PICK A SIDE:

MAPPING DEGREE OF INVESTMENT FREEDOM VALUES, FLOWS AND FEES

April 2016

Summary: We applied our proprietary *Degree of Investment Freedom* framework to a broad category of fixed income funds and found a remarkably strong relationship between the direction and levels of flows and fees with the level of freedom employed by managers. At the extremes, active and passive funds have both been flow winners. The real challenge is avoiding getting stuck in the middle.

The Propinquity ***Degree of Investment Freedom (DIF)*** analytical framework maps the potential range of flexibility and breadth of investable components in a manager's decision-making process.

Managers with a *high* Degree of Investment Freedom are able to utilize a broad array of instruments and techniques in the management of an investment strategy. Managers with a *low* DIF are constrained to rigid, often index-defined limitations.

DIF values are readily measurable. They can be plotted within ranges – from low to high. Propinquity has built a proprietary ranking system that identifies, scores and maps the DIF values of thousands of investment strategies offered around the globe. They can easily be compared.

To do this, we isolate the instruments and techniques available to investment managers as a set of *components*. Investment strategies are scored based on the use of each component. Component scores are then combined to provide an overall DIF value and profile map for the investment strategy.

For instance, managers of 'Fixed Income' have an array of components including duration, credit and currency that they may use to navigate markets and add value. Greater flexibility and breadth of components used indicates a higher DIF value.

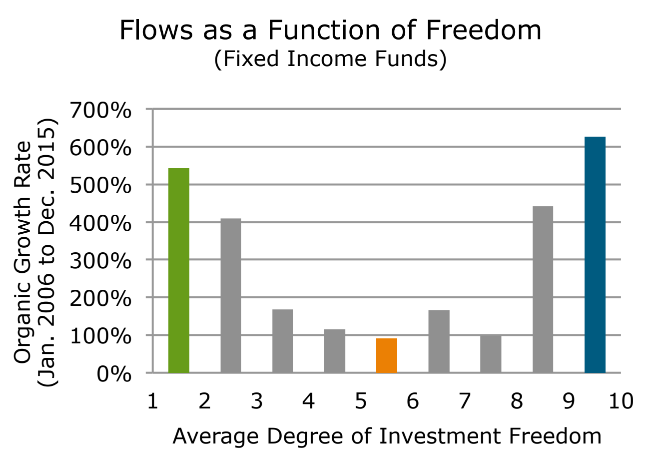

Figure 2. Analysis: Propinquity

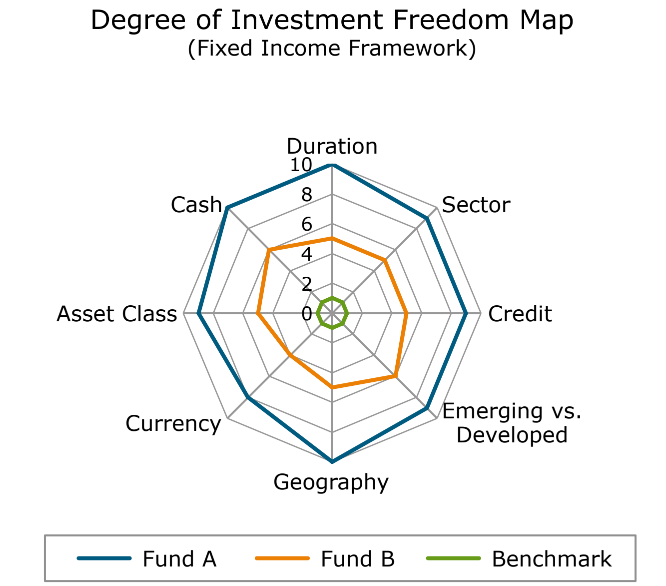

Figure 1. Analysis: Propinquity

One might consider these components as being the 'tools' available to a manager to generate a desired outcome. Each component is ranked on a scale of 1-10. A score of '1' indicates that the exposure range is 'static' while '10' indicates it is exceptionally dynamic.

While the two funds illustrated above (FIGURE 1) are in the same broad 'Fixed Income' category, it is clear by mapping them according to the DIF framework that there are substantial differences in the managers' respective approaches.

For instance, over the period observed, the manager of Fund A has been highly dynamic in shifting duration while the manager of Fund B has been more constrained. The same can be said for each component observed. The conclusion of which is that the Manager of Fund A has a substantially higher DIF than the Manager of Fund B.

