ALFI Global Distribution Conference 2023

20 September, 2023 Luxembourg

Fund industry refocuses on retail investment amid democratisation drive

The discussions at ALFI's 2023 Global Distribution Conference on September 20 reflected the evolving priorities of Europe's – and the world's - investment fund industry. The gathering of industry professionals at Luxembourg's European Convention Center, along with guests from the United States and Asia, examined in particular the new focus on retail investment – not just to help individuals and households save for their retirement and other priorities, but to unlock new capital flows that can help fund the climate transition.

Newly-elected ALFI chairperson Jean-Marc Goy, conducting officer and board member of Capital Group's Luxembourg management company, pointed out that this year ALFI is celebrating its 35th anniversary, a birthday it shares, not coincidentally, with the EU's first UCITS Directive, the legislation that paved the way for the European single market for funds and for the grand duchy to become a global hub for the industry.

Mr Goy says his priorities in the chair are to strengthen ALFI's inclusivity, diversity and representativeness, further the industry's dialogue with stakeholders, regulators and public authorities at both domestic and international level. Mr Goy adds that a third priority is to consolidate and extend Luxembourg's positioning as a market leader. This includes exploring avenues, opportunities in digital transformation and embracing technology and developments in cybersecurity, crypto-assets and AI.

Industry headwinds

He reminded conference participants that in the past few years the fund industry has faced significant headwinds, from the Covid-19 pandemic to Russia's invasion of Ukraine, wider geographical tensions that have hurt market performance, a surge in inflation and higher interest rates, all of which contributed to a drop in Luxembourg's fund assets from €5.9 billion at the end of 2021 to €5.2 billion today.

But there are also reasons to be cheerful, Mr Goy declared: "There's widespread optimism about the relaunch of the European Long-Term Investment Fund regime, with Luxembourg home to 59 of the 95 funds launched so far in Europe. There's sustainable finance - according to EFAMA, Luxembourg accounts for 34% of Europe's SFDR article 8 funds and 51% of those under article 9. And Preqin reports that Luxembourg's share of alternative assets has risen from 16% in 2010 to 62% today."

Growth in these areas, he argues, is down to Luxembourg's readiness to modernise and update its fund legislation regularly, most recently in July this year, and to expand the capabilities and flexibility of the country's toolbox. And, Mr Goy says, the industry needs to be ready to capitalise on new trends and opportunities, such as actively-managed exchange-traded funds, which are rapidly gaining appeal in the US: "We need to make sure Luxembourg attracts them too."

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PwC partner Mike Delano, who chaired the conference's morning session, noted that the European cross-border fund distribution market has grown by 50% over the past 10 years. While Ireland has also emerged as a leader in the market, Luxembourg is the biggest provider of investment products in 18 of the 20 jurisdictions where cross-border funds are distributed, including countries outside Europe such as Singapore, Chile, Saudi Arabia and South Africa.

Inflation aftershock

The world is still dealing with the after-effects of the Covid-19 pandemic, in particular, the biggest inflation shock in more than 30 years, according to Anton Heese, a senior portfolio manager and global fixed-income strategist and portfolio manager at Morgan Stanley. He noted that while inflation in the US is principally driven by the housing market, elsewhere it is inflation in the services sector, driven by labour markets, which is the biggest concern for economists.

For more than a decade up to 2021, Mr Heese said, inflation was kept close to all-time lows by countries importing cheap goods from China. However, "this trend has run its course, as China shifts away from reliance on exports. But even if goods inflation were to fall back to zero, it will be harder in the future for central banks to achieve their 2% inflation target." He points to the impact of higher energy prices on the manufacturing sector, especially in Germany and other northern European countries.

In some respects, the economic situation is less gloomy than expected, especially the absence so far of the expected wave of defaults and bankruptcies. Households have been cushioned by the savings they put aside during periods of lockdown, and more recently by higher wages. In the corporate world, many companies refinanced themselves at low interest rates in 2020-21, and earnings have been better than expected this year as businesses passed on cost increases to customers.

By contrast, the apparently enduring changes to working patterns sparked by the pandemic ("London is very busy between Tuesday and Thursday, but a ghost town on Mondays and Fridays") spell a fall in demand for commercial real estate. Mr Heese argues it could also doom many of the small businesses, from sandwich shops to dry cleaners, that previously thrived off the custom of big-city commuters.

Tide of legislation

"Inflation is also present in the regulatory environment," remarked Olivia Moessner, a partner with Elvinger Hoss Prussen, pointing to the ongoing tide of legislation affecting the fund industry, including Luxembourg's new fund modernisation legislation, the European Commission's launch of its Retail Strategy Review, progress toward updating of the UCITS and Alternative Investment Fund Managers regimes, and the most recent announcement of the review of the Sustainable Finance Disclosure Regulation.

