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9 Partners for the Next Decade

Fund providers with strong prospects are differentiated and offer low-cost, repeatable investment strategies.

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The past decade has been a disruptive one for asset managers and their fundholder clients. Investors have been put off by the poor performance of actively managed funds, and they've increasingly sought lower-cost options. As a result, investors have moved assets to passively managed indexes and exchange-traded funds in droves.

What's more, coming regulation and competitive forces are changing the way some funds are distributed. For example, broker/dealers are becoming more discriminating about which funds they'll offer to clients. Funds with poor performance and high expense ratios are less likely to be offered for sale on the major platforms.

Actively Managed Funds for the Next Decade

Taken together, these trends are putting significant pressure on asset managers. To be successful in the coming decade, asset managers will be best served by differentiating themselves from the competition, offering low-cost funds with repeatable investment strategies, and adapting prudently to the changing competitive landscape.

Differentiation

In an era when investments are facing higher scrutiny, active managers must be able to differentiate their approaches and offerings from the pack. One way to do so is with pure scale of assets under management. Others may do so with a deep, well-known expertise in a single asset class or investment type. Another approach is to diversify, offering a variety of well-supported investment capabilities and services that appeal to a broader set of clients. Such differentiation will take many forms, but will likely be a theme among active managers that weather industry disruption over the next decade.

Low-Cost Funds

Good partners for the next decade will offer inexpensive funds. By lowering funds' expense ratios, asset managers give their investment products a leg up and better the odds that they'll outperform the passive competition. Lower expenses and better performance are more likely to yield scale, but asset managers' profit margins will decline, too. Asset managers that have been mindful of cost to date are under less pressure to dramatically lower fees in the near future, giving them a competitive advantage as well as steadier profit margins and healthier earnings.

Repeatable Investment Processes

Active asset managers will require reliable, repeatable investment processes that yield strong performance overall. These processes should be backed by experienced, stable investment teams that are well-resourced in terms of personnel and tools, including risk-management analysis. The resulting investments typically have predictable return patterns, making them better tools in a diversified portfolio. Firms that have such investment processes avoid key-person risk through thoughtful succession planning.

Adaptable Business Models

Finally, active managers will need adaptable business models. When growth is harder to come by, firms take a variety of actions. They may overhaul their leadership or investment processes, buy a competitor, or branch out into passive or strategic-beta strategies. We expect these responses will become commonplace in the coming years, and the impact of each requires careful evaluation by fundholders. In general, we look positively on firms whose actions are designed to protect their moat, or competitive advantage, and we look skeptically on firms that are working to repair a serious deficiency. Such repairs are difficult to execute well.

Promising Partners for the Next Decade

Looking collectively across the four traits that will drive success going forward--differentiation, low costs, repeatable investment processes, and adaptable business models--several firms are especially representative of these trends. They're promising partners for the next decade.

Vanguard

Among the best-positioned industry leaders, Vanguard's business model is differentiated and formidable. The firm's mutual ownership allows it to offer investments at cost, and that, along with a robust lineup of straightforward active and passive investments, has made it the largest retail money manager. At $3.4 trillion in assets, the law of large numbers will catch up with Vanguard, and indexing could suffer in a market correction, which would lead to outflows. Even so, we have issued forward-looking, qualitative Morningstar Analyst Ratings to 84 Vanguard funds and ETFs, 79 of which are rated Gold, Silver, or Bronze, indicating that we think these funds will outperform their benchmarks and typical peers over a full market cycle.

Schwab

We are highlighting Schwab for its more-recent arrival to the passive scene. Its launch of plain-vanilla ETFs with very competitive prices is a strong example of a firm adapting its approach to the changing competitive landscape. Inflows to the ETFs have boosted Schwab's market share and have attracted and kept investors on the firm's brokerage platform. That low-cost approach and access to distribution through Schwab's retail and advisory platforms will fuel further growth in the coming decade. On the manager research side, we have assigned Morningstar Medalist ratings to 18 of this firm's funds. And on the equity side, Morningstar Research Services assigns a wide Economic Moat Rating to Charles Schwab (SCHW), indicating a strong competitive advantage.