The overall DIF value can be mapped for each fund allowing investors to readily see the historic and potential[1] profile.

For illustration purposes, the benchmark used is a low duration government bond index. It represents 'static' exposures and therefore has the lowest possible DIF value.

The DIF framework is used to analyze the dynamic decision making potential of an investment strategy. Investment strategies can be compared to enhance diversification and proper positioning. DIF analysis enables investment managers to articulate and differentiate their investment capabilities while demonstrating their value potential for fees.

DIF Values and Flows

Investors have made massive shifts in use of investment products over the last ten years and particularly since the Great Recession. Flows into mutual funds, as seen through the lens of DIF values has trended in two polar opposite directions (FIGURE 2). Investors have sought passive strategies offering 'access' to a particular market or beta as indicated on the left side of the DIF range. On the other, they have invested with highly flexible, often unconstrained approaches as indicated on the right.

This has left the middle ground represented by traditionally benchmarked strategies with very modest DIF values in an increasingly precarious position.

For the universe of fixed income funds analyzed, there is a clear correlation between the DIF Values of funds and their respective average management fees (FIGURE 3). Lower DIF value funds are not able to charge the same level of fees as their higher DIF value counterparts.

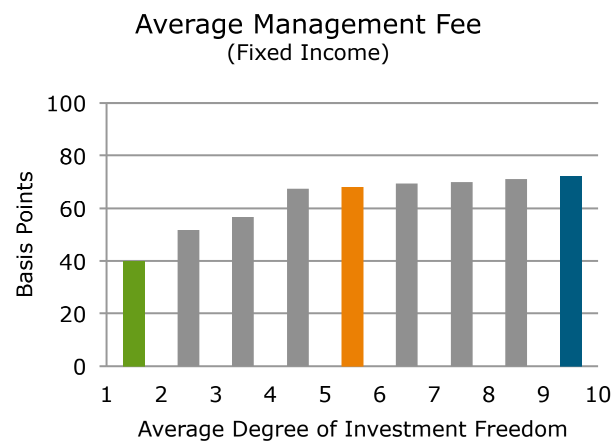

Figure 3. Analysis: Propinquity

Conclusion

We believe that the Degree of Investment Freedom framework is essential for understanding the dynamic evolution of the global investment management industry.

At its core, DIF is an innovative approach to evaluating and positioning investment products consistent with investor demands to evaluate and set expectations for managers on a broader basis than the legacy approaches available.

We invite your interest in exploring how the Degree of Investment Freedom framework could be useful in providing more robust and transparent measures to articulate and differentiate your investment offering.

Footnotes:

[1]DIF values can be calculated on both an ex post and ex ante basis. The analysis shown herein utilizes 'realized' (ex post) data. This historically oriented approach shows developments over the last 10 years on products for which data was available (January 2006 to December 2015). Please contact Propinquity for a detailed explanation of methodology for calculating DIF values.

Notes on Data & Methodology:

A total of 9,335 US and 'cross border' fixed income funds were considered for the study. Net flow and exposure data for the eight fixed income components (duration, sector, credit, emerging vs. developing, geography, currency, asset class and cash) were captured for each fund over the 10-year period from Jan. 2006 to Dec. 2015 on a monthly basis. Using the proprietary Propinquity DIF framework all 9,335 funds were assigned DIF values for each component subject to availability. Single-market funds (with the exception of the U.S.) were excluded in addition to any fund with less than $100 million USD in assets as of December 31st, 2015. Ample data for six or more of the eight components was also required for the analysis to calculate an average DIF value. After these conditions were imposed 2,063 funds remained for the organic growth rate (OGR) and management fee analysis summarized in figures 2 and 3 respectively. The OGR over a particular period is defined as the net flows during the period (January 1st, 2006 to December 31st, 2015) divided by the initial asset base (December 31st, 2005). The management fees from the oldest share class as defined by Morningstar, and figure 3 is equal-weighted. All data sourced through Morningstar Direct at the time of analysis unless noted otherwise.

About us:

Propinquity provides strategic research and advice to investment management companies seeking to measure, optimize and thoughtfully grow their businesses. In support of our clients' objectives, Propinquity conducts original research into the evolving themes driving the direction of the investment management industry. Propinquity assists its clients in understanding the drivers of these themes and positioning their capabilities and products in the global distribution markets.

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