The grand duchy's revision of its domestic legislation is intended to enhance the country's existing fund toolbox and the harmonisation of its investor classification with that of the EU's MiFID legislation, according to Arendt & Medernach counsel Florent Denys. Notably, the new law lowers Luxembourg's minimum investment threshold for well-informed investors from €125,000 to €100,000, and provides an exemption from Luxembourg's subscription tax on fund assets to ELTIFs.

By contrast, the Retail Investment Strategy, while pursuing the worthwhile goal of protecting individual investors, carries the risk of unintended consequences, according to Adam Henley, head of European product development at J.P. Morgan Asset Management. The Commission's proposals pick up the UK's approach prioritising the value for money of investment products, and would set benchmarks on cost to which asset managers would have to adhere or justify their failure to do so.

The review of the SFDR could lead to the abolition of the article 8 and article 9 categories of sustainable funds, which were never intended to be used as product labels, under a consultation launched this month. Mr Henley said: "It is important that we learn lessons from the SFDR and go back to its goals. We've ended up with a level of disclosure that may be incredibly complex for end investors to understand." The process should be simplified, and, importantly it should result in a diversity of products as different clients have different needs and preferences."

Defining the retail investor

The renewed focus on retail investors reflects concern in the industry and among policymakers about the low proportion of investment funds within European household savings – 10%, compared with 22% in the US, noted EY partner and markets leader Robert White. The reasons are varied, he says, ranging from lack of suitable financial education and of tailored advice to cumbersome sales processes, costs and fees.

One problem for the industry is deciding what constitutes a retail client in the first place, argued Christophe Verboomen, public affairs manager at industry group Invest Europe, noting that even high net worth individuals are not necessarily treated as professional investors. Meanwhile, individual investors of relatively modest means are liable to have exposure to sophisticated and complex asset classes through insurance and pension products.

Nick Millington, a principal with Blackstone Group, noted that domestic legislation is an important factor in how retail investors can access a wider range of products. However, he believes that education is critical, both of advisers and intermediaries and of end-clients, to ensure wider knowledge of different asset classes, including those of private markets, and their role in a broader portfolio.

Frédérique Dugény, head of business solutions and implementation at Amundi, said the growth of fund distribution platforms reflects the uncertain business climate. She sees a change in platforms' business model involving a reduction in fees for distributors in order to increase volume, while increasing charges for asset managers. “At times it feels like a racket!”, she said.

Concern about the economy

For industry professionals and investors in Asia, market sentiment is largely prudent and conditioned by the state of China’s economy, according to Sally Wong, CEO of the Hong Kong Investment Funds Association, noting that retail savings are mostly held in bank deposits and money-market funds.

In the US, the economy is also a major issue, said longstanding NICSA president and CEO Jim Fitzpatrick, pointing out that while the environment appears to be improving and hopes of a ‘soft landing’ growing, markets remain volatile. Sustainability remains at the top of the agenda: “We are still a couple of years behind Europe on ESG, but it is very important for asset and wealth managers.”

The revision of the ELTIF regime – due to become applicable in January 2024 – is widely viewed as a key opportunity for Luxembourg to extend its dominance in Europe’s fund sector, connecting as it does asset classes that were previously confined to institutions with retail investors seeking asset classes with better returns than traditional securities and who may be less concerned than in the past about the need to lock up capital for longer periods.

The first iteration of the ELTIF regulation struggled from the complexity of the rules applicable to the eligibility of individual investors and investment restrictions that deterred many asset managers, according to Salvatore Sberna, head of alternative investments at Italy’s Azimut Investments. Added Pictet Alternative Advisers head of product strategy Jane Griffin: “There was ambiguity in parts of the legislation, and distributors didn’t know what ELTIFs were – we found it hard to get scale.”

Toward ELTIF 3.0?

Panellists at the ALFI conference are broadly satisfied with the way the industry’s feedback was incorporated into what has been dubbed the ELTIF 2.0 regime, but they believe there are still improvements to be made, for example to facilitate fund of funds and master-feeder products. And Partners Group global head of private wealth structuring René Herren cautioned: “We really need a secondary market, and how to manage lock-ups is a key issue. The revised regulation is a good start, but let’s go to the end.”

Liquidity management is not just an issue for retail investors placing savings in long-term assets; it is also a major concern of regulators and international policymakers who fear the damage to financial stability that could arise from a mismatch between the liquidity of open-ended funds’ assets and their investors’ redemption rights.

Luxembourg has been a leader in the introduction and use of liquidity management tools for the fund industry, pointed out Georg Kieffer, head of the international risk division of the

CSSF's funds department, notably amid the market turbulence surrounding the onset of the pandemic in the early months of 2020. Also important, he said, is the anti-dilution aspect of liquidity management – that the first investors to withdraw their money should benefit at the expense of those remaining in the fund, a factor that can further exacerbate liquidity squeezes.