest part of any asset management business is to raise assets and reach scale/critical mass, especially if you are entering a crowded asset class. SR suggested that one of the hardest parts for them was (and is) to attract assets despite having a decent track record and credible principals. SI bought a fund vehicle with ~£50m and, despite a long and successful track record, also feels raising assets is the biggest challenge. SR and SI also suggested that the FCA or NEST could explore a mechanism in which large pension funds or public investors would have to allocate a small %-age to new or small fund managers in a bid to open the market and make it more competitive. Both further suggested that the current pensions reforms (i.e. auto-enrolment) could provide tail winds for such an idea.

No discussion around raising assets would be complete without mentioning investment consultancy firms and the large platforms/fund supermarkets. SI's distribution strategy was to ensure the fund was available on popular platforms and to get on a "Recommended" list by one of the larger providers, as that could have a material and immediate impact on assets being directed towards the fund. Investment consultants are also the gate keepers for considerable deployable capital, often allocating slugs of at least £50m to managers. A recommendation from a leading consultant can be the breakthrough an emerging manager needs and may open other doors just in itself. Nevertheless, consultants have detailed checklists (discussed more below) and due diligence requests and often demand a certain scale and track record combined with world-class operations and processes which may not always be affordable for a nascent manager.

The larger investors we spoke to confirmed that raising capital was difficult for funds with less than £100m AuM and/or a track record shorter than 3 years. Investors (especially larger ones) and their consultants have very strict criteria and checklists before a fund is admitted to a platform or is invested in, notably;

- Concentration limits, where an investor or distributor will not hold more than 5 or 10% of any one investment vehicle for liquidity and risk reasons. Thus, with a £100m fund, a £5m investment by a large firm is almost not worth the work and due diligence and puts a natural floor on fund size. Private banks and wealth managers may be more open to new and interesting strategies and are often a good source of initial capital.

  VC houses and Multi-Asset funds may also be good seed investors but there is potentially a high cost associated with taking AuM from either (in the form of reduced management fees via founder shares or perhaps a profit share agreement until the seed investment is redeemed).

- Tier-1 back office and third-party providers, again to satisfy due diligence and ensure operational robustness. NC suggested that hiring a top COO was one of the best decisions to make for a start-up fund manager as it gives instant credibility around robust processes/procedures and may help open doors. BM felt that London has a very large and well-established ecosystem of talent and providers and that this part was relatively easy to solve (working capital allowing of course). SR also felt that a credible and solid back office team was a good advantage to opening doors and reducing questions around operations and compliance.

- Operating and regulatory capital was mentioned as a relatively high initial hurdle, both as a cash requirement and as an opportunity cost for the founders. Current capital adequacy rules suggest that you need to have enough working capital to sustain 3 years of forward losses which can be a significant amount. Furthermore, the founders will often have to take a significant pay cut compared to their roles at an established firm, which further adds to early financial pressures. NC suggested that a firm can take longer than 3 years before even hitting break-even.

- The Regulator and the overall UK business environment was deemed as good by all interviewees, who suggested that the FCA is a commercial, transparent and practical regulator that doesn't stifle innovation and which provides a world-class regulatory environment. SI suggested that the FCA could provide more standard documents and guidance online, i.e. FAQs or "how to" documents to reduce the need for a law firm when getting your permissions. On the other hand, SR said that they probably could have applied for authorisation themselves, but chose to use a specialist law firm to streamline the process and reduce margins of error.

- In terms of competitive response, it was felt that the market is both sufficiently large and wide enough for new strategies and approaches to flourish without fear of an immediate competitive response (BM suggested that the big houses have far larger issues to solve, especially in our current investment environment) – however, innovation in Passives (such as Smart Beta) was flagged as an area where the competitive response could be much more swift and brutal as the cost of replication by one of the big houses (i.e. BlackRock) is minimal.

The UK remains a supportive environment for start-up Fund Companies.

Overall, the four interviewees felt that the UK was a good place to carry out Asset Management and that the barriers to entry were reasonably low compared to other industries – with raising AuM constituting the main challenge to achieving success.

We thank the four firms for their openness and willingness to contribute to this paper.

Competitive response

We believe the pooled funds market is both sufficiently large and diverse for start-ups with new strategies and approaches to flourish without fear of an immediate and direct competitive response. The large, incumbent firms are generally focused on larger issues and pre-occupied with other challenges. That said, asset management is a competitive industry and has been experiencing fee declines now for a number of years due to a variety of factors unrelated to start-up activity, building a back-drop against which it is difficult to launch a start-up business.

Exhibit C shows that since 2014 there are signs that the very largest firms with AuM >£100bn are starting to take market share. Whilst Exhibit C suggests that the total number of investment firms has remained steady over the past five years, there has been a stream of M&A activity with larger more established firms annually acquiring c.20[xii] or so boutiques for their high performing or niche products.

Conclusion

In conclusion, we believe that customer acquisition and increasing AuM are the biggest barriers to success for start-up fund companies. Many start-ups fail to gain sufficient scale to become really profitable and succeed past the 3-year mark. Finding the required regulatory capital can also be challenging, though we note that these requirements are significantly less onerous than in insurance, for example, where regulators have to be sure that insurers have sufficient resources to honour claims, potentially far into the future.

We have provided a weighted assessment of the various barriers to entry ranging from 0 – very low to 3 very high.

Operating costs: 2 – (average)
Customer acquisition: 3 – (high)
Competitive response: 0 – (very low)

The FCA's recent initiative in launching the Authorisation Hub to help new start-up companies become authorised, the wide choice of agents available to assist start-ups with the authorisation process and a relatively clear authorisation process are all supportive factors for new start-ups. Likewise, start-ups can keep their operating costs competitive by using third-party back-office service providers.

Future drivers

Technology and market regulations are likely to shape the sector in years to come.

It is likely that for entry and continued success, both existing and new firms will need to continue to invest in technology to improve efficiency and reduce operating costs, mine big data for quantitative analysis to offer improved or novel investment strategies and improve customer experience. This could reshape the future fund sector landscape and also impact investor behaviour. Technology has the potential to allow the asset management sector to engage with a far wider investor demographic and expand its reach into new markets. This growth, in turn, should make the market more attractive for new firms to enter and succeed. Whilst not all start-ups can afford to make the most of these technology investments on their own, outsourcing aspects of their operations to specialist third-party providers makes this technology accessible at an affordable cost. Meanwhile, the current focus and direction of regulation aiming to increase transparency and standards in the investment sector of the future can only be good for the end-user and help win their trust. However, regulators need to somehow take greater account of the danger that the costs of its implementation may fall disproportionately on the smaller firms, especially start-ups.

Exchange Traded Fund Companies

Introduction

An exchange-traded fund (ETF) is an investment wrapper that trades on an exchange like a common stock. As a fund, it pools money from many investors and invests the money across multiple asset classes to deliver an investment solution available to both institutional and retail investors. It has been one of the most important innovations in the fund sub-sector in the past decade and has democratised access to a number of asset classes, providing institutional and retail investors with low-cost options for diversification.

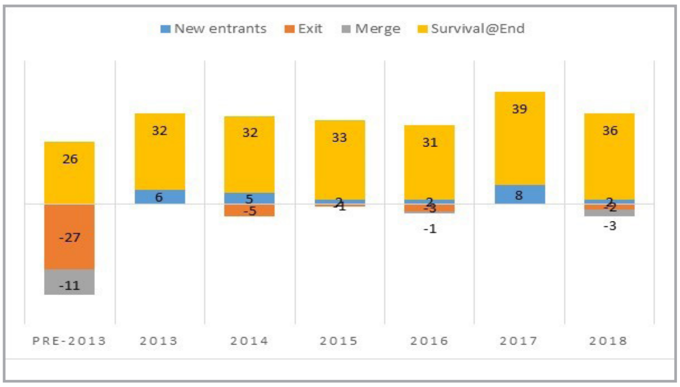
The first ETF fund in Europe was launched in April 2000, seven years later than in the U.S. Since then, the ETF sub-sector has experienced strong AuM growth in Europe, largely driven by institutional investors. UK institutional clients are globally the second-largest taker of ETFs behind the U.S. The AuM in the ETF sector doubled in the five years from 2011 to 2016 and the growth has accelerated to 40% in 2017 alone and a total AuM of $802 billion. However, this is still significantly below the total AuM of $3.42Tn in the U.S[xiii]. The ETF sub-sector looks set to accelerate in Europe and the growth will create opportunities for new entrants with well-positioned products and a strong salesforce. In this section, we look at existing barriers to success, and the changing forces that may lead to a higher penetration of the fund market by the ETF sector.

