

Canadian Investment Funds Industry: Recent Developments and Outlook



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Introduction

The International Investment Funds Association reported that, at the end of 2018, total worldwide assets in mutual funds (open-ended and fund of funds), and exchange-traded funds (ETFs) were \$50.4 trillion, with ETFs making up 9.3% of the total¹. These assets were held in approximately 126,000 different funds. Whatever statistics are used, it is evident that the global investment funds market remains substantial and complex.

This report has been commissioned by The Investment Funds Institute of Canada (IFIC) to act as a point of reference about the current state of the investment funds industry in Canada, and the changes that have taken place in the business environment in which the Canadian investment funds industry operates.

Investor Economics, a Strategic Insight business, has structured the report on the basis of key themes and areas of unique development, such as the shift from commission-based accounts to fee-based accounts. The report examines, at a high level, the role of investment funds in the day-to-day savings and investing activities of Canadians; the products that have been and continue to be used by savers and investors; how these products are accessed by Canadians of various levels of wealth and investment knowledge; and the nature of the changes to the various elements within the investing cycle and environment that have occurred over the past decade.

Despite the severe capital market difficulties of the early part of the decade, changes in regulations impacting both manufacturers and dealers, and the shifting demands of financial consumers, the Canadian investment funds industry has recorded steady growth in assets while, at the same time, taking advantage of the scale of the industry to reduce costs associated with the purchase and holding of investment funds.

The report does not provide detailed analysis of specific issues but, rather, seeks to present topics in a straightforward and objective manner in order to provide a background to discussions by industry participants of all types.

¹ IIFA Industry Statistics: Fourth Quarter 2018.

Resources and Methodology

The development of this report has relied heavily on the databases maintained and managed by Investor Economics, the leading independent authority on investment funds in Canada. In addition to the databases, considerable use has been made of the ongoing analysis of the investment fund industry undertaken by Investor Economics in Canada and its parent organization, Strategic Insight, in the United States and other major markets.

Over and above these proprietary resources, IFIC data and third-party survey results have also been used to provide evidence of the various developments referred to in the report. As necessary, Investor Economics has also accessed reports, presentations and articles dealing with the key issues mentioned in the report. Care was taken to ensure the quality and integrity of third-party sources.

Where any non-proprietary sources have been used, appropriate references have been made in the report. In cases where explanations or additional comments are appropriate, footnotes have been used.

Throughout the report, information sources have been recognized using references within the text of the report. Year-end 2018 data has been used where available; in cases where the data is not available for 2018, the most up to date data available to Investor Economics has been used.

Executive Summary

At the end of 2017, investment funds, which include mutual, individual segregated and exchange-traded funds, reached \$1.6 trillion in assets in Canada. This represented 36.1% of total personal financial wealth—a measure of discretionary financial assets that excludes equity in real estate and assets held in defined benefit pension plans. Investment fund assets have grown consistently in Canada (and most developed countries globally) over the last decade as a by-product of rising capital market valuations and healthy economic growth, which contributed to generate sustained levels of household savings.

Beyond the favourable macroeconomic environment, however, a number of factors endogenous to the financial services industry have had a great influence in the growth of investment funds in Canada and beyond. Changing advisor practices, innovations in product design and the growing scale of the business have all contributed to make investment funds one of the fastest-growing cornerstones of household financial wealth.

Nearly half of all Canadian households owned mutual funds in 2017 and almost two thirds of their registered retirement savings plans (RRSPs) were held in the form of mutual funds.

Influences on product design

The number of seniors aged 65 and older outnumbered children aged 15 and under for the first time in 2016². This changing demographic profile of the Canadian investing public has exerted, and will continue to exert, impact on the various aspects of the investment funds industry. This impact ranges from product design, through to the type of delivery needed, to the willingness and possibilities of households to save, to the ability and desire to assume investment risk and to the length of the investment time horizon.

As demographic trends develop, investment fund managers and distributors face two dilemmas: How can they meet the needs of those over 65 who seek income and capital preservation solutions, along with face-to-face contact with an experienced advisor, at the same time as they retool themselves to attract the attention of millennials which may favour alternative approaches to investing? And also very importantly: How can they assist millions of pre-retirees who are still unprepared to fund their retirement both from a personal and group savings standpoint, in growing a sufficient portfolio?

Beyond the overarching demographic trends, fund product developments have also been influenced by four factors likely to continue over the medium term. First is the changing nature of competition at a product manufacturing and a distribution level and the emergence of non-traditional competitors, followed by regulatory changes focused on investor protection through enhanced transparency and investor education. Third are the changing attitudes of investors toward risk and value as they look to preserve capital, and, lastly, is the ongoing impact of new technologies on all stakeholders. All these factors will determine, individually and collectively, product design, pricing and features.

These influences and issues have created an environment that has spawned two specific and far-reaching trends: The rapid expansion of the ETF product shelf and their positioning as both a complement and a competitor to mutual funds, and the movement from conventional stand-alone funds toward fund-based asset allocation solutions, such as fund wraps.

² <https://www150.statcan.gc.ca/n1/pub/11-627-m/11-627-m2017016-eng.htm>

The growth of exchange-traded funds

In 2008, Canadian ETFs represented 2.9% of total investment fund assets. By 2018, that share had increased to 9.3%. The asset growth and proliferation of ETFs experienced in recent years reflects an interplay of a number of factors.

ETF issuers emerged from the 2008-2009 bear market with renewed vigour to cultivate relationships in, and engage with, a wide range of direct, advice and institutional investment delivery channels. Over the past decade, helped by strong equity markets which boosted investment returns of these mainly index-tracking investment vehicles, ETF issuers have successfully built a presence in advisor-led investor portfolios and on diverse product and distribution platforms. ETFs have become a ubiquitous portfolio construction tool for retail advisors, self-reliant investors and institutional portfolio managers, attracted by the vehicle's liquidity, diversification and cost characteristics. The latter feature could be leveraged in an environment of growing scrutiny of the costs associated with owning investment products fuelled by regulatory and media interest. Similarly, the continuing shift towards unbundled advisor fee-based models, in which an advice fee is charged outside of the product expense structure, expanded the distribution opportunity for ETFs.

Against the backdrop of these factors, the past decade saw the ETF asset base expand rapidly as strong equity market returns buoyed valuations and both the availability and the product range increased significantly.

Despite its generally positive experience and prospects, the ETF sector faces a number of challenges. Firstly, ETFs may be perceived to be subject to market risk, liquidity risk and concentration risk, factors which may not be suitable to every individual³. Secondly, scale is more important to low-cost providers and reaching a level of assets and revenue required to be profitable is difficult, particularly for new entrants and independent issuers. Thirdly, competition has intensified, as a growing number of companies, as well as major domestic bank-owned managers, have launched ETFs over the past five years. Also, competition does not respect borders, as Canadian ETFs coexist with U.S.-listed ETFs in the platforms where they are available. Finally, product proliferation and commoditization make it difficult for issuers to take advantage of novel products and strategies for long as competitors are quick to imitate products that are well received by investors and advisors.

Fund wraps gaining share

Asset allocation solutions have been gaining ground globally over the last decade. Both fund-based asset allocation solutions (fund wrap programs) and fee-based accounts, where advisors have discretion to execute and rebalance a diversified portfolio, have grown significantly in recent years as technological advancements, the scale of the business and overall competitive dynamics combined to allow fund services providers to deliver more value for the same (if not declining) price.

Fund wraps have, over time, eroded the market share held by stand-alone funds. At the end of 2013, stand-alone funds held a 72.6% share of the mutual fund market, a share which declined over the five-year period to 62.9% in 2018. The product benefitted from several previously mentioned trends (such as the need to manage market risks), but also from its time efficiency features for advisors. By delegating asset allocation, investment selection and rebalancing to professional overlay management teams engaged by fund wrap manufacturers, advisors—primarily in the financial advisor (FA) and branch advice (BA) channels—have gained bandwidth to focus on working with their clients on their financial needs and financial plan construction.

³ Patricia Meredith and James L. Darroch, *Stumbling Giants: Transforming Canada's Banks for the Information Age*, (Toronto: Rotman-UTP Publishing, 2017), 103-104.

Distribution of investment funds.

Currently, do-it-yourself channels, online advice (often referred to as robo-advisors) and direct-to-investor channels, remain largely the expansionary domain of ETFs. Hybrid channels that combine the best elements of digital- and advisor-based channels, are set to expand at higher rates than those of the conventional advice-based networks and will likely carry all investment funds with them. Penetration by deposit-takers is expected to increase as the banks' dedicated mass affluent sales and service models expand wealth management at the branch level. Insurance companies, which intensified their focus on the wealth management business after the market event of 2008, have leveraged their growing ownership of the mutual fund-centric dealers in the financial advisor channel to expand their presence and a number of independent dealers have also continued to expand their asset base.

The shift to unbundled fee-based advisor practice models represents one of the most significant changes in practice management across the advisory channels over the past two decades. The full-service brokerage (FSB) channel led this charge in the early 2000s, accelerating following the 2008 downturn, and has been more recently joined by the dealers in both the FA and BA channels. By 2026, it is expected that \$2.9 trillion in assets will be held in discretionary and non-discretionary fee-based accounts, across all distribution channels, an increase of \$2 trillion, the equivalent of an 13.0% compound annual growth rate over the decade⁴.

