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POINT of VIEW
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Our Perspective on Issues Affecting Global Financial Markets

The Rise of the Global Asset Management Industry: TOO BIG TO FAIL, TOO?

While regulators fight the last war, other beasts lurk in the global financial system: big asset managers. But are they too big to fail? What are the consequences for asset markets? We inquire.

The Rise of the Global Asset Management Industry: Too Big To Fail, Too?

Here's a quiz: in which industry do the top ten companies hold 28% of the total assets?

If you answered "the too big to fail banks" you'd be wrong. It's the big asset managers. The 10 largest banks on earth hold 22.4% of all bank assets while the top 10 asset managers hold 28.3% of global assets under management.[1] It is towards these 10 mega managers, with assets under management ranging from \$1.2 to \$3.8 trillion, that regulators, academics and investors have turned a more discerning eye.

Unlike the big banks, these giant asset managers are buy-and-hold, long-term investors who are unlikely to cause or exacerbate problems in the financial system. At least that's the theory.

« HOW SIMILAR ARE LARGE ASSET MANAGERS TO THE TOO BIG TO FAIL BANKS WHICH BROUGHT THE GLOBAL FINANCIAL SYSTEM TO THE BRINK OF COLLAPSE IN 2008? »

Until recently, investors, academics, and practitioners alike drew a sharp distinction between the dangers posed by banks (financial intermediaries who issue liabilities, such as deposits, used as currency economy-wide) and asset management firms (entities which hold assets on behalf of end-users like pension funds). Now, however, with asset managers such powerful players, we wonder: how similar are large asset managers to the too big to fail banks which brought the global finan-

fig.1 RISING WEALTH TIDE LIFTS ASSET MANAGERS' BOATS

Source: OECD Statistical Database, Bank of England, and Haldane, Andrew (2014) cial system to the brink of collapse in 2008? We examine the market environment and incentive structures in the asset management industry, concluding that while the threats they pose may not be dire, the area deserves careful study.

HOW BIG IS BIG?

Assets held by and managed on behalf of clients (from pension funds to retail households) now measure $87 trillion on a global basis. That sum compares to about one year of the sum total of world economic output.

These two facts may not be a coincidence. The spectacular rise in global gross domestic product (GDP) sits at the heart of the story of such a large asset pool (See Figure 1 on previous page). Rising wealth leads to increased savings stored in the form of financial assets (e.g., stocks and bonds). As the world continues to grow, populate and save, the asset management business will thrive for the simple reason that savings need to be looked after. Today, emerging market countries account for 50% of global output but only 20% of global financial assets. In the coming two decades we expect vast increases in emerging markets' share of asset ownership.

The rise in global savings is indeed one of the reasons behind the inexorable decline in global interest rates over the last 30 years, labeled by some as a mystery. "Safe assets" like developed market sovereign bonds have benefitted enormously from the growing pool of saved money looking for a safe, liquid, and decently profitable financial home.

« TODAY, EMERGING MARKET COUNTRIES ACCOUNT FOR 50% OF GLOBAL OUTPUT BUT ONLY 20% OF GLOBAL FINANCIAL ASSETS. »

In the U.S. alone, total assets under management (AUM) accounted for more than 230% of GDP at the end of 2013 (see Figure 3 on page 4). Included in this measure are the assets held by and on behalf of insurance companies, pension funds, mutual funds, ETFs and money market funds. U.S. dollar-denominated asset markets are among the deepest and most liquid in the world. For savers, liquidity and relative price stability are extraordinarily appealing.

COMPOSITION SHIFT: THE SEARCH FOR YIELD AND THE QUEST FOR COST

Unsurprisingly, global savers have not been content to amass multi-trillion dollar portfolios of just low yielding government securities. As financial markets matured over time, alternative asset classes, including high-yield, emerging market funds, index mutual funds and ETFs, saw spectacular growth. Don't believe us? Data reveal that emerging markets (EM) and high-yield fund assets have grown by 40% per year since 2008.

Other curious characters now populate the investing landscape, filling a role occupied by banks in years past. Recognizing this is vital. Passive or tracking strategy assets jumped to $8 trillion in 2012 from just $2 trillion in 2003, with ETFs (a type of passive strategy we've written about before) now totaling more than $2 trillion.