We conducted interviews with founders to understand how new entrants, both in forms of start-ups or existing active managers, can navigate through the barriers in this market of dominant giants.

Evidence of Past Entry

The European ETF sub-sector is dominated by existing incumbents. The top-ten players commanded 91.3% market share in 2017 and the degree of market concentration has been stable for the past five years. Blackrock alone claimed 46% of the total ETF market in 2017[xiv]. Looking at the statistics on new entrants in Europe, most players entered the market before 2013. A majority of the new entrants are not genuinely new; as they are either a new division of an established financial institution or a start-up backed by a consortium of incumbents such as Source ETF (acquired by Invesco in 2018). While successful entrants into the European ETF market have been few and far between, some independents such as Finex or ETF Securities managed to break-through, launching the right products at the right time.

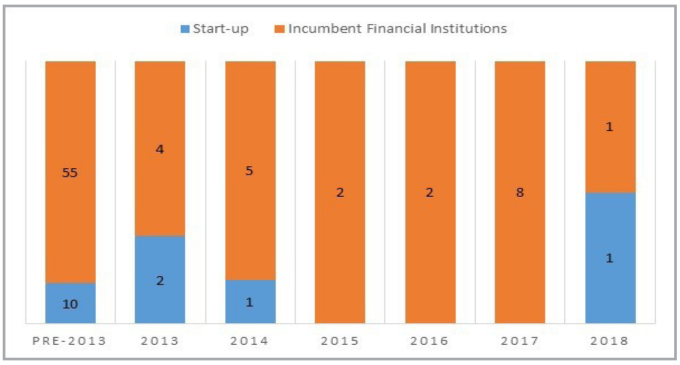
Exhibit E: Number of ETF operators in Europe (excluding ETNs and ETCs)



Data Source: Morningstar

As Exhibit E above illustrates, the number of both new entrants and take-overs suddenly accelerated in 2017[xv]. The desire of incumbents to enter or re-enter marks, in our opinion, the start of chapter III[xvi] in the story of the development of the European ETF sub-sector - eight incumbents decided to grow ETF divisions organically and four additional incumbents increased their scale through acquisitions. The growing numbers of new entrants signal the expectation of an acceleration in AuM growth, in product innovation and a new wave of start-ups.

Exhibit F: Analysing new ETF entrants split by start-up and incumbents



Source: Morningstar

Exhibit F above reveals the proportion of ETF new entrants that were independent and those set up by incumbents. In the decade before 2013, 8 out of the 10 independents staved off being acquired until "chapter III", the consolidation wave in 2017. On the other hand, less than 50% of the established financial institutions that sought to diversify and organically enter the ETF market succeeded to survive beyond 2013. Certainly this data reveals that having an incumbent's backing has not been a guarantee to success in the European ETF market. While these institutions had either some kind of access to customers in a particular geography or capital market expertise in a distinct asset class in a certain geography, they failed to gather sufficient assets. Those firms who made the decisions to venture into ETFs without matching the product supply to client demand forced firms to exit the market fairly quickly.

Components of Barriers to Success

Cost of Operations

The costs of setting-up and operating an ETF product are generally high. Additional operating costs not born by pooled funds include listing fees to exchanges, license fees for index-providers and NAV valuation fees to 3rd party validators. For example, in the U.S. a start-up can outsource the trading and settlement to a specialised ETF-trading service-provider with 10% of their expense ratio[xvii]. In Europe, the fragmentation in trading and post-trading processes creates additional complexity, work, risks and consequently costs of operations:

- Settlement. Regulatory compliance is different in settlement and settlement costs are higher in Europe. In the U.S., all the trades are settled at the Depository Trust Company (DTC), but there are 25 exchanges and consequently diverse places to settle trades in Europe.

- Redemption process. In the U.S., transaction costs happen outside funds, whereas in Europe redemption and creation activities use cash and occur inside the funds.

- Off-exchange. In Europe, nearly 70% of ETF trades occur off-exchange and via RFQ (request for quote), which gives large incumbents a cost advantage in trading.

Customer acquisition

The fragmented nature of the European market also adds to distribution costs. There are 25 exchanges in Europe and eight to nine sizable national markets. In addition, heavy reliance on local banks/institutions for distribution into the retail markets determines that all European ETF businesses are quasi-institutional businesses. These two structural features make customer acquisition the highest barrier for success in Europe. Typically, an ETF can break-even by reaching $50-100mn AuM[xviii]. As the past entry data reveals, gathering sufficient AuM is a make-or-break condition for most new entrants. Additional cost burdens in Europe include:

- Cross-listing fees. In order to access a retail channel in a country, operators have to list in their national exchange, for example in Italy.

- Multi-geography and/or multi-lingual sales-force.

- Multi-asset and/or multi-sector. New entrants need to quickly establish a range of products to be on the radar of fund-selectors as all businesses in Europe are quasi-institutional business.

- Implicit cost. Bid/Offer spreads are significantly higher in Europe compared to in the U.S. and can erase the low-cost advantage of ETF completely and damage the customer experience.

Competitive responses

Incumbents have responded in four ways:

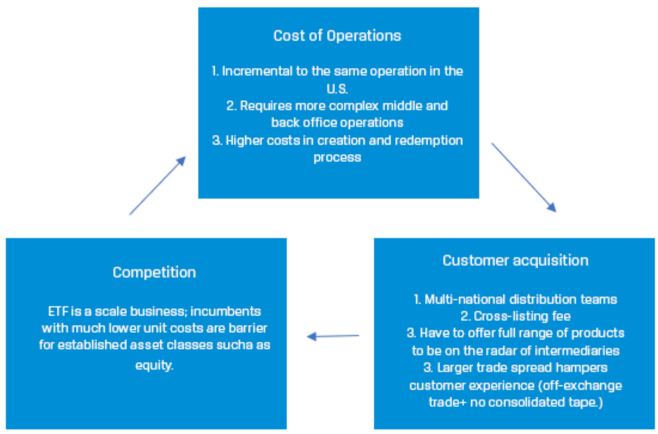
- The pure index-players with economics of scale, such as Blackrock or Vanguard, compete on price for standard products. Security lending provides an additional and unique source of revenue for these big firms that smaller players cannot rely on.

- Pure players of smaller scale acquired independents to gain scale or grow into new geographies. Wisdomtree grabbed the European business of ETF Securities in 2017 and VanEck started their European expansion through the acquisition of ThinkETF in 2017 (both deals completed in 2018).

- Some incumbent asset managers started to establish a presence in ETFs by acquiring independents. Legal and General acquired the Canvas platform by ETF Securities and Invesco bought Source ETF.

- Some large incumbent asset managers decided to build their ETF business organically. JP Morgan, Morgan Stanley, Fidelity and Franklin Templeton are in this camp. All of them entered the business in 2017. Goldman Sachs introduced ETF products in 4Q2018.

Exhibit G: In European ETFs, the three barriers to success are re-enforcing of each other



CASE STUDY: ETF Independent White Space

White Space Remains in Non-Equity Asset Classes for New Entrants

We interviewed Michael John Lytle the former founding partner of Source and the founder of Tabula ETF, a start-up company that recently launched their first fixed income ETF in Europe. Mr. Lytle still sees meaningful opportunities in the fixed income space for start-up ETF manufacturers to enter. Globally ETF products constitute 20-30% of the total AuM in equity; however, only 2-4% of the total AuM in fixed income consists of ETFs. Given fixed income is an asset class of double the size, Mr. Lytle expects significant fixed income ETF growth going forward, notwithstanding the inherently more complex manufacturing process of fixed income ETFs.

We asked him how his funds can succeed on ground roaming with giants and overcome the barriers to success.

"People think that ETFs are all about price competition… [and therefore new entrants have no chance]. Price matters, but it is more about whether your clients perceive your products have good value. Even in the ETF space, the investment decision is not solely based on price." Mr. Lytle thinks that there are three ingredients for success and hopefully growing sizable AuM rapidly enough: Firstly, you need to be purely client-focused and launch an innovative business to meet clients' needs; secondly you need to rapidly set up a series of products instead of perfecting one product, as clients need tool-kits; thirdly you need to be highly focused on a few well-selected buckets: there are 7-8 geographies needing product coverage and each geography has 5-6 different investor types - so you have 35 - 48 potential buckets to target. Mr. Lytle sees it is critically important for a new entrant to launch products to tackle as many of these different buckets as possible.