Drivers of the move to fee-based accounts

A number of factors will continue to drive the movement to fee-based practice models, including specific practice management decisions made by advisors and their firms, as well as external factors such as recent and expected regulatory changes. These factors are motivating dealers and their advisors to develop business models that are increasingly transparent and flexible with respect to fees and that closely align their practice interests with those of their clients. The ongoing shift to fee-based practices has led asset managers to increase their shelf of F-series mutual funds and incorporate ETFs. Asset managers have also been sharpening their pencils to ensure the pricing of their products is attractive to these advisor practice models.

Concerns exist that the move in favour of fee-based accounts may represent a disadvantage to small investors and may limit the amount of advice available to those who may need financial guidance. This has been the case in both the U.K. and Australia, where changes to account structures, brought on by regulation and not by market forces, have taken place. It is germane that the shift to fee-based has been the strongest in the FSB channel where the target client segment is further up-market than in the financial advisor channel. Not lost in the equation is that the shift in the FSB channel had been well underway before the introduction of the Client Relationship Model – Phase 2 (CRM II) or the more recent introduction of client focused reforms and changes to mutual fund fee structures.

⁴ Investor Economics' *Household Balance Sheet Report—Canada 2017*, Appendix 13: Statistical Tables.

Competition

The Canadian investment funds industry is a mature industry, demonstrated by both its relative size and its level of concentration. At the end of 2017, 145 managers accounted for \$1.6 trillion in fund assets. Of that total, 65.6% of assets under management (AUM) were managed by the top 10 firms, five of which were bank-owned.

Among other factors, business concentration has been impacted by the size of mergers and acquisitions (M&A) activity. Over the five-year period ended 2017, there were 10 transactions in the Canadian investment funds industry involving the transfer of approximately \$23.8 billion in AUM. Yet despite transactions aimed at consolidation, there have also been a number of new entrants over the past decade, although their record of success has been mixed.

This activity within the industry suggests that there are fewer barriers to entry than there are barriers to achieving significant scale. These barriers include constraints on the shelf space of dealers and advisors; the absence of a unique selling point or competitive advantage for many fund products; difficulties for the firm to invest heavily in technology; and an inability to attract or, in some cases, to retain, innovative and experienced talent. Additional hurdles that may restrict new entrants include the dominant position of a small group of managers; pricing levels that prevent a reasonable break-even period; current and possible additional industry regulatory changes that may impose costs on firms either unprepared or unable to bear them.

These barriers and the overall level of maturity of the industry argue against medium-term expansion of the industry in terms of participant numbers, particularly within the mutual fund sector. It is worth noting that concentration, at an even faster pace, has been also witnessed in the two primary advice-based channels; those regulated by the Investment Industry Regulatory Organization of Canada (IIROC) and those regulated by the Mutual Funds Dealers Association of Canada (MFDA).

Technology

Asset and wealth managers recognize that technology is an essential part of the infrastructure of the investment process, irrespective of whether the application of technology is in the area of research, investment selection, trading, risk management, operations, or client servicing. Pressure to accelerate change through the application of technology has been exerted through a combination of factors already discussed, including margin pressures and investor demand for greater value at a time when digital service expectations are growing and the opportunity to become more self-reliant is increasing.

Greater operational sophistication in both the middle- and back-offices, improved investment selection and multi-platform distribution are all advantages that will accrue to the asset and wealth management industries through the adoption of technology. One area of risk associated with technology that is coming to the forefront for both asset managers and their clients is cybersecurity and the protection of client data and other personal information, which is now recognized as one of the leading risks that has to be managed by the financial services industry⁵.

Both the application of technology and the expanded use of digital tools and channels have some fundamental implications. Many larger firms are, and will remain, more able to make the necessary capital investments in technology than will their smaller counterparts. While the application of technology is likely to reduce costs over time through the displacement of

⁵ https://www.brookings.edu/wp-content/uploads/2018/10/Healey-et-al_Financial-Stability-and-Cyber-Risk.pdf

personnel, the immediate impact of the implementation of a technology strategy will often involve higher operational costs.

There is also the risk that the asset and wealth management industries will attract the attention of extant technology-based businesses, whether start-ups or established companies, such as Amazon. These businesses will be encouraged by the slow-to-adopt nature of wealth-related industries, as well as the positive outlook for growth in asset management and the limited capital requirements when compared to other sectors, such as banking.

The outlook remains positive but slower growth is ahead

The pressure on asset manager margins may lead to a further contraction in the number of major participants in the industry over the medium term. The Canadian fund industry has matured and is expected to move through a period of relative stability and consolidation, rather than a period of expansion. However, on the assumption that the headwinds of change are addressed through the introduction of innovative strategies and a willingness to invest in technology and digital solutions at all stages, the outlook for most fund manufacturers and fund distributors remains positive.

The medium-term future of the Canadian investment funds industry is partly reliant on the ability of participants to anticipate and respond to the financial needs and expectations of various age segments, particularly baby-boomers. In the medium-term, notwithstanding the limited flows that are expected, the sheer size of the baby-boomer cohort and the wealth that they currently control will offset any negative impact on the investment fund industry brought about by the indebtedness and new attitudes to savings and investments from younger generations.

The outcome, at least over the medium term, will be further, if muted, growth for the Canadian investment funds industry as the growth of exchange-traded funds continue to outpace mutual funds and a companion move from across-the-desk advice to do-it-yourself electronic platforms and artificial intelligence takes place.

Role of Investment Funds

At the end of 2007, total assets of the 14.7 million households in Canada stood at \$8.2 trillion, of which \$2.5 trillion was in the form of financial wealth, a category that excludes assets held in government defined benefit (DB) pension plans, private companies, real estate and life insurance. Within financial wealth, fixed income investment funds represented 4.2% and balanced and equity funds 18.9%. Ten years later, at the end of 2017, the financial wealth held by 15.9 million Canadian households had risen, despite a severe economic recession at the early part of the decade, to \$4.5 trillion.

Concerns about wealth preservation, coupled with a decline in long-term interest rates, resulted in fixed income investment-fund holdings, in absolute terms, quadrupling to \$425 billion, representing a 9.5% share of financial wealth. Equity and balanced investment funds added \$521 billion in holdings over the period, totalling \$1.1 trillion and representing 25.6% of financial wealth at the end of 2017.

Figure 1: Canadian Financial Wealth and Number of Households

	2007	2017
Canadian financial wealth	\$2.5 trillion	\$4.5 trillion
Number of households	14.7 million	15.9 million
Average wealth per household	\$172 thousand	\$281 thousand

Ownership of mutual funds

Viewed on a household basis, using the latest available data, investment funds per household (not only those that invested) at the end of 2007 were \$54,495, a total which increased to \$101,350 by the end of 2017 and represented a CAGR of 6.4%. This rate of growth was 1.4% higher than the rate of growth of total personal wealth over the same period. Put another way, both new flows and generally positive capital markets contributed to the growth of fund holdings, although the impact of the markets materially outweighed that of flows.

Data from approximately 8.9 million Canadian households served by members of the Mutual Fund Dealer Association of Canada⁶ (MFDA) indicated that, as at year-end 2016, 27% of the assets administered by MFDA dealers were held by households with assets of less than \$100,000. Those households made up 81% of all households served by MFDA dealers. At the other end of the scale, MFDA-serviced households with more than \$500,000 in assets accounted for just over 2% of the households, but also held 27% of balances administered by those dealers.

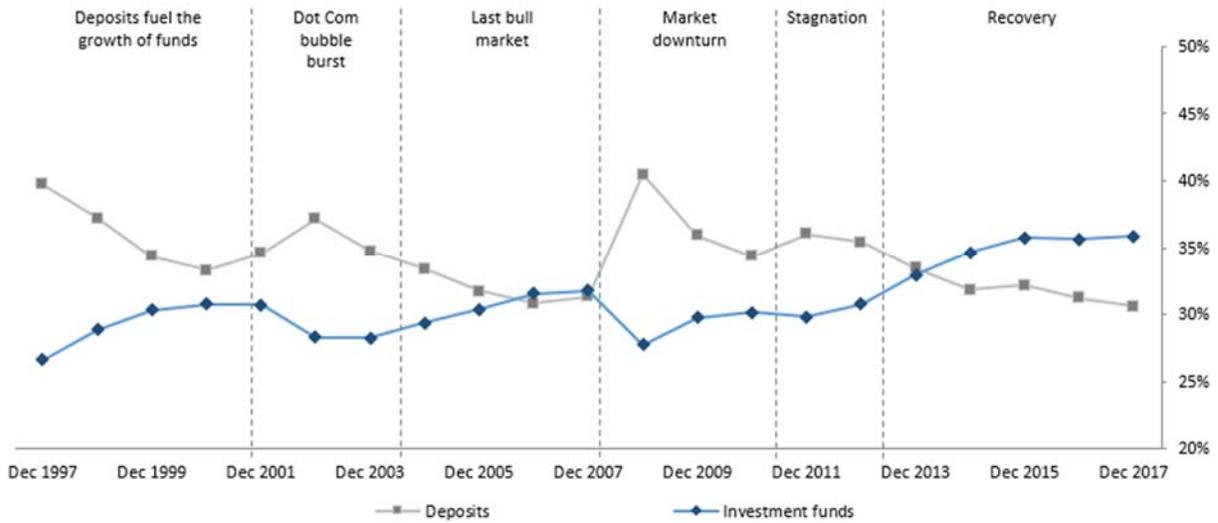
⁶ MFDA Client Research Study, 2016.