Meanwhile, mutual funds holdings of government securities and large cap equities have fallen. Institutional investors, in particular, appear to have shunned equities. Data gleaned from large U.K. investors typify this trend. Looking at the assets holdings on the balance sheets of U.K. life insurers, the "de-equitization" over the recent past is stark (See Figure 2 on page 3).

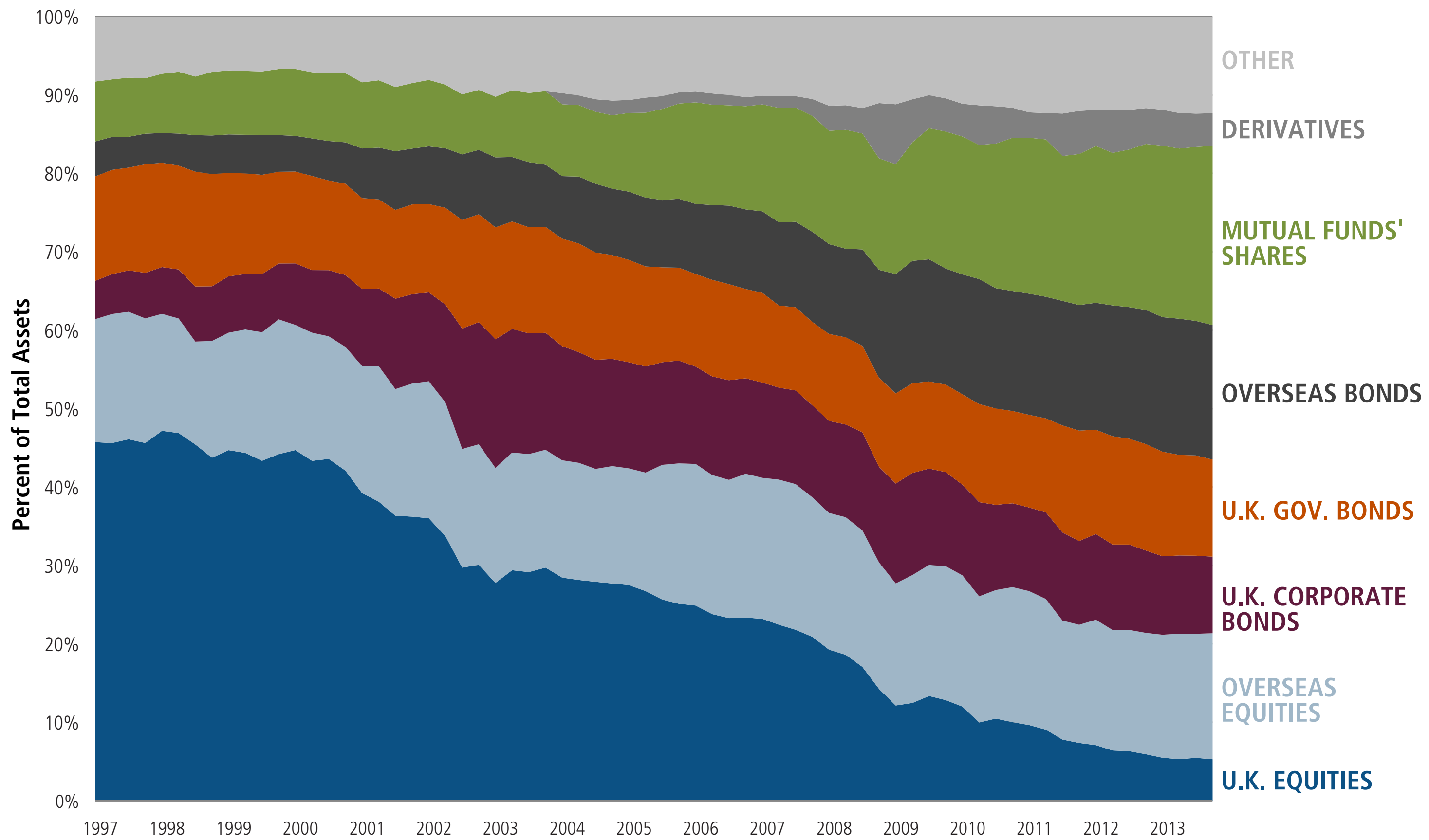
TOO BIG TO FAIL OR NOT, SIDE EFFECTS NONETHELESS

Given their size and the shift in the composition of asset holdings, many now wonder, what could go wrong? Are asset managers, to steal the oft-used phrase, "too big to fail?" On the face of it the answer is no. Unlike their financial market brethren, the banks, which are subject to occasional "runs" on their short-dated liabilities ("deposits"), asset managers appear impervious to runs.

