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Fund industry 'overpaid by $1,300bn'

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The "overpaid" fund management industry is destroying $1,300bn of value annually, according to an unpublished draft report conducted by **IBM**.

The document, seen by FTfm, claims the industry is "paid too much for the value it delivers" and that "destroying value for clients and shareholders is unsustainable".

It also carries a prediction of swingeing job cuts in parts of the industry, such as sell side research, credit rating agencies and funds of hedge funds.

The wide-ranging report, Financial Markets 2020, is based on a survey of more than 2,600 industry participants and government officials across 84 countries by the IBM Institute for Business Value.

The bulk of the value destruction, almost $1,100bn a year, equivalent to 1.9 per cent of global gross domestic product, is seen as impacting on clients. This includes $300bn in excess fees for actively managed long-only funds that fail to beat their benchmark (this figure is quoted as $834bn in the draft report but it is believed IBM has since revised it lower), $250bn spent in fees for wealth management and advisory services that fail to deliver promised above-benchmark returns, and $51bn in fees for hedge funds that also fail to deliver their targeted returns.

Credit rating agencies, sell side research and trading are seen as destroying a further $459bn, largely due to the perceived inaccuracy of much of the analysis these sectors deliver.

Across the financial sector as a whole, IBM said "alpha generation" or the ability to deliver index-beating returns, was "pitiful", despite the huge sums paid in pursuit of this. Perhaps unsurprisingly, it found 87 per cent of investors expressed no loyalty to their "primary investment provider".

The report argues the industry is destroying a further $213bn a year for shareholders due to organisational complexity, largely as a result of inefficiencies.

This value destruction is "unsustainable" in a world where, according to respondents to the report, regulation is likely to become tighter in the wake of the financial crisis and investors are becoming more financially sophisticated, more price sensitive and increasingly keen to measure the "value-add" of their investment managers.

"Government influence and client behavioural shifts over the next decade will destroy the majority of today's revenue base," the report states.

Against this backdrop, the survey respondents indicate that significant job losses are inevitable. In particular, clients forecast a 45 per cent headcount reduction in sell side research and 42 per cent reduction at credit rating agencies in the next decade, as the buyside takes more of this activity in-house.

Funds of hedge fund staff are seen as most vulnerable on the buyside, with headcount cuts of 37 per cent forecast.

Liz Rae, senior adviser, investment and markets at the UK Investment Management Association, said fund houses were already bringing more research activities in-house, partly driven by a view that sell side was irredeemably conflicted.

Sell-side research "probably is overstaffed and there is probably too much of it", she said. However, Amin Rajan, chief executive of Create Research, a consultancy, argued that the bulk of the industry's post-crisis job losses were now behind it. He said much of the value destruction was caused by the "behavioural biases" of investors.