The usage of investment funds by Canadians is often hard to gauge, although recent surveys provide some guidance. A 2017 survey of investors by the Canadian Securities Administrators⁷ indicated that 47% of respondents who had savings set aside for the future owned at least one mutual fund⁸ and that 13% of this total sample owned an exchange-traded fund.

Since 1990, there has been a gradual, but persistent, restructuring of the savings and investment assets held by Canadian households. Specifically, investors have favoured market-sensitive instruments over both variable and fixed-rate deposits. In 1990, deposits represented 68.3% of household financial wealth. By 2000, the share held by deposits had decreased to 33.3% and, by the end of 2017 and despite a lingering uncertainty created by the market correction of a decade ago, the share of financial wealth held in deposits had fallen to 30.2%. Although this level of ownership of deposits may seem low, the comparable share in the U.S. is 9.4%⁹.

Historical data suggests that, over this 30-year period, only downturns in equity valuations or periods of high volatility have persuaded Canadian investors to rapidly and briefly lower their overall risk profile by allocating more assets to deposits and to various fixed income instruments.

Figure 1.2: Share of Financial Wealth Held in Deposits and Investment Funds



⁷ 2017 CSA Investor Index, November 23, 2017.

⁸ It is worth noting that the IFIC website indicates that 33% of Canadians owned mutual funds as of 2017.

⁹ Strategic Insight U.S. Asset Management Industry Market Sizing: 2018-2023

The move toward market-sensitive investments

In the past decade, however, substantial flows into investment funds have been influenced not only by positive equity markets, but also by a prolonged period of historically low interest rates. Such modest returns encouraged investors to move up the risk-reward scale by increasing their exposure to market-sensitive investments in search of higher rates of return. Interest rates offered by deposits, which were at historically low levels until 2017, were further reduced by inflation: The inflation-adjusted nominal five-year GIC rate peaked in 2008 at 1.7% and subsequently reached an all-time low in 2010 and 2011 at -0.4%.

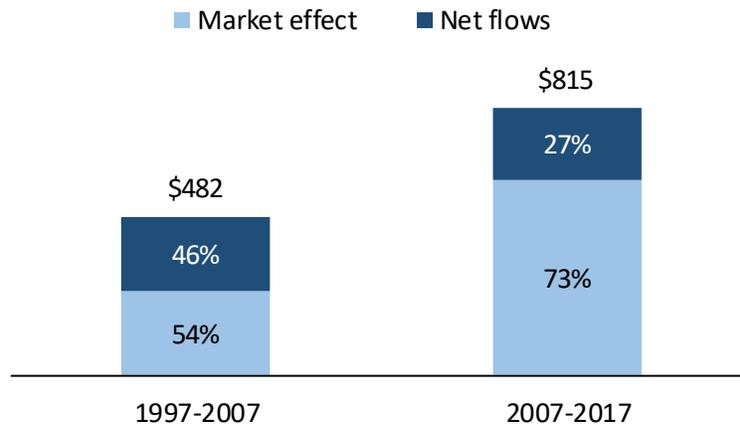
That said, rate initiatives taken by the Bank of Canada and other central banks over the 15-month period ended October 2018 to place the brakes on the expansion of credit and to contain inflation within policy guidelines may herald a modest slowing of inflows into all types of financial assets as households prioritize debt reduction.

Investment-fund flows

A combination of the amount of liquidity on personal balance sheets and the changing risk appetites of Canadians have fuelled expansion of the investment-funds industry in Canada since 2010. Growth in investment funds has outpaced other medium- and long-term financial products, such as guaranteed investment certificates (GICs), market-linked notes (MLNs) and directly-held equities and bonds.

Over the past two decades, and despite the events of 2008 and 2009, long-term investment-fund growth has totalled \$1.3 trillion. This growth has been driven by both strong net flows and positive market effect. Between 1997 and 2007, net flows accounted for 39% of investment funds growth, a share which declined to 27% between 2007 and 2017. Market effect, however, proved to have a much greater impact on investment funds' growth, as global capital markets recovered from the financial crisis and recorded only three years of negative returns between 2007 and 2017¹⁰.

Figure 1.3: Investment funds growth: Net flows versus market effect
Assets in billions of dollars



¹⁰ MSCI WORLD INDEX (USD).

Registered savings vehicles

A portion of the flows into investment funds has been driven by contributions to registered retirement savings plans (RRSP). In each of the past 10 years, investment funds have represented over 50% of total assets held in RRSP accounts: At the end of 2017, 59% of RRSP assets were in the form of investment-fund units¹¹. Using CRA tax filer data, gross contributions to RRSPs have steadily increased, rising from \$31.1 billion in 2006 to \$39.9 billion in 2016. It is worth noting that, over this 10-year span and despite the increase in the amounts contributed to RRSP accounts, approximately 270,000 fewer Canadians have been contributing to these retirement savings vehicles. Reasons for this decline in popularity likely include the advent of the tax-free savings account (TFSA) and the number of baby-boomers reaching age 71.

In 2009, in a move to boost the national savings rate through tax relief to savers, the Canadian government introduced a new savings option through the launch of TFSA. While both the use and the purpose of the TFSA in the retirement savings matrix have been the subject of debate, the TFSA has been widely accepted as an all-purpose savings vehicle and one which has been a contributing factor to the lower levels of participation in RRSPs.

Based on Investor Economics' analysis, assets in TFSAs rose from \$40.7 billion in 2010, the year following its introduction, to \$300 billion in mid-2018. While initial inflows were due to the account's general-use nature, which allowed it to attract a portion of existing savings held in taxable accounts, TFSAs, notwithstanding limits on new contributions, have continued to benefit from consistently higher contributions than withdrawals. At the outset, investment funds represented 6% of total TFSA account balances. However, allocations to investment funds have risen in line with the improvement in equity markets and, by mid-2018, allocations to investment funds accounted for 37% of total TFSA assets.

The individualization of retirement assets and savings

The growth in the relative importance of investment funds to Canadians is not the result of a single driver, such as the juxtaposition of interest rates and equity values, or the introduction of new savings vehicles, but is rather the confluence of a number of factors, including the ability and propensity of Canadians to save and the emergence of retirement risk.

Retirement risk is the risk of individuals failing to accumulate sufficient assets to adequately fund their retirements, either in terms of the lengthening years of retirement¹² or in amounts sufficient to cope with inflation or other financial pressures. An increasing number of Canadian households are facing retirement risk due to inadequate levels of savings, as well as decisions taken by their employers to download retirement risk from corporate balance sheets to individual employees. A study produced by Broadbent Institute¹³ found that nearly half of Canadian couples between 55 and 64 did not have an employer pension between them, with the majority of these families (more than 80%) having inadequate retirement savings. While this study highlights concern for retirement preparedness among Canadians, other studies have shown a more optimistic view, particularly when accounting for "Pillar Four" assets. These assets refer to funding and income sources, such as non-registered savings and investments, ownership in privately owned businesses, insurance products, real

¹¹ Investor Economics' *Household Balance Sheet Report – Canada 2017*.

¹² Retirement is lengthening due to the general age of retirement remaining at age 65, even as the average lifespan of Canadians has exceeded 80 years of age.

¹³

http://www.broadbentinstitute.ca/canadians_approaching_retirement_with_totally_inadequate_savings_seniors_poverty_rate_s_increasing_new_study

estate equity and potential inheritances, and which may individually or collectively improve the retirement readiness of Canadians¹⁴.

Expansion of the Canada Pension Plan (CPP)

In June 2016, the federal government announced an agreement to expand the CPP in order to increase retirement benefits for Canadians who contribute to the plan. While annual contributions are expected to increase modestly over a seven-year period starting in 2019, the enhancement is forecast by the federal government to reduce the share of households at risk of not having adequate retirement savings from 24% to 18%.¹⁵

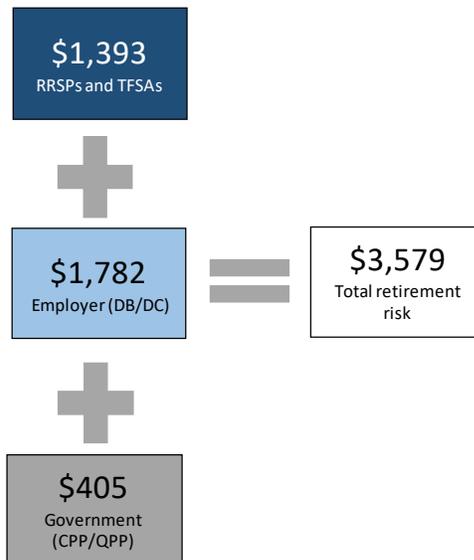
The seven-year implementation period and the extent of the contribution increase are not expected to have a major impact on the investment industry, despite the fact that CPP contribution rate increases have, historically, crowded out some personal retirement saving flows. While the expanded CPP will improve the income replacement level from 25% to 33% of eligible earnings, the majority of pension responsibility will continue to remain with the individual.