But, the absence of checkings and savings accounts at large asset managers does not preclude other, less well-advertised, problems. While these entities may be bankruptcy remote, they are not without investors. And the threat of poor (relative) performance functions as a universal incentive across the fund management industry–an incentive which often promotes herding behavior.

Chief among the consequences of large asset managers' actions is the possibility of fire sales. If a large portion of the asset management industry has purchased one asset class consistently for a long period of time, and if that asset class at some moment becomes suddenly unfavorable, then to avoid underperforming their peers, man-

fig. 2 FEWER EQUITIES AND MORE BONDS! ASSET ALLOCATION OF U.K. INSURANCE COMPANIES & PENSION FUNDS



Source: Office of National Statistics, Haldane, Andrew (2014). "The Age of Asset Management?"
*Bonds include money market instruments, medium and long term bonds. The split of overseas bonds by issuer is not available.
"Other" includes currency, deposits, loans, other accounts revivable and insurance technical reserves. Derivatives data begin in 2004, but prior to 1997 are included in corporate bonds

agers will sell the undesirable assets, often at unattractive prices (think of mortgage-backed securities during the 2008 financial crisis).

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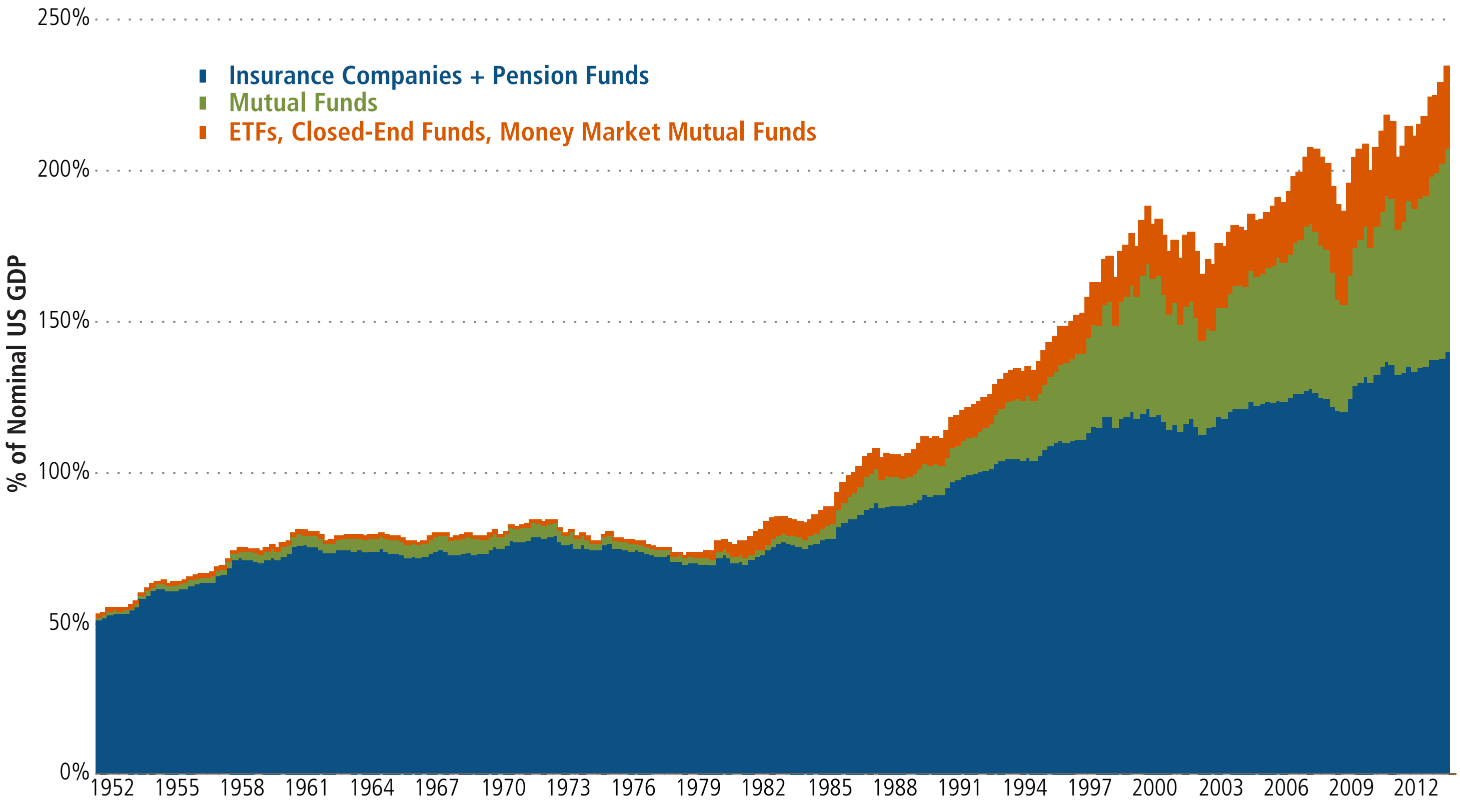
Collective selling into markets with few buyers ("thin markets") drives prices precipitously lower. While it is not, strictly speaking, a bank run, widespread portfolio adjustments would impact the global financial system and global economies as capital flees to safer shores. The consequences will stem less from the first order effects (selling, liquidity, leverage, etc.) and more from the second order, larger scale effects.