In terms of managing costs, Mr. Lytle considers operating costs as an inevitable part of entering this business and so new entrants need to be appropriately capitalised and resourced from the outset. Nonetheless, a start-up absolutely has to have a cost-structure that is allowed to scale and for that, highly scalable institutional pricing for each service is critical,othewise the business will fail straight away.

Conclusion

Overall, the barriers to success are high for new entrants into the European ETF sub-sector. Access to effective distribution channels is a make-or-break barrier for start-up and established institutions alike. However, historical entrance data shows that access to both clients and/or scalable cost infrastructure alone do not bring success for established institutions. The decision to launch the right product ranges at the right time that can appeal to several pockets of clients is key to success. However, the relatively moderate penetration, especially in fixed income and overall in Europe, provides opportunities for start-ups and incumbents to succeed.

We assigned the following scores to the categories of barrers to success as follows:

- Cost of Operations: 2 (average)
- Customer acquisition: 3 (high)
- Competitive response: 2 (average)

Future Drivers

There are, however, some favourable forces for change on the way in Europe. One highly desired change among the stakeholders in the European ETF sub-sector is the creation of the so-called "consolidated tape", i.e. a service that can collect the trading activities from 25 different exchanges on one asset into one place. A consolidated tape would significantly increase transparency, contribute to liquidity and reduce trading costs for investors. This will materially improve the relatively high servicing costs of ETFs in Europe and thus customer experience.

Regulatory changes such as MiFID II are expected to increase the willingness of advisors to allocate assets to ETFs, and thus increase their market penetration. New service providers such as white labeller HAN ETF or ETF advisory firms will start to establish business in Europe and they can help to lower the costs of operations for ETF manufacturers. Last but not least, the rise of direct distribution such as robo-advisors (see section 6) could change the nature of retail business in Europe in the long-run and therefore lower the barriers to customer acquisition.

For incumbent active managers, understanding what the right ETF product ranges are at the right time will automatically help them to define the right products in the active space.

Discretionary Fund Managers

Introduction

A Discretionary Fund Manager (DFM) offers an investment service to retail clients either directly or via financial advisors. Typically, the DFM has discretion over the investment decisions within defined risk parameters and utilises either in-house or external funds to implement its investment process.

Often the investment process is part of a Model Portfolio Service which involves adhering to a strict quantitative process that invests according to an asset allocation strategy and automatically rebalances at pre-defined times and/or divergence intervals. Although not always the case, some DFMs offer a truly 'bespoke' product, typically for higher net-worth clients; a model portfolio is usually at the core of the DFM's investment proposition.

While the scope of this section focuses primarily on DFMs whose primary distribution is through financial intermediaries (usually financial advisors like IFAs), it will also provide commentary on those DFMs that are vertically integrated and own the end-client relationship as well.

As we will present, our findings are broadly consistent with some of the impressions of the CFA UK community as evidenced in the survey conducted in conjunction with the publication of this paper; namely, the cost of operations, increasing regulatory burden and customer acquisition costs all feature as barriers to success for start-ups. Competition within DFMs is reducing as a wave of consolidation continues. However, competition from other routes to market appears to be increasing, driven by new entrants such as robo-advisors and low-cost D2C propositions. Overall, competition is on the increase and margins are under pressure and DFM new entrants face a challenging start in life.

Components of Barriers to Success

Competitive Responses

Extrapolating from data compiled by Compeer, the total amount of assets managed by DFMs increased by 26% between 2013 and 2018[xix]. Meanwhile, the number of providers with greater than £50 million AuM declined marginally by 6%. The data, therefore, suggests that the level of competition, at least among firms with at least £50 million AuM, has either remained constant or declined moderately from 2013-2018.

While the overall level of competitiveness within the sector appears to have declined only moderately, there are nevertheless a number of factors considered to have made it more difficult for new entrants to emerge.

Cost of Operations

The past decade has seen significant downward pressure on fees, not only due to increased regulation but also due to the proliferation of low-cost investment options such as tracker funds/ETFs.

The proliferation of lower-cost Model Portfolio Services, including those from robo-advisors but mainly from large incumbent passive asset managers like Vanguard, has forced down the fees that DFMs (who often act largely as asset allocators) are able to charge. Anecdotally, clients are much more "fee conscious" and when a DFM does not own the end-client relationship, it is most susceptible to a squeeze on its fees as the client's advisor is encouraged to choose a lower-cost option.

Lower fees mean, of course, less income per £ of AuM and therefore a greater amount of AuM is required for DFMs to generate acceptable margins. Achieving the necessary scale generally creates a higher bar for new entrants to succeed and drives consolidation among existing firms.

The ever-increasing use of technology is a double-edged sword for the competitiveness of DFMs. On the one hand, third party technology and/or platform providers have made it easier for smaller DFMs to manage their operations, offsetting some of the fixed costs of the business. However, in many instances there are significant costs to such technology (either explicitly or in costs that are effectively passed onto the client, thus potentially impacting the DFM's overall fee). The expectations of clients, and other stakeholders like the regulator, essentially require an increased use of technology – and the cost of such technology can have a meaningful impact on smaller DFMs' profitability.

Customer Acquisition

For DFM firms focused on servicing the IFA community, the cost of distribution is high and favours those with greater scale, rather than direct access to retail clients.

The good news, for the DFM sub-sector, is that the introduction of RDR in 2012 forced many IFAs to outsource their discretionary assets to DFMs. This has significantly helped drive AuM growth for DFMs. MiFID II, which came into force at the beginning of 2018, may serve to exacerbate this effect.

However, greater regulation has also created more of an advantage for larger, incumbent firms. For example, there is a greater emphasis on the fund selection criteria performed by IFAs. DFMs typically must have a track record of at least 3 years, minimum AuM thresholds and other characteristics before the IFA community will recommend them to clients. There is also a need to be on the relevant advisory platforms, which are the primary means by which IFAs select funds and manage client accounts (and there are relatively few large platforms). Often the platforms themselves have minimum barriers that must be met.

Furthermore, as DFMs achieve greater scale, their marketing and business development costs (e.g. hiring new personnel) increase. It is not unusual for DFMs to host conferences and other such relative high-profile events that are costly to organize. DFMs also provide services to the IFA community and advisor platforms in various ways, including ongoing market commentaries as well as tech support and general customer service. Again, with scale, the marginal costs of such services are reduced. These are more difficult for start-ups to make economically viable.

The IFA community itself is undergoing a wave of consolidation, which is likely to further entrench the need for DFMs to have scale. For example, a large IFA firm will have greater pricing power – and greater scale is necessary for DFMs to protect their profitability.

The silver-lining, perhaps, as far as DFM competition is concerned is the direct-to-consumer space. Due to RDR and MiFID II, IFAs have been facing greater hurdles in offering an investment proposition to clients – this has resulted in more IFA firms gaining their DFM permissions and also DFM and IFA firms merging. For DFM firms, by owning the relationship with the end-client they are better positioned to protect their margins. While there is no doubt that the profitability of all parts of the value chain are under pressure – and that the resultant need for greater scalability leads to increased barriers to entry – those that have a direct relationship with the end-retail client are arguably best positioned to protect those margins.

Conclusion

Competition among DFMs does not appear to have declined as much as sub-sector participants anecdotally think it has. Competition from outside the sector (e.g. Vanguard) has intensified notably and that has put sector margins under pressure. However, greater barriers to successfor start-ups have emerged especially with regards to client acquisition (particularly of a B2B nature). Lower margins – primarily driven by lower fee income – are further increasing the barrier to success for start-up DFMs.

We assigned the following scores to the categories of barriers to success as follows:

- Operating Cost: 2 – (average)
- Customer Acquisition: 2 – (average - 3 organic / 1 via M&A)
- Competitive Responses: 2 – (average - 3 external / 1 internal)

Future Drivers

It is encouraging for DFMs that their aggregate AuM has increased significantly over the past five years (helped by a buoyant market but also by the RDR-fuelled shift of IFA discretionary assets to DFMs). At the same time, the regulatory burden has continued to increase (due principally to RDR and MiFID II). Meanwhile, the primary client base for DFMs, the IFA community, is undergoing a wave of consolidation itself that is likely to make greater scale even more necessary in the future.