Passing the retirement risk

The catalyst for the movement away from defined benefit (DB) plans has been the negative impact of rising pension liabilities and pension-fund shortfalls on corporate balance sheets. DB pension plans, a relatively standard employee benefit until the late 1990s which place a burden of responsibility on employers, were severely harmed by the financial crisis of 2008. Companies suffered significant funding deficits that were brought on by poor or negative market returns, as well as a lack of cash resources to fund the deficits. As a result, many employers stopped offering DB plans to new employees. While DB plans accounted for two thirds of all registered pension plan assets in 2016¹⁶, their share of total pension assets has steadily declined in recent years as most new employees (excluding those in the public sector) are not offered membership. From 2002 to 2012, the proportion of private-sector workers covered by DB plans fell from 73% to 48% and, subsequently, to 29% in 2016¹⁷.

Figure 1.4: Canadian retirement risk

Assets in billions of dollars as at December 2017



¹⁴ C.D. Howe Institute, *The Bigger Picture: How the Fourth Pillar Impacts Retirement Preparedness*, September 2016.

¹⁵ Government of Canada, Department of Finance, *Background: Canada Pension Plan (CPP) Enhancement*.

¹⁶ Statistics Canada: Table 11-10-0106-01 (formerly CANSIM 280-0016).

¹⁷ Ibid.

Preparedness for retirement

As individual households assume greater responsibility for their retirements, irrespective of their ability to do so, they are required to make frequent investment decisions and to exercise an increased level of control over their retirement assets. This is in contrast to the member's position in a DB plan, where the employer assumes the funding and market risks and maintains control over the plan assets. In a defined contribution (DC) pension plan, employees and employers share in the investment decision-making, as employers curate the investment shelf from which employees select the investment funds; however, the risk of failing to accumulate assets sufficient for retirement is fully borne by the employee.

The impact of group savings

Due to the declining availability of private sector DB pension plans and the resultant privatization of retirement savings, there has been a notable shift toward the use of investment funds within pension plans and group retirement plans. Based on Strategic Insight's group retirement savings research, investment funds (including special group pools) accounted for over 80% of surveyed capital accumulation plan (CAP)¹⁸ assets at the end of 2017¹⁹.

Within the CAP market, individually administered accounts and member participation in the investment selection process have led to greater use of unitized products within plan investment menus. At the same time, evolving economic and capital market environments have resulted in revised product suitability views for long-term investment horizons. This has ultimately encouraged greater usage of target-date funds and balanced funds as default investment options, as opposed to shorter-term investments such as money market and deposits instruments.

Despite the greater adoption of more suitable long-term investment options, individual plan participants and investors continue to bear the risk of failing to achieve financial security. With an upward-trending average life expectancy and a static retirement age of 65, the risk of outliving one's assets in retirement has been magnified in recent years. Between 1996 and 2016, the average life expectancy at age 65 increased by approximately 2.6 years in Canada²⁰.

In summary, as Canada's aging population has been required to supplement conventional pension income with personal savings, individual investors have turned toward market-sensitive investments to achieve long-term financial goals. A greater willingness and need to assume a degree of volatility in their portfolios has helped shape the demand for unitized access to the capital markets. As a result, investment funds have grown to become a primary investment option used within the group retirement savings landscape.

¹⁸ As per CAPSA's Guideline No. 3, CAPs include defined contribution (DC) plans, group registered retirement savings plans (GRRSPs), group registered education savings plans (GRESPPs), and deferred profit sharing plans (DPSP).

¹⁹ Strategic Insight's *2018 Group Retirement Savings and Pensions Report—Canada*.

²⁰ Statistics Canada Tables: 13-10-0063-01 and 13-10-0371-01.

Investment Fund Distribution Channels

In Canada, investment funds are distributed through the seven distinct channels responsible for the distribution of financial wealth. These channels can be characterized by three primary factors: firstly, the degree to which advice can be provided and the manner in which that advice is offered; secondly, the primary target client segments in terms of financial wealth and how narrow the channels' focus is by segment; and thirdly, the relative importance of investment funds within the range of products offered within the specific channels.

Figure 2.1: Distribution channels

Financial advisor	Dealers, MFDA with some IIROC, focus on mutual fund funds, financial planning and operating primarily independent advisor models. Also includes insurance-only licensed distributors/advisors.
Full-service brokerage	Full-service investment dealers, IIROC registrants with broad shelf of securities, deposits and other investments. Generally open architecture, balanced mix of fee-based and transaction based models.
Branch advice	Dedicated advisor/mass affluent client sales and service models operating out of deposit taker branches, focus on financial planning using both MFDA and IIROC registrants
Branch direct	Branch banking and savings activity largely focused on deposits, but includes MFDA registrants responsible for on-demand mutual fund sales (books not assigned).
Private wealth management	Discretionary management and/or private banking services and/or trust services through bank-owned or numerous independent firms. Regulated by provincial securities commissions or OSFI (banking and trust).
Direct sellers	Includes fund managers that sell directly to investors and robo-advisors. Regulated through MFDA and CSA.
Online/discount brokerage	Order execution only, IIROC registrants focused on do-it-yourself investors and active traders. Limited guidance under specific exemptive relief.

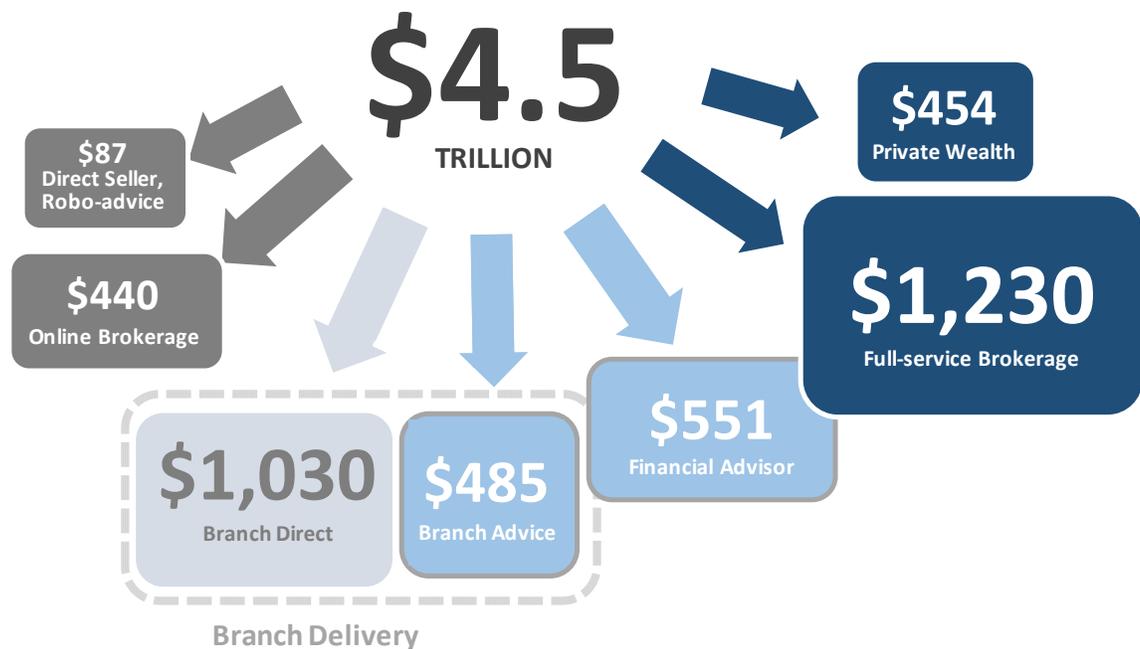
The wide variance in the size and scope of channels

The size of the various channels, in terms of mutual fund investors and assets, varies considerably—from the relatively small proportion of mutual fund investors and assets using self-directed platforms (online/discount brokerage or direct sellers), to the millions of mutual fund investors who access investment products through independent advisors at dealers overseen by the MFDA in the financial advisor (FA) channel and through the branch networks of deposit-takers. Prior to the rise of the deposit takers' mutual fund dealer and asset management arms, the FA channel was the channel primarily associated with the distribution of Canadian mutual funds and the channel remains a mutual fund-centric distribution channel. While the other intermediated advice channel—full-service brokerage

(FSB)—holds a material share of the total mutual fund assets in Canada, mutual funds remain less than a third of the total assets held on the deep product shelves of that channel.

The distinction between the two branch-based channels housed within deposit-taking institutions—branch direct (BD) and branch advice (BA)—is primarily based on the client segment on which each is focused and the dedicated nature of the advisor/client relationship. The MFDA registrants in the BD channel generally provide clients with access to mutual funds on a walk-in basis within a well-defined suitability framework. The customer service representatives in the BD channel also provide client discovery resulting in referrals to branch partners, notably the BA advisors, when a more comprehensive financial planning or investment need is uncovered. The BA advisors are dedicated to providing financial planning and investment products through assigned client relationships and the service breadth of these relationships varies by bank.

Figure 2.2: Financial wealth distribution landscape at the end of 2017
Total assets in each channel



**Total financial wealth includes some assets not aligned to a distribution channel*

Over the past 10 years, the strongest relative growth came in channels that were in an emerging growth phase and focused on a self-directed, or digital online advice-driven investment approach—specifically online/discount brokerage and online wealth or robo; and those where target client segments were more narrowly focused and up-market than in competing channels—for example, the very high-end focused private wealth management and the mass affluent focused service offer of branch advice. The former benefitted from the strong growth in financial wealth arising from the affluent segment (>\$1 million) and the latter benefitted from the mass affluent branch clients being directed to them from branch partners.