DFA

Over the previous decade, Dimensional Fund Advisors, or DFA, has demonstrated the power of asset-gathering that can come from strategic-beta strategies. DFA's cost advantage comes from its quantitative, repeatable strategic-beta strategies, and its 10% three-year annualized organic growth has made it a top-10 industry player. We think DFA has staying power. All 21 of the firm's funds that earn Analyst Ratings are medalists, which is a strong endorsement of the investment process at this firm. To be sure, the strategic-beta landscape gets more competitive each day, but DFA's business model and investing approach give it a sustainable edge.

BlackRock

BlackRock is known for its scale through its passive iShares ETFs, as well as its investment scale among institutional accounts. Beyond passive investing, BlackRock has a strong reputation for active fixed-income investing, with many of its active bond funds earning medalist ratings. Its fixed-income data platform, Aladdin, is another differentiator that should contribute to this firm's staying power and industry influence in the years to come. BlackRock's vulnerabilities include its active equity fund lineup, which is undergoing a makeover, as well as prolonged underperformance of indexed funds. Even with those risks, we've issued BlackRock's (BLK) stock a wide moat rating, indicating its relative competitive advantage among publicly traded asset managers.

American Funds

Another strong partner for the next decade is Capital Group's American Funds. These funds have been redeemed in recent years, victims of the flight to passive investing. Even so, the firm's returns are competitive on a risk-adjusted basis, primarily because American Funds' approach to managing assets in sleeves across multiple independent managers has been effective. The funds' multimanager approach limits succession risk. The firm also has an edge when it comes to low fees. Morningstar rates more than 92% of American Funds' assets across 23 funds as Gold, Silver, or Bronze. This shop has some vulnerabilities on the fixed-income side, but overall, we think it has long-term appeal.

T. Rowe Price

T. Rowe Price stands out among the large firms for its consistent and repeatable investment process. This firm is a leader at succession planning, doing more than most competitors to eliminate generational-transfer risk that comes with portfolio managers' retirements. T. Rowe Price also has been mindful on the cost side. Many active competitors are realizing now that their higher fees have been a disservice, but T. Rowe Price has been cost-conscious all along and will be under less pressure to cut fees and costs. The firm's profit margins and earnings should be more stable and predictable going forward. Like BlackRock, T. Rowe Price's (TROW) stock carries a wide moat rating. And Morningstar's manager research analysts are bullish on T. Rowe's funds, too. Thirty-eight of the firm's funds are rated Gold, Silver, or Bronze because of its proven, repeatable investment processes, smart management succession planning, and lower fees.

Dodge & Cox

This California-based shop uses a low-turnover value strategy among its actively managed funds. That approach can run hot, producing great returns--as it has recently--or cold, as it did during the financial crisis. But the team-based investment process is tested, consistent, and well-supported. That bodes well for the firm's six funds going forward. Low fees give the firm another competitive advantage. We have Gold ratings on five of the firm's older funds, nearly 100% of firm assets.

Primecap Odyssey

Another firm with a strong, team-based approach to active equity investing is Primecap Odyssey. The firm subadvises three funds for Vanguard, and on its own it offers just three active equity strategies, all rated Gold. Performance across the lineup has been strong, which is a rarity in active equity, and expense ratios on the funds are low relative to the competition. This firm actively avoids the spotlight and is unlikely to pivot if its approach falls out of favor. Those potential drawbacks seem relatively slim; we think this firm will be a good partner going forward.

Parnassus

Parnassus is another firm that's been growing quickly with strong-performing, actively managed investments, but it's also riding another growth wave: ESG investing. The firm uses environmental, social and governance criteria for its stock-picking, and an increasing number of investors are including ESG funds in their portfolios. We expect ESG investing to grow in popularity over the next decade, particularly since wealth is growing among women and millennials--two demographics of investors who say they seek ESG investments. Otherwise, we think this firm has a sound investment process--three of its six funds are medalists. This firm could be humbled should its funds hit a performance snag that triggers outflows.

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