It appears likely that the DFM (and the IFA) market will continue to consolidate. In fact, the pace of consolidation may quicken dramatically, especially if the tail-wind of a favourable investment climate reverses. So for DFM start-ups aiming for long-term success, it may well need to have the capital backing to be a consolidator and to acquire rival companies to succeed.

Investment Platforms

Introduction

Investment Platforms ("IPs") are a relatively new, but significant and fast-growing distribution channel for investment products in the UK and indeed the rest-of the-world. In the UK today, according to data provided by Platforum, they account for over £750bn of AuM. Over the 5 years 2013-17 investment platforms grew AuM at a CAGR of c.15%.

The mainstream sector is best sub-divided into two component parts:

- Advised platforms: accounted for £540.4bn of AuM as at September 2018 having grown at a CAGR of 17.2% over the previous 5 years. The Advised sub-sector is more fragmented than the D2C - the four leading players all have a market share of under 25%. This sub-sector has seen massive growth from its origins in 2001 as existing advised assets have moved onto platforms; now growth is slowing in line with the asset growth of advisor assets more broadly. Products are becoming more differentiated and offering increasingly advanced (and sometimes outsourced) solutions to advisor clients. Advisors negotiate discounts on about a third of the business.
- D2C platforms: accounted for £227.9bn of AuM as at September 2018 having grown at a CAGR of 14.3% over the previous 5 years. Hargreaves Lansdown is the dominant leading player with a market share of 40%. Growth has been steadier than in the Advised sub-sector, but impressive nonetheless. Retail clients rarely attempt to negotiate discounts from list pricing.

Evidence of past entry

Although most of the current leading players started within the last 20 years in line with the advent and development of internet-based technology, very few started-up within the last 5 years.

In the D2C space, there have been no notable new entrants that are not from existing manufacturers seeking their own direct route to market. In the Advised Platform market, Embark, Hubwise and Seccl are examples of recent new entrants. They all aim to provide a cheaper, "no frills" service than the incumbents. Of these, Seccl focuses on the institutional market.

As a consequence, market share has proven to be relatively stable and "most" of the top-20 firms (account for 90% of AuM) started more than 5 year ago[xx].

More recent investment platform start-ups have met with some success targeting the non-mainstream capital market product niche areas such as crowd-funding or peer-to-peer lending. These are still relatively small in AuM and scale, however, and so we have determined not to cover them here.

Components of Barriers to Success

Cost of Operations

The three largest costs for platforms are Staff, IT and Marketing (see Customer Acquisition below) representing 32%, 15% and 6% of operating costs[xxi]. IT costs were a source of considerable variability as most platforms found that they needed to undertake major re-platforming programmes at some point, thereby engaging in multi-year investments. In the FCA's study of 40 platforms, compliance costs were quantified at just 2% and found not to be a significant barrier for entry. Some products (like pensions or SIPPs, for example), have greater regulatory issues than others. The position of advised platforms, sitting between Advisors, Manufacturers and DFMs can be complex from a regulatory perspective. Unsurprisingly the 8 larger platforms had a far better Cost Income Ratio (86%) than the smaller firms (193%), which overall were still operating at an overall loss. The growth in customer numbers, revenues and AuM in the period vastly improved the overall sector's profitability, reducing the total cost base to an average of £510/customer in 2014 to £350/customer in 2016 on the smaller platforms.

Customer acquisition

Customer switching is difficult with the perceived administrative burden acting as a disincentive on Advised and D2C platforms alike. The growth in the total customer base is slowing as most wealthy individuals now have their assets on one portal or another. Start-ups in the Advised sub-sector of the market face the same problem as start-up fund managers in that their advisor clients look for a track-record of three years before they can even be considered for a selection panel. Even once they are added to a panel, new platforms may be given new accounts but existing clients tend not to be switched over to them from existing providers.

In its recently completed Investment Platforms Market Study[xxii], the FCA reported on customer acquisition costs distinguishing by both the size of the platform business and by the nature of the cost incurred for the 3-year period 2014-16. For smaller firms, each new customer cost on average c.£35 in marketing spend, whereas at larger platforms that figure was £150/new customer. In all cases the trend was rising, with smaller investment platforms spending c.£60/new customer in 2016. Some costs came in the form of straight-forward introductory fees or rebates (averaging £150/customer), other costs came in the form of marketing costs and the overheads of a business development team. The established D2C platforms have now built significant brands but are still relatively unknown outside of the active investment community.

Competitive responses

The Investment Platform sector has enjoyed a period of rapid growth and success in recent years. Some of that growth can be attributed to the buoyant stock markets in recent years which have helped to swell the sector's AuM, but there is no doubt that collectively platforms have been gaining market share particularly driven by the shift of nearly all advisor assets onto some form of platform.

If we consider the larger platforms as incumbents, we have seen below in our analysis of customer acquisition costs that, once profitable, the larger platforms are choosing to invest heavily in their brands through an increased marketing spend. This might explain why new entrants have been forced to focus on product niches and high-net-worth clients. In the Advised sub-sector, pricing competition is now intensifying with incumbents defending existing business by offering discounts when advisors threaten to move their assets.

In terms of the traditional asset managers, some have responded to the success of investment platforms by launching their own direct platforms themselves.

The FCA is concerned about the difficulties some customers experience in trying to switch between investment platform providers and are now consulting further on proposals to reduce barriers to switching. Evidence of multi-platforming is growing, but it seems very probable that customer loyalty and inertia, like in retail banking, will mean that customers once acquired will prove remarkably 'sticky'.

The prevalence of "clean" and "super-clean" share classes, where platforms have negotiated a better deals from underlying fund managers and passed these on to their clients, also appears to act as another barrier to switching for customers looking to move to another platform. These share classes increase the time and costs of a switch to a rival platform: not only might the rebate be lost, but also potentially the customer might suffer bid/offer costs if the shares cannot be offered by the new platform and customers have to cash out and re-invest in something similar but not identical. This in effect is a barrier to success for new start-up platforms since it acts as a drag on customer acquisition.

Conclusion

The Investment Platform sector is still enjoying significant growth and this climate is conducive to new entrants. That said, the actual number of new entrants appears to be low and focused on niche areas of investing or the acquisition of more profitable larger clients with higher net worth and AuM.

The D2C segment in particular is more concentrated with the likes of Hargreaves Lansdown investing heavily in their brand. The wide-spread use of bespoke share-classes acts as a barrier to switching and therefore by extension a barrier to success for start-ups.

We assigned the following scores to the categories of barriers to success as follows:

- Cost of Operations: 1-2 – (low-average)
- Customer acquisition: 3 – (high)
- Competitive responses: 1/3 – (low for D2C; high for Advised)

Future Drivers

We have firmly entered the era of the power of the internet and investment platforms are hugely benefiting from the attractiveness to customers of being able to see and manage their wealth on-line, either with or without the help of a financial advisor.

In the D2C market, consolidation (such as the recent acquisitions of both TD Direct Investing and Alliance Trust Savings by Interactive Investor) is likely as platforms seek to gain market share or new products and consolidate the power of their brand. Auto-enrolment and the recent pension reforms around SIPPs offer a growth area for those D2C platforms willing to support the additional regulatory infrastructure.

In the advised sector, price competition is likely to become more intense and to mitigate this advised platforms are seeking to specialise and target their product to specific types of advisor.

In both sub-sectors, start-ups will probably need to attack niche client or product markets to be successful; platforms providing access to the mainstream asset-classes are already well-established and given the importance of economies of scale it is very hard to see a new entrant succeeding on its own. Well-targeted regulation looks likely to help increase the sector's transparency and quality of service. Financial services providers without web-enabled interface with their customers will continue to lose market share.

Robo-Advice Companies

Introduction

Robo-advice companies can be classified as online portfolio management solutions that aim to invest client assets by automating client advisory. They translate clients' inputs such as risk appetite or liquidity factors into investment logic and propose relevant investment opportunities that may go well beyond simply highlighting a few ETFs[xxiii].

While Robo-advisors have just 1.2% of the UK non-advised online investment market[xxi] , they have been growing rapidly, and have drawn investments from all sort of investors, including major traditional financial institutions such as RBS, HSBC, UBS and Goldman Sachs[xxv]. Some people argue that, following the introduction of the RDR in 2012, banks reduced the number of financial advisers, creating an "advice gap" in the market. Robo advisers may have helped fill that gap. As of 2016, there were already more than 15 robo-advisors in the UK.