The more mature and broadly focused intermediated advice channels, FSB and FA, have generally expanded at rates below the rate of growth of personal wealth in Canada. In the case of the former, maturity of the channel has created impressive scale at the higher end of the mass affluent and affluent client segments. As a result, beyond market sensitive asset growth, the sheer scale of the channel has tended to impede growth rates relative to

competing channels. The mature FA channel remains heavily entrenched in both the mass market and mass affluent segments. The channel's heavy reliance on mutual funds, together with significant regulatory changes facing all dealers, has weighed on advisor capacity and challenged relative growth.

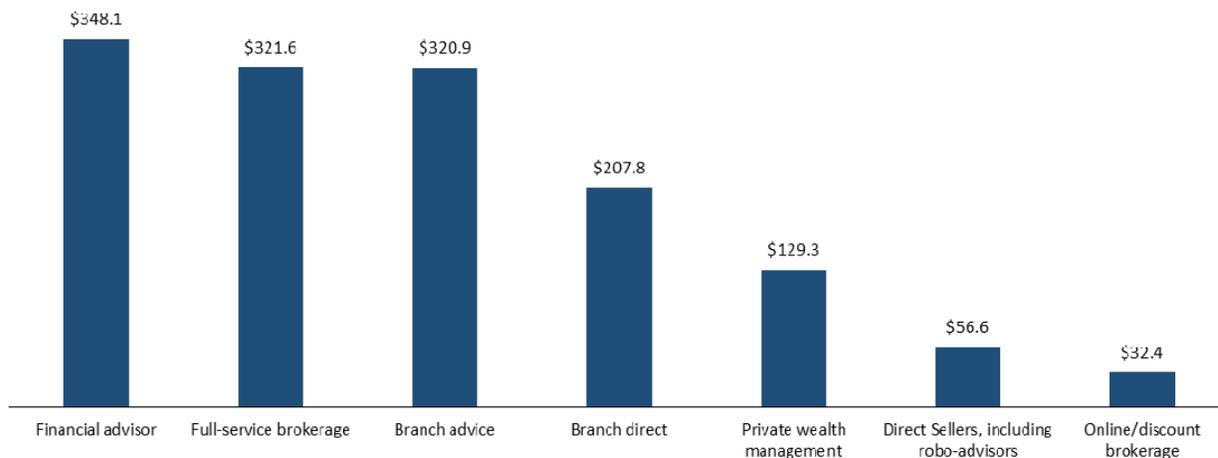
The impact of branch sales forces

Despite very different product approaches, compensation models and targeted client segments, the relatively immature BA channel and the long-established intermediated advice channels, FSB and FA, held very similar levels of total mutual fund assets at the end of 2017—all in the \$320 to \$350 billion range. As alluded to earlier, where these similar absolute dollar levels depart from one another is in the relative role mutual funds play and their profile in each of the three distribution channels.

Among the three channels, the FA channel relies the heaviest on mutual funds as they make up about 90% of the assets held by dealers in the channel. The dealers' shelves are generally open and reflect a broad mix of manufacturers. Over its long tenure, the channel has remained firmly linked to the mass market client segment, in terms of numbers of client households, but has moved up market with its core asset holding and financial planning value proposition anchored in the mass affluent segment.

Figure 2.3: Mutual fund assets held in each channel

Assets in billions of dollars at the end of 2017



The BA channel, while highly reliant on mutual funds as its primary driver of long-term investment planning, also holds a large balance of both fixed-term and demand products within the assigned relationships between advisors and clients. The share of funds has been increasing, and at the end of 2017 sat close to two-thirds of the assigned books of BA advisors. The mutual fund profile differs from FA, with a relatively narrow shelf focused primarily on proprietary funds and fund wraps. The BA offer evolved to service the mass affluent client segment within deposit-takers—the focus on the segment is intense and the entry level, generally set at \$100,000 in investible wealth, unencumbers the channel and its advisors from a mass market capacity drain. This, plus a well-structured product offer and a strong referral framework with branch partners, has elevated the growth rates in the channel.

The big step-out from the three channels is the very large and mature FSB channel. While of critical importance in the distribution of mutual funds, funds play a lesser role in the

channel's product shelf and practice management of advisors than FA and BA. At the end of 2017, mutual funds made-up about 26% of total assets held in the channel—including those held in any of the channel's fee-based platforms. Mutual funds are integral to the channel although they compete with a significantly greater variety and volume of securities and other investment and deposit products, than they do in FA or BA. Client-focused reforms around know-your-product may alter the competitive shelf dynamic in the channel creating both opportunities for mutual funds as well as challenges. Unlike the BA channel, the mutual fund profile of the FSB firms attached to deposit-takers has remained largely focused on third-party mutual funds, with affiliated mutual funds (not ETFs) making up about 17% of total mutual fund assets.

Future growth being redirected, new investors exercising choice

Much of the overall asset growth recorded in the FA and FSB channels arose from market growth, rather than material flows attributed to new investors or new money from existing investors. This in part relates to the scale, as well as capacity issues, mentioned earlier. A growing number of Canadian investors using these channels have entered their retirement years and, as such, inflows have been offset by an increasing level of both voluntary and mandated withdrawals from registered accounts.

Competition for new clients has become intense for a variety of reason—not the least of which has been a desire for the FSB channel to move decidedly upmarket, constraining the pipeline for the clients of tomorrow. This is occurring to a lesser extent in the FA channel, but that channel has also come under intense competition from the BA channel where the deposit takers are intercepting high-end mass market and mass affluent clients that once contributed to the growth of the independents in the FA channel. The BA offers have also expanded further upmarket, significantly slowing down the referral engine to the FSB firms—though FSB remains an option for BA clients who have reached the ceiling in their respective mass affluent offers.

Competition is emerging from beyond the face-to-face confines of the three channels discussed above. The osmosis of online and digital consumption into the investment management world has been well documented and covered extensively by Strategic Insight²¹. This started with the rapid expansion of the online discount brokerage (ODB) channel over the past decade and a half. The growth in ODB reflected a rise in self-directed investment behaviour, in many cases by investor choice, but also, in part, from an economic limitation of face-to-face options among mass market investors. It was in this environment that online wealth was launched—for those not-so-do-it-yourself, but still outside the sphere of face-to-face advice, either by choice or by exclusion.

These channels tend to be viewed as the new entry points for young or new investors and savers, but the acquisition of clients has been difficult despite triple digit asset growth rates from a near zero base. The digital platforms and their sponsors are moving towards hybrid applications of both digital and face-to face advice that involve established dealer firms in both the FA and FSB channels. For a face-to-face advice firm, these approaches will ideally provide an economically feasible capability to greenhouse early stage or younger clients until their situation indicates more complex wealth planning needs and advice.

²¹ Strategic Insight Quarterly Fintech Report, 2017, 2018

Private clients

The relatively strong growth rate recorded by the private wealth channel, which is focused almost exclusively on households with over \$1 million in investible assets, derives primarily from the private investment counsel (PIC) business. At the end of 2017 pools or unitized investment products reached 58% of total PIC assets up from 54% three years earlier. The balance of assets held in segregated accounts, those which are primarily made up of individual securities, were once the staple offering of PIC firms. These account structures have been relegated to minority status and are frequently reserved for accounts with balances in excess of \$3 million.

Currently two thirds of the pools used in the PIC channel are prospectus-issued mutual funds which have been primarily developed exclusively for the PIC business. The adoption of these products in the channel, along with the balance of pools issued pursuant to an offering memorandum, could serve as an indication that there is general appreciation of the accepted benefits of unitized pooled investments in the HNW client context.

The influence of the move to fee-based accounts

Across the three key distribution channels for mutual funds, the FSB channel remains the primary evidentiary source of the impact that the move to fee-based services will have on advisors and fund managers. At the end of 2012, mutual funds and ETFs represented 26% of channel assets, with 23% and 3%, respectively. By December 2017, the combined share had increased to 32%, with mutual funds at 26% and ETFs at 6%.

Of critical importance to the mutual fund industry is the extent to which the rapid adoption of fee-based practice models will involve mutual funds. Looking at non-discretionary, fee-based accounts, the growing importance of investment funds becomes readily apparent. In these accounts, the share of assets held by investment funds moved from 27% (22% mutual fund, 5% ETFs) at the end of 2012 to 38% (31% mutual funds, 7% ETFs) at the end of 2017.

In absolute terms, the increase in total mutual fund and ETF holdings represented approximately \$63 billion, or 44%, of the total increase in non-discretionary fee-based assets. This change in asset mix took place at a time when non-discretionary fee-based brokerage assets had grown at a three-year CAGR of 15.4%, compared to a CAGR for channel assets overall at 6.9%.

Much of the mutual fund growth in fee-based programs over the past five years has come from the transition of existing mutual fund assets held outside fee-based programs into fee-based programs. ETFs, on the other hand, have grown gradually, primarily through net new flows of ETFs to both the channel and to fee-based programs. Unlike mutual funds, a larger portion of ETFs have always been held in fee-based than in transaction-based accounts.