If the bonds were corporate, the cost of borrowing could temporarily sky-rocket for companies, inhibiting investment and hiring. If the bonds were sovereign, then the elevated cost of sovereign borrowing could drive up tax rates or spark austerity measures to calm investor nerves. These scenarios may not be traditional textbook bank runs, but macroeconomic turbulence could still result.

Another neglected problem is the prevalence of benchmarking performance to an index. Manager adherence to a common index creates herd-like capital movement within the financial system and promotes a pro-cyclical tendency in asset price movements.

Market structures or incentives that promote harmonized buying and selling trends across various investment managers also cause asset markets to become more correlated and therefore more exposed to violent shifts in investor sentiment. One such market "tantrum" may have occurred in the summer of 2013 as asset managers suddenly shifted out of U.S. Treasury securities and in-

fig.3 ASSETS UNDER MANAGEMENT ARE MORE THAN 2 TIMES GDP IN THE U.S.



Source: Federal Reserve and Haldane, Andrew (2014). "Age of Asset Management?"

duced swift changes in asset prices, as the interest rates on longer-term fixed-income securities across a range of sectors and regions moved in response. The subsequent impact on price performance encouraged further shifts in portfolio allocations by large but unlevered investors.[2]

> « MANAGER ADHERENCE TO A COMMON INDEX CREATES HERD-LIKE CAPITAL MOVEMENT WITHIN THE FINANCIAL SYSTEM AND PROMOTES A PRO-CYCLICAL TENDENCY IN ASSET PRICE MOVEMENTS. »

A highly-concentrated pool of managers shepherding clients into similar strategies in the name of quarterly performance check-ups: what could go wrong? Recent data compiled by professors at the University of Chicago shows the extent to which correlated asset movements now exist. In our post-crisis, central bank obsessed world, data shows that the same asset classes which sold off most violently last June in the "taper tantrum" rallied most fervently in the "taper head fake" of September.[3]

FIGHTING THE LAST BATTLE

Regulators seem keen to reign in leverage metrics in the banking system. They may succeed in turning banks into highly regulated utility-like entities. But such actions do not necessarily extinguish risk or banish asset price fluctuations from the global financial system. Instead, it is likely that the topography of global asset management will continue to evolve, and as it does, the locus of risk will move and change.

SOURCES

1 Andrew Haldane. "The Age of Asset Management?" Speech at At the London Business School, London 4 April 2014.

2 Michael Feroli, Anil K Kashyap, Kermit Schoenholtz, and Hyun Song Shin. "Market Tantrums and Monetary Policy." Conference Draft presented at the 2014 U.S. Monetary Policy Forum, February 2014.

3 Atif Mian and Amir Sufi. "Who Bears 'Federal Reserve Risk'". House of Debt. April 9, 2014.