Components of Barriers to Success

Customer Acquisition

Robo-advisors' customer acquisition costs in the D2C space varies, but it is estimated to be between £200-£500 per customer. This cost is likely to be significantly higher than for traditional banks[xxvi].

"At one end of the spectrum, the banks have relatively low costs when it comes to converting existing customers to their investment propositions. Newer robo-advisers have to spend more and in some cases the spend goes above £400", Holly Mackay, CEO at Boring Money.

The high customer acquisition cost coupled with relatively low charges mean that it would take robo-advisors years to build up a sufficiently sizeable AuM to break even[xxvi]. The major reasons for the high acquisition costs seem to be:

- UK consumers tend to show inertia and low levels of awareness and engagement when it comes to managing personal finances. This means that many consumers do not engage with robo-advisors, mostly because they are not seeking to buy investment products in the first place. For this reason, robo-advice firms such as Scalable Capital have decided to focus on the more self-sufficient and financial-savvy consumers, mainly people who already invest online.

- However, the more engaged and financially-savvy consumers are less familiar with start-ups than established financial institutions. Given the lack of familiarity, many people would not invest a large amount of money with "little known" robo-advice firms. That means that robo-advisors would need to spend on expensive marketing campaigns and customer education if they wanted to build widespread awareness. The alternative model is to partner with established consumer brands and offer services to their existing customer base[xxvii]. This option is only likely to be feasible, however, for those start-ups that built their core IT systems from scratch, rather than buying off-the-shelf solutions. This is because it is hard to integrate an off-the-self IT system with another company's IT system In the B2B space, robo-advice firms could partner with traditional wealth managers to help serve unprofitable clients (usually those clients with less than £50-100k of investable assets). However, financial advisers seem to be reluctant to adopt robo-advice to serve their clients.

- Many consumers want some form of human interaction and advice when investing, especially when facing more complex problems (e.g. at retirement). As a consequence, many robo-advice firms are introducing face-to-face or over-the-phone financial advice/ guidance in their investment process (e.g. Nutmeg, Scalable Capital). However, this move increases the robo-advice cost base and potentially reduces margins even further. Also, the robo-advice business model becomes more similar to that of traditional wealth management firms. Those existing sales processes, thick with human interactions and relationship building, have traditionally acted as a moat against new entrants who could not afford to build or access a sales force to distribute their products.

Cost of Operations

We found evidence that robo-advisors think regulation is a significant barrier to success in the market. Also, finding ancillary service companies that are willing to work with start-ups may be hard. Finally, once up-and-running, start-ups may find it hard to attract and retain talent:

- Robo-advice start-ups need to comply with the same regulations that apply to large financial institutions. The first obstacle when setting up operations is interpreting the regulatory framework and applying for a licence with the FCA. Historically, robo-advice has been considered as providing guidance rather than regulated advice and, for a few years, it has lived in a "grey" regulatory zone. One of the main risks with robo-advice is that of a large misselling scandal. Indeed, since the system is automated, it may repeat an error over and over! This risk has led large institutions to steer away from robo-advice. However, most recently, the FCA has made efforts to help regulate robo-advisors, such as clarifying the requirements for the provision of "automated regulated advice". The FCA has also launched the Project Innovate[xxix] to help new entrants set up operations and, the Asset Management Authorisation Hub, which, while it may still be not so widely known[xxx] , helps new entrants apply for a licence (see below for more details).

- Custodian and ancillary service companies may de-prioritise start-ups, which are small clients with few, if any, customers. So, many start-ups may find it hard to find a suitable partner and may have to settle for sub-optimal solutions to overcome this barrier.
- Hiring and retaining top talent is a challenge. In particular, IT skills seem to be a key shortage area, which is likely to be a problem not just for start-ups, but also for established institutions.
- Last, but not least, start-ups need to weigh risks and benefits of spending money and time building their own core IT systems. Robo-advice start-ups have the opportunity of using third party technology platforms to outsource some of the most challenging operations, such as handling client money and managing transactions. In this way, start-ups don't have to invest in building their IT platform from scratch. However, that strategy impacts profitability, since the outsourcing company will charge a fee and can prove to be a barrier when trying to integrate with other providers[xxxi].

Competitive responses

Large financial institutions such as banks and asset managers are entering the market to avoid missing out on a growing market. While some are building their own robo-advisory solution, many others are partnering, investing in or acquiring existing start-ups and so providing much-needed capital. In general, it seems that established players are actually supportive of start-ups. Also, in a win-win solution, firms from non-investment sectors may start partnering with robo-advice firms to expand their product offer for their existing clients and employees (e.g. Uber and MoneyFarm).

Conclusion

Based on our analysis, the barriers to success in the robo-advice sector seem to be high, and in line with other financial services sectors. On-going customer acquisition is hard and costly and setting up operations is often a lengthy and complex process[xxxii]. This conclusion is slightly different from the CFA membership's general view of the asset management sector: members ranked setting up operations as the highest barrier for start-up investment firms.

We assigned the following scores to the categories of barriers to success as follows:

- Setting up operations: 2 – (average)
- Customer acquisition: 3 – (high)
- Competitive responses: 0 – (very low)

Future drivers

Looking ahead, it is unlikely that customer acquisition will get easier for robo-advisors. A cultural shift among UK consumers is needed to increase engagement with investments. However, while there are several proposals to educate consumers (e.g. some argue for the introduction of financial education onto the primary school curriculum), a major shift is unlikely to happen quickly, if at all. Therefore, we agree with the CFA members that customer acquisition and brand recognition are significant barriers for start-ups and likely to stay so in the future. Instead, it is more difficult to predict the impact of regulatory requirements in the future.

Insurance – A Comparator

Introduction

This review of the UK insurance sector serves as an interesting comparator to our reviews of other sectors of the UK investment industry.

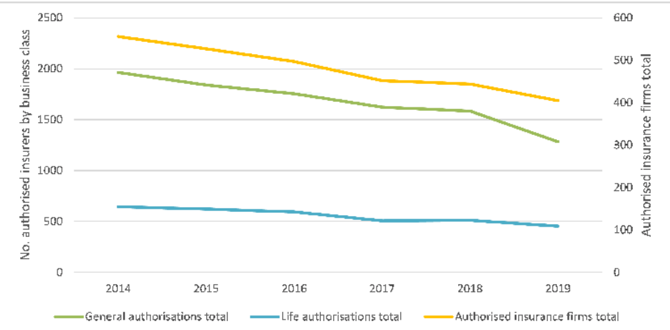
Insurance is one of the oldest types of financial product in the UK; many of the mainstream UK insurers are hundreds of years old. The insurance market has evolved several subsectors covering insurance of property, motoring, life and health, among others. For insurers to remain competitive they must manage their assets to remain profitable while seeking to ensure they have adequate capital and liquidity to meet their future insurance liabilities. Many experienced investment managers and CFA charterholders are employed within this asset-liability management area.

Evidence of past entry

The level of new insurance company registrations in the UK has been low compared to the investment management sector and start-up activity in the UK economy generally.

As illustrated in Exhibit H below, data from the Prudential Regulation Authority (PRA) for the period 1/1/2014-30/4/2019 shows a net loss of 151 insurance firms, representing a reduction of 870 insurance authorisations across both life and non-life insurance business classes. The period has seen some new entrants, but looking at these new entities more closely, only a handful are genuine new entrants to the UK market, with the balance representing acquisitions and re-branding of existing firms.

Exhibit H: Insurers authorised for insurance business classes, 2014 – 2019



Source: PRA

Data from Beauhurst, a research group for private-equity funded start-ups, reveals a similar picture. In the 5 years from 1st January 2014 to 31 December 2018, there were two new life insurance companies established and eight new non-life companies[xxxiii].

The Beauhurst data reveals a richer vein of start-up activity in both insurance broking and providers of specialist ancillary services to insurers, with 87 companies having been established in the 5-year period to June 2018, 81 of which were still actively trading. The ancillary service providers to insurers, referred to under the 'Insuretech' buzz-word, harness technology to offer a range of service and solutions to existing providers, such as improving the accuracy of insurance premium pricing via tech devices and phone apps, decreasing administration costs, increased market transparency for consumers, catering to niche market segments, or by reducing fraud.