The fee-based practice adoption has spread to both the FA channel and the BA channel where F-series mutual funds remain the dominant product choice. Growth of fee-based in the FA channel has occurred on both the MFDA and IIROC platforms offered by dealers in the channel, although the growth has been much faster on the IIROC side of dual-platform dealers. While only two BA dealers currently offer a fee-based account for F-series mutual funds, the growth over a short period has been dramatic. In less than two years, assets reached just below \$10 billion at the end of 2017 and more than doubled over the course of 2018. In comparison, the FA channel held approximately \$35 billion.

The outlook to 2026

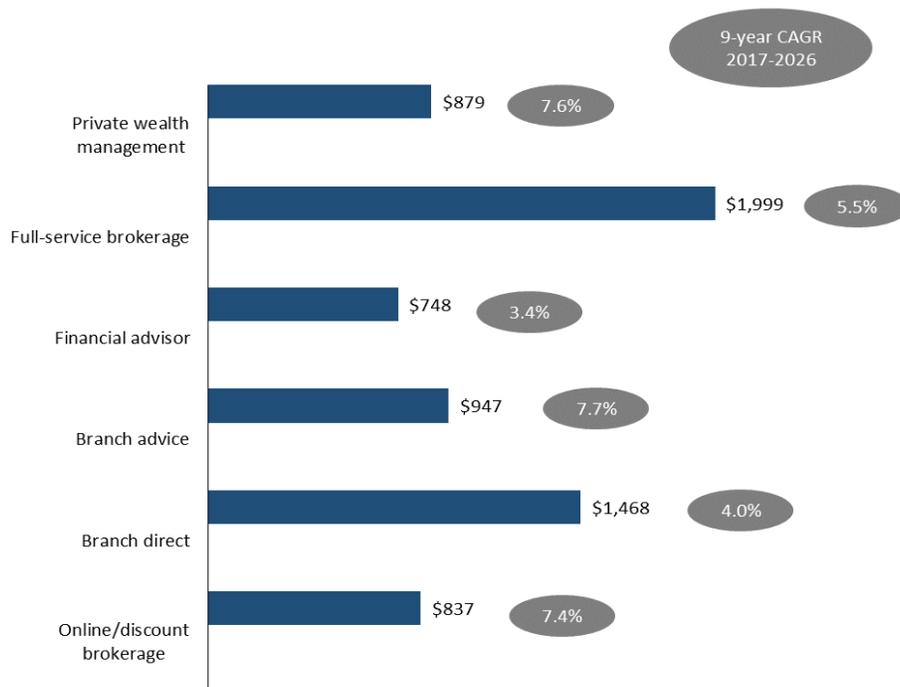
Projections for channel development up to 2026 paint a similar picture of modest growth for intermediated advice, continued strong growth in the self-directed and online advice

investing platforms and robust growth in the BA channel and PIC business—related to their specific segment focus and the growth outlook for those client segments and effectiveness of acquiring those clients via established referral frameworks.

In absolute terms, the FSB channel is projected to retain its position as the largest channel in asset terms, adding approximately \$770 billion over the period to reach approximately \$2 trillion by 2026. The projected growth in the FA channel of \$196 billion is influenced by modest gains in market valuations while being challenged by an aging advisor sales force, regulatory change heavily focused on its primary product and competition in its core client segment. The FA channel's growth is projected to be almost \$300 billion less than that projected for its major competitor, the BA channel.

The shift in fortunes of the various channels will be driven by the ability of participants to react to demands for value and convenience by the mass market and mass affluent segments, as well as the development and implementation of strategies that focus on the delivery of integrated wealth solutions to households in the upscale (\$500,000-\$1 million in investible assets) and affluent (\$1 million+ in investible assets) segments. With regulatory change facing all dealers, particularly those that are mutual fund-centric, the challenge for the FA channel is to remain flexible and to adapt to forces of change—whether competitive, economic or regulatory. It is likely the large array of dealers in the channel will experience further consolidation, whether by mergers or simply selective recruitment of advisors. This will result in a thinned-out field with several large, strong players capturing much of the growth and the assets in motion from advisor retirement and exit. Opportunities for growth will also exist for boutique firms focused on a strong local market or regional presence and those firms that can create a specialized suite of wealth services for a particular client segment (e.g. professional or ethnic markets).

Figure 2.4: Outlook by distribution channel, 2017 to 2026
Assets in billions of dollars at the end of 2026



Self-directed and online advice investing platforms

These channels, including the ODB, online wealth, as well as the direct to client offerings of mutual funds, demand and term deposits, ended 2017 with total assets of \$525 billion, and are forecasted to reach approximately \$1 trillion by 2026, with 14% of that growth coming from the rapidly expanding reach of the online wealth or robo-advice firms. Despite the strong asset growth through investor adoption of the online wealth offer, which to date has been entirely comprised of ETFs, the ODB channel is expected to represent the majority of new assets, as the channel will continue to attract retail investors. These will include those investors just starting out, those with the time and inclination to do some or all of their investing themselves, and those who will move away from face-to-face advice entirely—by choice or by lack of qualifying financial wealth.

The channel's growth through client acquisition will be helped by the fact that the largest ODB firms are owned by Canada's largest banks with their large number of existing client relationships in the branch system, some of which might ultimately feed the growth of the ODB clientele.

The shift in share from mature channels to self-directed and online digital interfaces is well-illustrated by the observation that, between 2007 and 2026, the share of total financial wealth held by the aforementioned channels is projected to move from 9.5% (2007) to 14.5% (2026) as growth fueled by up-and-coming investors will outpace that in the FA and FSB channels.

Growth in these channels will be impeded by the progressive blurring of competitive lines between *like* face-to-face channels and *unlike* digital and face-to-face channels. This is already becoming apparent as many face-to-face firms are adopting approaches to allow and even encourage digital client experiences. The blurring of the product and service offer between FA and BA is evidence of how a large well-funded channel like BA can, arguably, close the offer gap and exert significant competitive pressure on a highly fragmented channel, like FA, despite the fact that the latter was delivering a relevant planning and investment offer.

The blurring will also contribute to an increasingly competitive battleground involving all firms in all channels. While history tells us that the advantage in such a scenario will likely go to those with size and scale, it may well be the case that the future will favour flexibility and nimbleness.

Fee-based Accounts

The shift from commissioned-based to fee-based practice models—and the stabilizing influence that it has had on revenue generation—has arguably been among the most significant changes to take place in the intermediated advice channels over the past two decades. This change has been driven by a combination of strategy at the dealer level, evolving advisor practice preferences, technology advances and regulatory encouragement. By 2026, it is expected that investment assets totalling \$2.9 trillion will be held in discretionary and non-discretionary fee-based accounts, a total which will represent an increase of \$2 trillion, the equivalent of a 13.0% CAGR, over the amount held in such accounts at the end of 2016²².

The shift to fee-based models has largely been viewed in the context of how FSB dealers have been paid for the distribution of direct securities—in other words, the movement from a single transaction-based point-of-sale commission to the generation of an ongoing fee based on the level of assets under administration. It is the case that while mutual funds have long straddled both approaches, with point-of-sale commission payments paired with the payment of an ongoing embedded fee based on the level of assets, the evolution in mutual fund compensation had been decidedly in favour of a single embedded fee on assets.

As a result, the mutual fund context for the fee-based shift has been far more around fee unbundling and transparency than altering the nature, or the amount of the payments which dealers and their advisors have received. This distinction between investment dealers in the FSB channel and the mutual fund dealers in the FA channel has been largely responsible for the difference in the fee-based shift dynamic across the two intermediated advice channels.

The big picture

In December 2009, when Canadian investors were recovering from the market correction of late 2008 and early 2009, a total of \$82 billion was held in non-discretionary, fee-based investment accounts, virtually all of it held in the individual securities-focused, FSB channel. By the end of 2017, assets held in non-discretionary fee-based accounts in the FSB channel had reached \$281 billion, a 10-year compound annual growth rate of 14.5%.

The impressive growth of assets in those non-discretionary fee-based accounts reflected the emerging economic realities in 2009 around advisor practice models from both the advisor and the dealer level. Added to that was the growing wealth management mantra that was being adopted by many firms in the FSB channel. This mantra brought with it the need to deliver much broader holistic wealth management services than was the case in a traditional transaction-based securities brokerage model. This was accompanied by a gradual change in the nature of relationship between investors and their advisor. Some advisors have leveraged fee-based practice models to transition from acting as a link between individual investors and the capital markets to providing wealth planning and management services to Canadian families. Fee-based practice models became the starting point for FSB firms in the new wealth management-focused world.

Simultaneously, regulatory attention on the embedded fee-based model among the mutual fund centric FA channel dealers began to grow. The unbundled fee-based models common in the FSB channel, began to take hold in the FA channel as both fee transparency and relationship pricing flexibility around advice, grew in importance.

²² Investor Economics' *Household Balance Sheet Report – Canada 2017*, Appendix 13: Statistical Tables.

Not only has the recent growth of non-discretionary fee-based accounts in both intermediated advice channels been noteworthy, but the anticipated future growth is expected to be almost as robust in spite of a slight easing of the expected overall growth rate of personal wealth assets. Non-discretionary fee-based assets were projected to grow at an annual growth rate of 15.7% over the nine-year period ending December 2026. This projected rate of growth will result in total assets held in those accounts comfortably overtaking total assets held in accounts in which revenue is sourced from transaction-driven commissions. In other words, fee-based accounts are likely to solidify and build on their position as the *new normal*.

Figure 3.1: Assets held in non-discretionary fee-based accounts

Assets in billions of dollars



There may be resistance to change from some in the FA channel, accompanied by the argument that the clear pricing distinction between a fee-based model and a transaction-based pricing model in the FSB channel simply does not exist in the FA channel. Additionally, the nominee business of the FSB channel presented a more efficient conversion route, operationally, than the client name dominant approach among mutual fund dealers in the FA channel. In any event, the change to the unbundled fee-based practice models, and the relationship pricing flexibility it offers, has brought benefits to advisors and some, but not all, segments of investors in both channels.

Wealth and product shelf play a big part in fee-based benefit

In the early growth of non-discretionary fee-based practices in the FSB channel, the relatively low weighting of mutual funds allowed for a controlled reduction in cost as a tiered or negotiated fee primarily replaced set transaction-based commissions charged on individual, directly-held securities. This model, for better or worse, represented a clear and distinctly different value proposition for clients in terms of how they were going to pay their advisors.

As mentioned earlier, the fee-based practice driver in the mutual fund centric FA channel—the separation of distribution costs from other fund expenses, and the replacement of embedded and fixed distribution charge by the negotiated fee levied at the account level—was driven by the benefits of transparency and relationship pricing flexibility. It has not yet translated into lower costs for the majority of mutual fund investors using that channel, largely because of the limited adoption of the fee-based model and the similarity to existing embedded pricing model fees—with the exception of high net worth clients taking advantage of lower-than-trailer fees at very high account balances.

Greater investor cost savings can be realized when the fee-based account is populated by low-cost, passively-managed vehicles, such as ETFs or index funds, though the latter are—for the most part—only the domain of IIROC registrants. While ETFs were readily adopted into the early fee-based practices of FSB advisors, the IIROC advisors in the FA channel remained largely mutual fund-centric in their move to fee-based. In the case of the latter, ETFs have, more recently, been gaining in popularity along with fee-based practice models on the IIROC platforms of the FA dealers. In the case of ETFs, a 1% advice fee charged by the dealer may represent two thirds of the cost-to-customer, with embedded manufacturing and management costs representing the balance. In comparison, for a mutual fund, a 1% trailer can represent less than half the total cost-to-customer.

Value for all costs, and cost savings, have to be well understood and incorporated into an advisor's overall competitive value proposition—whether fee-based or otherwise. It should also be noted that while lower costs may be achieved through the use of direct securities to build a fee-based portfolio in the FSB channel, even that view of cost savings can be complex. The growing focus on best execution through regulatory initiatives is highlighted by the revised *Markets in Financial Instruments Directive* (MiFID II) which includes improved transparency and reporting of the hidden or opportunity costs associated in the order execution of direct securities transactions. While these embedded costs, like those associated with fixed income securities trading, may be small at the level of individual securities, they do highlight the problems in making apples-to-apples cost comparisons between and across practice models.

Factors driving the shift to fee-based

As discussed, the practice and product shelf dynamic vary dramatically between the intermediated advice channels and this is further impacted by other differences arising from supply, demand and regulatory factors. These factors are divided between those that stem from external forces; those that reflect the client and demand and the regulatory oversight on practice models; and those that are consistent with the emerging business interests of both dealers and advisors.

External factors

Recently the direction of regulatory changes, both anticipated and explicit, has been an important driver in the consideration of fee-based practice models in the FA channel, but much less so in the FSB channel. It is important to note that the shift to fee-based practice models in the FSB channel predates the current level of regulatory interest by many years. This suggests that while increased regulatory focus on conflicts of interest and fee transparency provided an additional catalyst in the adoption of fee-based practices in the FSB channel, it has not been the defining motivator that it has been in the mutual fund-centric FA channel. Dealers and advisors, irrespective of their regulatory affiliations, have become sensitive to the fact that business models and practices that hint at possible conflicts of interest are going to become unpopular. As a result, many FA firms and advisors have altered their practice management strategies, and have modified the platforms upon which their offers are based in order to transition to fee-based.

The other external force fuelling the move to fee-based investment accounts is the activity of the competition and the examples set in other jurisdictions. While the FSB firms in Canada are the current champions of non-discretionary, fee-based accounts, they have been influenced by the success and growth of the private investment counsellor (PIC) community, which has always been fee-based. Dealers and advisors in Canada have also seen the rapid development of the registered investment advisor (RIA) channel in the United States, which is also almost entirely fee-based. The RIA channel, which reported assets of US\$2.3 trillion at the end of 2017, has been projected to reach US\$6.6 trillion by 2026.

Client-related drivers

As external forces have been making an impact on the thinking of dealers and advisors, the attitudes and expectations of investors have also been changing. The market correction that took place in late 2008 and early 2009 made a lasting impression on most investors, irrespective of their personal levels of wealth or degree of financial sophistication. The non-financial outcomes of the market correction included lingering concerns about value and the alignment of interests in terms of advisor/client relationships. Dealers and advisors have both paid heed to these concerns leading to the rising wealth management mantra and the fee-based practice model as a cornerstone of delivering that value. Fee-based practice models, with advice fees uncoupled from both product structure and activity and charged

separately, are widely viewed, by all stakeholders, as aligning advisors' interests with those of their clients.

A recent Vanguard Canada study²³ indicated that among financial advisors who had made the transition to a fee-based model, 86% reported that it had a positive impact on client trust. Media attention and competitive forces arising from fee-based incumbents have also played a role in heightening investor interest in the balance between investment cost and value. Anecdotally, while this has resulted in dealers and advisors across the FA and FSB channel being increasingly proactive in the shift to fee-based practice models, the majority of investors do not yet appear to be demanding the shift.

Dealer and advisor-related drivers

On top of the growing pressure of external factors, all dealers are under economic pressures to put in place business strategies that provide for sustainable, steady revenue and consistent profitability in a highly competitive marketplace.

The acceptance of fee-based accounts as the new normal is not without its own set of challenges. One of these is the need to both embrace a new basis for revenue generation and to recognize the fact that the nature of the relationship with clients is changing. FSB relationships were often centred on transaction-based securities recommendations. Establishing a relationship where there is a visible and regular payment of fees likely raises the expectations of clients and suggests that those FSB advisors will provide both an ongoing and a more advanced level of advice and service.

This is not to say that all transaction-based advisors in the FSB channel avoided value-added wealth management services, but that fee-based models avoid some of the conflict of interest inherent in an activity-based commission sales model. It is also the case that in the FA channel, advisors had long based their value proposition on using mutual funds as an integral element of financial planning. The nature of the mutual fund-centric practice models, even with the embedded fee structure, differed from the focus on individual securities transactions that were typical in the FSB channel.

Although these evolving expectations create new pressures on financial advisors, there are also additional reasons why more advisors are shifting their practice models. Research undertaken in the United States has indicated that the average financial advisor spends up to 40% of their time focused on administrative, operational and research-oriented activities²⁴. The nature of the fee-based model can help simplify an advisor's practice. This is clear in the context of a discretionary fee-based practice in the FSB channel and is, to some extent, in non-discretionary fee-based practices versus a transaction-based commission practice. The streamlining benefits in the latter arise from the advisor/client relationship and the elimination of the conflict attached to a recommendation involving a trade commission.

These practice efficiencies are less straightforward in the FA channel where many advisors have already moved to an embedded trailer fee-only compensation model—there has been a material decline in the use of deferred sales charge funds in favour of initial sales charge funds, minus a negotiated sales charge—and so advice typically comes without a transaction-based motivation/conflict. The shift to fee-based in the FA channel brings with it a move to nominee and the argument that efficiencies to the dealer and client reporting in that environment becomes clearer.

To fee-base or not fee-base

²³ <https://www.vanguardcanada.ca/advisors/articles/vanguard-news/news-from-vanguard/fee-based-model.htm>

²⁴ *Going Fee-Based: The Top 5 Advisor Business Benefits, Why Go Fee-Based*, Bellatore Financial, 2015.

Despite the benefits mentioned above, the movement away from commission-based accounts to fee-based accounts may not benefit all investors. In the FSB channel with its focus on directly held securities, the big difference between commission-based models and fee-based models make it clear that a client with a commission-based securities account that does not trade at all versus one that trades a lot would likely not be better off with a fee-based model structure. It is also the case, however, that a low/no trade commission-based account will not require or attract the wealth management services that would be available in a fee-based model. Again, the cost of a transaction-based approach and a fee-based approach involve careful evaluation of both the cost and value provided.