Where there have been genuine new entrants, these firms have mainly been established in response to regulations:

- European insurance regulation (Solvency II, effective January 2016) has provoked an increase in demand for re-insurance and several new companies have been formed to meet this
- Government pension fund reforms, especially around annuities, have driven consolidation in the bulk-annuities market; and
- The UK government has sponsored the establishment of Flood Re, a specialist re-insurer to cover flood claims.

We did interview one new entrant offering life insurance and pensions in greater detail, but this company is well established in its overseas home market, and the set-up costs within the UK have been very high. Before setting up its own venture, it needed to partner with an established UK provider for several years.

Components of Barriers to Success

In a survey conducted by CFA UK of its members in August 2018 (see Appendix), given a choice of three responses, members ranked the cost of operations as highest, then customer acquisition and lastly incumbent competitive response as barriers to success for new asset management firms. In terms of future challenges, regulation requirements, maintaining brand awareness and incumbent competition were highlighted as the main ongoing challenges. We discuss these factors in more detail below:

Operating Costs

Setting up a new insurance business in the UK has a very high cost. Application fees for a complex insurer are roughly five times that of a portfolio manager application. A new insurer will also pay for capital requirement modelling permissions which can run into the hundreds of thousands for the FCA fees alone. Solvency II regulations require insurance firms to have low risk capital to cover 99.5% of expected annual insurance liabilities. In addition, personnel costs relating to fulfilling these compliance tasks are significant.

Solvency II regulations have increased capital requirements for most firms, particularly for life insurance, and has incentivised firms to become larger and diversified. Some restructuring and spin-offs of life insurance business has occurred.

Almost all insurance markets in the UK are mature and competition is at a high level among existing participants. Price competition is also increasing as technology enables more convenient comparison between providers, particularly for retail customers and the more commoditised products.

There are fewer insurance firms within life insurance sectors (e.g. annuities, pensions) compared to the non-life sectors (e.g. motor, home, public liability). Using PRA data, there are approximately three times the number of general insurance authorised firms than life insurance authorised firms. The lower number of life insurance firms reflects the more stringent regulatory and capital requirements for this type of insurance business.

The number and type of authorisations is detailed in Exhibits I and J below (note: some firms are authorised for multiple types of insurance). The aforementioned significant reduction in the number of especially General but also Life Insurance authorisations between 2014 and 2018 emphasises the ongoing consolidation and high competition in the sector and helps explain the relative low level of start-up activity:

Exhibit I: General Insurance Authorisations

Year	Accident & Sickness	Motor vehicle Liability	Fire and other property damage	Marine, aviation and railway	General liability	Credit and suretyship	Other classes	General total
2014	303	280	269	273	276	249	313	1963
2015	287	259	250	255	259	233	297	1840
2016	272	248	241	243	247	220	283	1754
2017	253	229	223	224	229	201	264	1623
2018	248	223	218	218	224	195	259	1585
2019	195	194	192	199	170	231	102	1283
2014/19 Change	-108	-86	-77	-74	-106	-18	-211	-668

Exhibit J: Life Insurance Authorisations

Year	Life and annuity	Marriage & birth	Linked long term	Permanent health	Tontines	Capital redempt'n	Pension funds	Collective insurandce	Life total
2014	149	60	185	117	1	58	72	3	645
2015	143	59	177	114	1	58	69	2	623
2016	135	57	166	109	1	57	68	2	595
2017	115	48	142	94	1	47	60	1	508
2018	116	49	143	95	0	48	61	1	513
2019	102	43	130	83	0	42	54	1	455
2014/19 Change	-47	-17	-55	-34	-1	-16	-18	-2	-190

Customer acquisition

Customer acquisition costs are also very high - UK consumers have a reputation for strong inertia and the well-known insurer brands have been household names for over 100 years. New entrants need to make significant investment to increase their brand awareness with the public.

Similarly, broker intermediaries stay loyal to established brands – new entrants must bear significant costs to educate advisors for their products and make investment in user friendly technology platforms.

Once a firm has established its brand name and product, marginal costs are lower for the same provider launching a new product in another insurance sector; there are economies of scale in regulatory, compliance and customer acquisition costs. Again, looking at the PRA data, existing insurance companies often create a separate corporate entity, under the same brand name, to offer different insurance product lines.

Of the approximately 450 firms authorised in the UK in 2018, 15% of these firms are multiple subsidiaries of a consolidated company.

Competitive response

While there are high barriers to entry for new insurance firms to establish themselves, the level of competition among existing market participants is also very high.

As mentioned above, with the UK insurance market maturing, and the customer acquisition costs remaining high but with some economies of scale, many participants have moved to offer products across several market sub-sectors, covering both life and non-life products. Firms encourage this behaviour by using some sub-sectors, notably motor and home insurance, as loss leaders in an attempt to encourage clients into other complementary sectors, such as retirement, pensions or critical illness. Comparison websites and ease of obtaining a quote online has increased the level of market transparency to the end consumer. Even in the relatively new sector of cyber insurance, products are offered by most of the large established firms.

The exception to this cross-sector model is annuities. The combination of the UK market maturing, Solvency II and pension freedoms regulation, has meant virtually zero new traditional annuity business is being written. Many mainstream life insurers are exiting the market and have sold off their existing books to specialist consolidators.

Government policy making insurance mandatory in some sectors creates social pressure to keep premiums low, for example home, motor and public liability insurance.

Conclusion

Given the maturity of UK insurance markets and their participants, and the level of regulation, there are a very high barriers to entry and the level of competition is high. Whilst there are differences across the various sub-sections of both general and life insurance, overall we consider all three component barriers to success considered by CFA UK "high".

We assigned the following scores to the categories of barriers to success as follows:

- Operating costs: 3 – (high)
- Customer acquisition: 3 – (high)
- Competitive response: 3 – (high)

Future drivers

Technology provides some opportunities for new entrants. Cyber insurance is a new high growth subsector. Moreover, it has been demonstrated that market participants will use technology if an advantage can be found in customer acquisition, premium pricing, anti-fraud, or regulation compliance. This can be seen in black box devices used in motor insurance, online price comparison platforms and use of mobile apps. arguably there is room for future disruption whithin life insurance and pensions markets, notably via increased use of big data to gauge user lifestyle habits and improve accuracy of life expectancy models.

Overall Conclusion

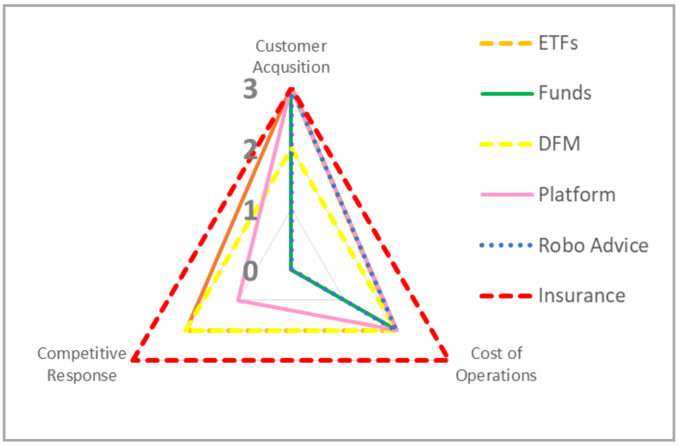
Current State

Start-up activity is important to the UK asset management sector. Start-ups influence competition and innovation within it and ultimately help drive the value produced by the industry for consumers. A truly competitive asset management sector will challenge existing incumbents to improve products and services. An innovative start-up culture will attract new ideas and talent.

In reviewing the individual sectors, we found that common across all the sectors, customer acquisition cost was the highest barrier to success of the three barriers identified under our methodology. On the other hand, the importance of competitor response was considered low or even zero outside of Insurance and ETFs.

Exhibit K consolidates the scores for Barriers to Success across all the individual sectors. In contrast to the UK insurance sector, encouragingly we found barriers to entry and success for UK asset management sectors that we reviewed as comparatively low.

Exhibit K: CFA UK scoring of Barriers to Success by sector



Future State

Looking forward into the future, technology will continue to play a key role in disrupting all the sectors we have reviewed. The internet is the mainstream platform and portal for an ever-increasing proportion of global wealth and so technology will continue to facilitate innovation and spawn start-up companies up-and-down the value chain. The key question is whether this exposure to developments in technology will ultimately make it easier for customers to understand their investment choices and be empowered to switch providers and so open the investment sector to more effective competition.

Established incumbents will need to keep pace with this innovation and will either acquire, out-source to or partner with those start-ups offering either new routes to market, new products or enhanced infrastructure to enable them to serve their clients better.

Regulators will need to keep pace with this innovation too. Indeed, increasing automation raises the stakes: if automation is not properly controlled, the scope for hiding poor performance and practice or even worse, mis-selling and fraud, is greatly increased. On the other hand, if automation is properly designed and controlled, technology can be harnessed to present both financial product information and financial advice in a clear, transparent and fair way on a mass-scale to better serve the needs of consumers.

The biggest barrier to success to any start-up asset management firm is customer acquisition, acquiring sufficient AuM and building a brand. At the heart of that challenge, is building the consumers' and customers' trust. In a world where human interaction may be increasingly reduced and replaced by machines, that will only be achieved, if the machines are built the right way.

CFA Charterholders have a duty to always place their clients' interest above their own. The promotion of competition and innovation within their industry is part of that responsibility – alongside the promotion of trust. The purpose of this paper – an examination of challenges which start-up asset management companies face – is a step in that direction.

Appendix I

The FCA's Asset Management Authorisation Hub

The FCA recognises that it is difficult for start-ups to navigate the regulatory landscape and wants to remove unnecessary regulatory barriers to establishing and running an asset management firm.

The FCA's Asset Management Authorisation Hub helps firms as they move from pre-authorisation to authorisation, and on to supervision. The Hub aims to:

- clarify expectations and support firms with better guidance on regulations and processes
- make information easier to access via a dedicated portal for investment managers on the FCA's website
- foster a more proactive, personalised engagement between the FCA and market entrants
- provide end-to-end support for firms moving through the start-up cycle

New services for firms include weekly pre-application meetings; access to a dedicated web portal; a named case officer and more support for firms as they move from being authorised into supervision.

The Hub helps make the FCA's expectations and standards clearer to applicants. It is not about lowering standards for market entry but rather to encourage competition by reducing unnecessary barriers to entry. New firms will be able to enter the market with greater efficiency than before, while keeping the high standards that make the UK an attractive place for asset management services.

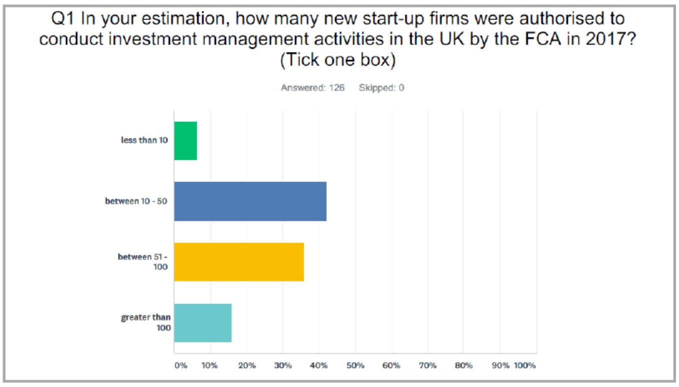
See the FCA's website for more details and to submit a request for a pre-application meeting

Appendix II

CFA UK Membership Survey Results

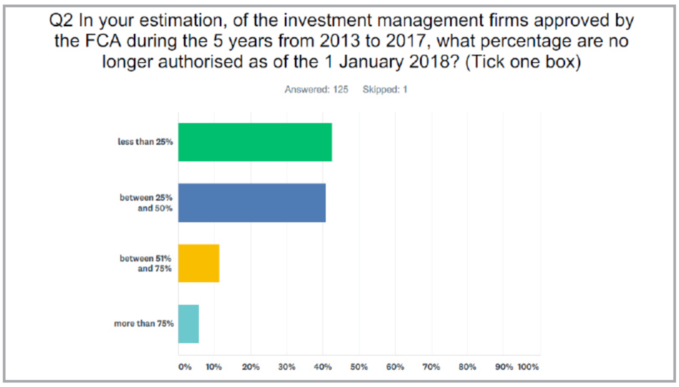
In August 2018, CFA members were invited to participate in an online survey on Competition in the UK investment industry. The online survey provided us an understanding of CFA UK members' views on the level competition with UK financial services, implications for start-up firms, the challenges they face, and how many new start-up firms are ultimately still in business. The responses to the survey are provided below.

The results revealed that CFA UK members believe there are many investment management start-ups within the UK each year.



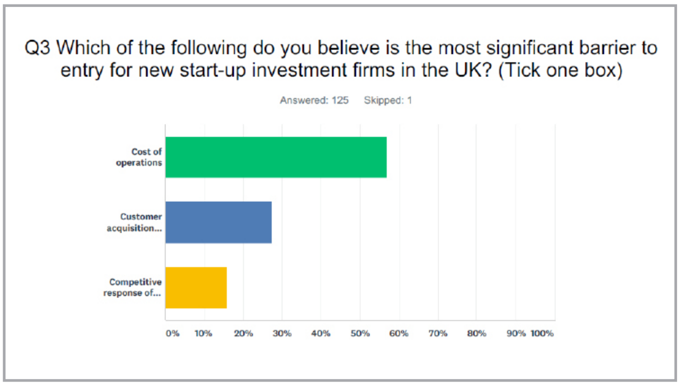
The FCA data we received via a Freedom of Information (FOI) request, indicated 672 new investment management firms were authorised in the 5 years between 2013 and 2017. According to ESMA data, there were 191 new authorisations of start-up investment firms in the UK in 2017 and our data-work has shown that 126 of these were genuine start-ups and not new ventures from existing companies.

This bullish view is a contrast with a more pessimistic tone on the number of failures:

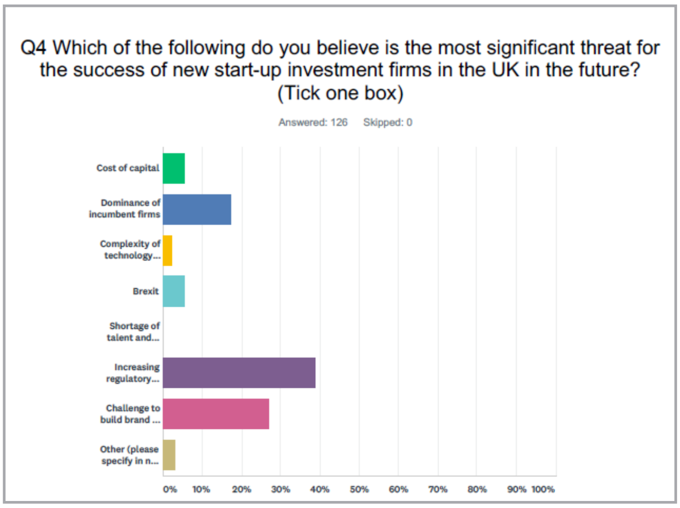


The most popular response was that one in four (25%) firms or less would not survive (i.e. 75% of firms or more would survive) beyond the short term of five years. Again, this agrees with real FCA data that shows that 5% of the newly authorised investment firms in the 5 years between 2013 – 2017 are no longer active and in business.

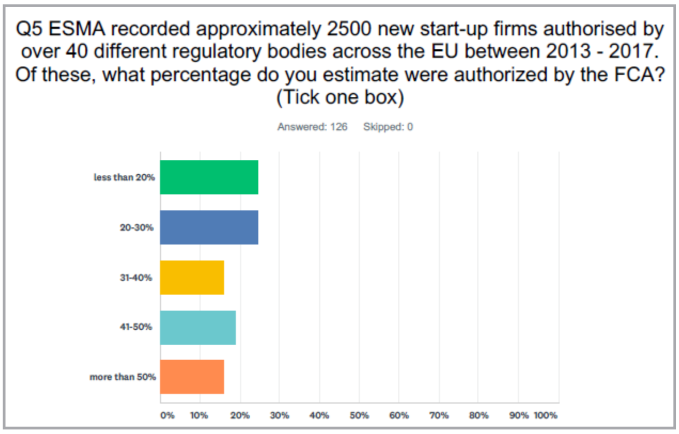
CFA UK members believe that the cost of operations and customer acquisition presented the main challenge to new firms. The competitive response of existing firms was believed to be of relatively minor importance which tallies with our own analysis of the Pooled Funds Sector but not necessarily other areas of financial services.



Looking forward, we also asked what the potential future threats are for UK start-up investment firms. While increasing regulatory costs are seen as the main threat (39%), the challenge of customer acquisition was mentioned again, ("building a brand and trust" - 27%). Interestingly recruitment of people and talent shortage received zero responses. Responses suggested that with or without a hard Brexit, even where a specific skill may be in short supply (e.g. coding), the UK's financial services work-force is adaptable and flexible enough to acquire and learn those skills.

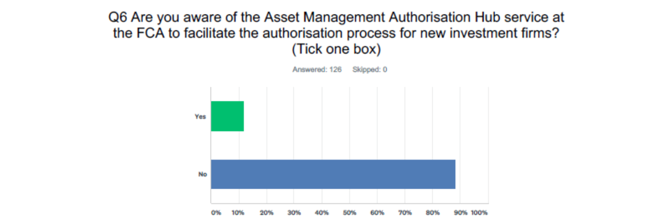


The survey results indicate that members fear an increasing burden of regulation costs and complexity but underestimate the relative significance of the FCA within Europe. Surveyed members underestimated the relative percentage of investment firms authorised by the FCA within the EU. The data show that the FCA authorized the majority (over 50%) of investment firms across Europe over last 5 years, whereas members estimated the numbers to be less than 50%.



Almost 90% of respondents are not aware of the FCA imitative to provide assistance to facilitate the authorisations process. Possibly this is an indication that many of our survey respondents are not directly involved with compliance or authorisation with the FCA. (https://www.fca.org.uk/firms/asset-managers-authorisation) and that often this is outsourced to specialist service providers and legal firms.

Finally, we asked if CFA members were aware of the FCA's Asset Management Authorisation Hub – a tool launched by the FCA in 2017 to expedite the authorisation process.



ANSWER CHOICES	RESPONSES	
Yes	11.90%	15
No	88.10%	111
TOTAL		126

Appendix III

Table of Exhibits

Endnotes

[i]Data as of April 2019, ESMA Registers portal provides web visitors with information concerning the European regulatory framework for investment firms and credit institutions.

[ii]There is no common accepted measure of how to define or identify a start-up company. For the purpose of this paper, we define start-up companies as small new entrants in the sector with less than six years of incorporation, in a growth phase and not associated, sponsored, partially or wholly-owned by an incumbent.

[iii]OECD, Competition and Barriers to Entry, 2007, pg 3. Sources: https://www.oecd.org/competition/mergers/37921908.pdf; OECD Barriers to entry, 2005, pg 28-38. https://www.oecd.org/daf/competition/abuse/36344429.pdf

[iv]https://www.thisismoney.co.uk/money/investing/article-4735344/The-world-s-oldest-investment-trust-going-strong.html

[v]"EFAMA Asset Management in Europe, 11th Edition Facts and Figures", September 2019. Data reported as of end 2017.

[vi]"Asset Management in the UK 2018-2019", The Investment Association Annual Survey, September 2019. Data from the Investment Association based on only the IA Member firms which do not account for all active asset management firms and tend to be more represented by larger firms than smaller firms.

[vii]Asset Management in the UK 2018-2019. The Investment Association Annual Survey, September 2019.

[viii]Financial Conduct Authority, Sector Views 2018, Chapter 8, Investment Management, https://www.fca.org.uk/publications/corporate-documents/sector-views-2018

[ix]Morningstar Fund Research and Insight, "Fund Fees Drop 20% But Investors Still Flock to Passives", October 2018. www.morningstar.co.uk/uk/news/171279/fund-fees-drop-20-but-investors-still-flock-to-passives.aspx

[x]https://www.theinvestmentassociation.org//assets/files/research/2018/20180913-fullsummary.pdf.pdf

[xi]FT, "Race to the 'trillion-dollar club' intensifies as markets turn", October 24, 2018. https://www.ft.com/content/9621add4-d6d2-11e8-ab8e-6be0dcf18713#myft:saved-articles:page

[xii]"Asset Management in the UK 2017-2018", The Investment Association Annual Survey, September 2018.

[xiii] Source: ETFGI, ETF Research firm

[xiv] Source: Morningstar

[xv] The announced M&A deals were all closed in 2018 therefore the merge activities appear in 2018's number.

[xvi] We consider 2000 to 2008 to be the chapter I in which big incumbents such as Blackrock or Amundi got their feet in the door and the awareness of ETF was limited. 2008-2016 define the chapter II; as the most successful independent new entrants in Europe were launched around 2008 and managed to grow to success until nearly each of them was acquired by an incumbent in 2017.

[xvii] Interview with Dustin Lewellyn Chief Investment Officer of Penserra, a U.S. financial service firm that offers trading and operational services to ETF white label providers or ETF operators in the U.S.

[xviii] Interview with Deborah Fuhr, the founding partner of ETFGI, an ETF research firm.

[xix] Compeer breaks down the market for providers into Execution Only (EO), Full Service Wealth Managers (FSWM), Investment Managers (IM) and Private Banks (PB) – and providers must have a minimum of £50 million AuMAuM to qualify. For the purposes of this study, we have assumed only FSWM and IMs to be "DFMs". This may not be a fully representative pool of DFMs, but we believe it at the least representative of the market.

[xx] FCA Investment Platform Market Study MS17/1.2, section 8.1

[xxi] FCA Investment Platform Market Study MS17/1.4: page 14-17

[xxii] FCA Investment Platform Market Study MS17/1.4, figures 4.15 and 4.16

[xxiii] The majority of Robo-advisors aim to allocate their clients to managed ETF-portfolios based on individual preferences. Source: Deloitte, "The expansion of Robo-advisory in Wealth Management 2016"

[xxiv] Around £2bn. Source: FT, UBS closes its UK robo-advice service to new customers, 2018, Boring Money, UK non-advised online investment, 2017

[xxv] Source: Reuters, "Goldman building robo-adviser to give investment advice to the masses", 2017

[xxvi] Banks typically spend less than £100 to convert existing customers into investors who use the banks' advice services. Source: "Robo-advisers pay £500 for each client", FT Adviser and BoringMoney, 2017

[xxvii] Possibly 5-10 years on a profit base, assuming customer invest £20,000 on average, and charges are 0.75%, and a profit margin of 50% for each customer. Deloitte estimates that robo-advisers would need around £6bn assets under management to generate enough revenues to cover their costs.

[xxviii] E.g. Robo-advisers could partner with companies such as Tesco to develop robo-advice solutions for Tesco Bank clients.

[xxix] FCA Project Innovate: https://www.fca.org.uk/firms/fca-innovate

[xxx] Based on our CFA member's survey, over 90% of respondents are not aware of the FCA initiative to provide assistance to facilitate the authorisations process.

[xxxi] It seems that few start-ups (e.g. ETFmatic) have tried to build and manage backend systems from scratch. This move has given them a competitive advantage when it comes to integrating IT systems with other providers/ partners, and a lower cost base. However, that also meant higher upfront investments, and longer lead time to start the operations. ETFmatic reports that they would only need £200m AuMAuM to break even. Source: http://darwinwealthcreation.com/how-the-ceo-of-etfmatic-wants-to-change-wealth-management-altfi/

[xxxii] This would help explain why UK Robo-advisers are still unprofitable. E.g.Nutmeg – the large UK robo-advisers, is far from being profitable, even after 8 year from his launch.

[xxxiii] Note Beauhurst data does not tie-up exactly with the PRA data as (i) it only covers private-equity funded start-ups; and (ii) some of these private-equity funded start-ups acquired existing authorised insurance companies as a quicker route to gain regulatory authorisation. Of these 20 new entrants, all were still going concerns as at 30 June, 2018 bar 3 of the non-life companies, of which one had closed and two been either acquired or de-listed.

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CFA UK: serves nearly 12,000 leading members of the UK investment profession.

- The mission of CFA UK is to build a better investment profession and to do this through the promotion of the highest standards of ethics, education and professional excellence in order to serve society's best interests.
- Founded in 1955, CFA UK is one of the largest member societies of CFA Institute (see below) and provides continuing education, advocacy, information and career support on behalf of its members.
- Most CFA UK members have earned the Chartered Financial Analyst® (CFA®) designation, or are candidates registered in CFA Institute's CFA Program. Both members and candidates attest to adhere to CFA Institute's Code of Ethics and Standards of Professional Conduct.

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- The organisation is a champion of ethical behaviour in investment markets and a respected source of knowledge in the global financial community.
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