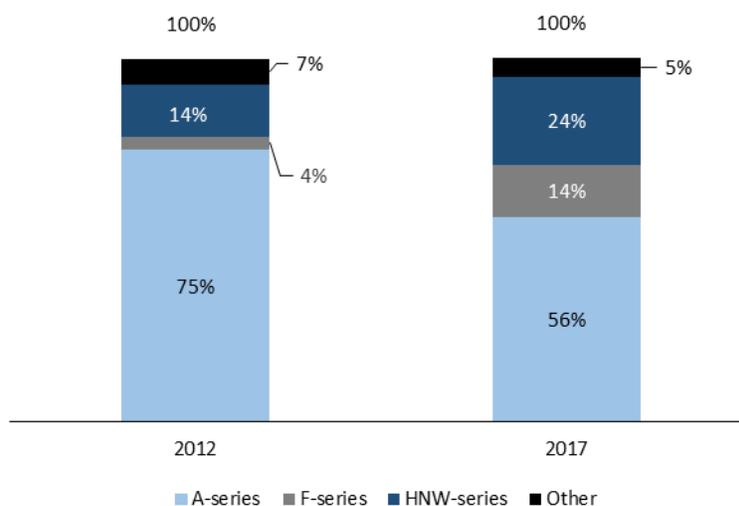
In the FA channel, the distinction between an embedded fee mutual fund account and a fee-based mutual fund account is less clear. The big distinction is in the relationship pricing flexibility of a fee-based account where most programs have a fee-structure that is tiered by asset level. While the embedded trailer fee structure basically ensures all investors pay the same relative advice fee on assets, the fee-based models typically discount the advice fee for higher asset holdings; very large account clients will likely pay less than the one-size-fits-all embedded trail and lower value accounts, if they are provided access to the fee-based platform, will pay a higher relative advice fee on assets.

Impact on the fund managers

From a manufacturing perspective, the significant rise in fee-based accounts in the FSB channel and the recent move in the FA channel has been mirrored by a sharp increase in the number of mutual funds available in an F-series. At the end of 2014, there were a total of 1,439 funds which offered F-series to investors. Over the next three years, that number more than quadrupled, to 6,704, with many funds having multiple F-series to accommodate tiered pricing programs. Total assets held in F-series units increased from C\$61 billion to \$179.1 billion over the same period, the latter figure representing the equivalent of 14.3% of total retail mutual fund assets at the end of 2017. This was driven largely by the fee-based conversion that occurred in the FSB channel and, in particular, the growing attention being paid to mutual funds held outside fee-based accounts over the past three to five years.

The tiered fee-based account fee structures fall into two broad categories: blended pricing and asset class-based pricing. The blended model, increasingly the pricing model of choice in the FSB channel, applies the tiered fee to assets regardless of the specific asset and product allocation within the account. This approach allows the advisor to establish the pricing of the fee-based relationship and separate it from the asset-mix recommendation. All assets except those designated as non-billable are treated equally from a fee perspective.

Figure 3.2: Multi-series assets



*Includes mutual funds and ETFs.

This approach has also emerged in the FA channel, though asset class-based pricing functionality remains. Not only have mutual fund managers been active in creating mutual fund options that suit fee-based accounts, but the promoters and managers of ETFs, who are often mutual fund managers, have also benefitted from the momentum toward fee-based assets. ETFs have long been popular in fee-based accounts in the FSB channel in both non-discretionary and discretionary accounts. This was largely driven by the individual securities-like nature of the ETF, including its low cost and its use for market exposure beyond domestic and North American equity markets.

ETFs in the both non-discretionary and discretionary fee-based accounts totalled almost \$20 billion and \$25 billion, respectively, at the end of 2017. This represented almost 65% of all the ETFs held in the FSB channel. Mutual funds, in comparison, totalled \$127 billion in the two types of FSB fee-based programs at the end of 2017, although that represented only 38% of total mutual fund assets held in the FSB channel. With the transition to fee-based continuing in the FSB channel and the focus on transitioning mutual funds on the rise, there remains a significantly greater volume of mutual funds than ETFs yet to be moved.

Impact on the dealers

This growing trend to fee-based will impose different, arguably greater, challenges to FA channel dealers registered with the MFDA than to IIROC-registered dealers in either the FA or FSB channels. Specifically, the MFDA dealers will need to make the move away from the still-prevalent client-name format²⁵ towards a nominee approach which most have available. While advisor resistance to nominee is fading it remains a primary impediment to adopting the fee-based practice model popular in the FSB channel. The move to nominee is certainly not without its challenges, given the volume of accounts and assets still held in the name of the client and the somewhat manual repapering of accounts that is required. This operational issue is a more significant obstacle to smaller dealers servicing retail clients than it is to the

²⁵ When a mutual fund dealer establishes accounts for clients in 'nominee name' the dealer becomes the registered/legal owner of any mutual funds purchased. The fund units are held in trust for the investor by the dealer. In the case of an account established in 'client name', the mutual fund securities are registered in the name of the client on the records of the fund company. The mutual fund dealer does not have custody of the mutual fund securities on behalf of the client.

larger dealer firms, some of which have already moved to adopt the nominee format. Expanding the product shelf may also help support the shift to fee-based in the FA channel. For those advisors whose dealers offer both MFDA and IIROC platforms and who have made the move to IIROC, an expanded product shelf and nominee way of doing business has become part of their practice model. On the MFDA side, while a few dual platform dealers have offered their MFDA advisors access to ETFs via a settlement clearing arrangement through their IIROC platform, these one-off structures are unlikely to move the needle on ETF holdings.

As with any change, there is a need for both an advisor and a client educational process to be developed and implemented. In the FSB channel, 90% of full-service advisors administered at least a portion of their book in a non-discretionary, fee-based account at the end of 2017, a noticeable increase from the 76% share at the end of 2012. These numbers are much lower in the FA channel with about 75% of the IIROC advisors administering some of their book through a fee-based program but only approximately 17% of MFDA advisors with some business in a fee-based account²⁶. In the case of the latter, the advisor adoption rate is only for firms that have been identified as having a fee-based option available, which impacts only about half of the MFDA advisors in the channel.

Clarifying the fee-based value proposition

As the adoption of the fee-based business model, particularly by mutual fund-centric advisors, continues, properly demonstrating the value-added benefits to the client will be critical—for advisors in both the FA and FSB channels. A failure to make clear the rationale and advantages of the fee-based model will likely lead to client pushback or rejection.

²⁶ Strategic Insight Financial Advisor Dealer Report, Winter 2018

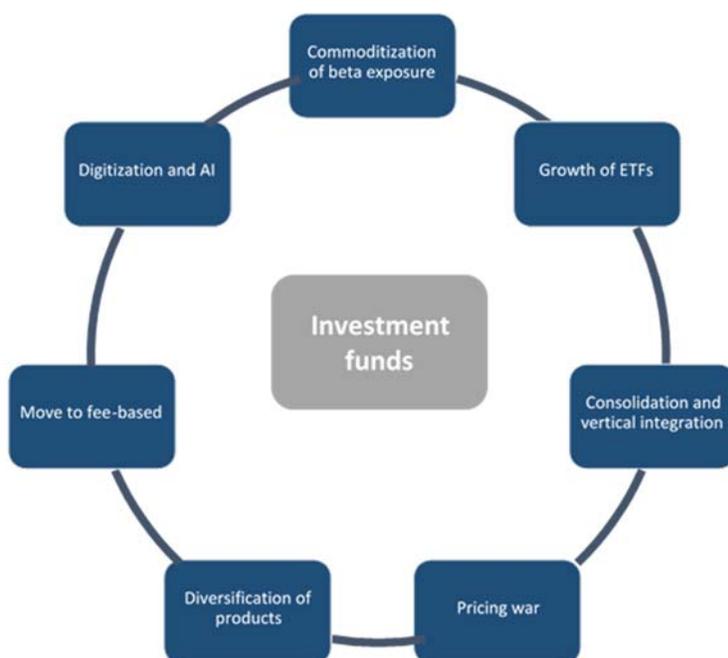
Competition

Competition in the investment funds industry exists at the corporate level (in terms of market share of assets and flows); at the overall product level (mutual funds versus other investment products); at the mutual fund product level (stand-alone funds versus fund wraps or ETFs); and, to some extent, at the distribution level (advisors versus technology-driven platforms). This section will focus primarily on the competition at the corporate level and, secondly, between various distribution channels.

The industry cycle

By most standards, the Canadian investment funds industry is a mature industry in that it is growing at a similar rate to the growth in the personal wealth of Canadian households²⁷. Industries in this phase of their business cycle are characterized by a highly competitive environment; by pressure on operating margins (resulting from pricing changes as product differentiation becomes more difficult); and by increased barriers to entry, as well as growth that is stable but which is no longer accelerating. Many businesses, such as those in the Canadian investment funds industry, seek to extend their life cycles during this maturity phase by reinventing themselves through investment in new technologies and through diversification into both new product areas and evolving markets.

Figure 4.1: Investment funds industry in transformation



²⁷ Investor Economics' 2017 HBS Report.

The historical perspective

Industry cycles vary from industry to industry, although many have completed their full cycle in a far shorter period of time than it has taken the funds industry to reach its mature phase. The Canadian investment funds industry emerged in 1901 through the establishment of the first closed-end fund.²⁸ The mutual funds industry did not develop until 1932, three years after the Wall Street crash of 1929²⁹. The Canadian industry grew rapidly after the Second World War and, by 1970, the mutual funds industry was made up of 149 different funds with total AUM of C\$3 billion. By comparison, at the end of 2017, there were 3,916 unique funds, offered by 145 fund managers, with total assets in long-term investment funds of all types of \$1.6 trillion.

Concentration

One sign of a mature industry is the level of concentration among a relatively small group of businesses. As indicated above, there were, as of the end of 2017, 145 active managers managing \$1.6 trillion. Of that total, at the end of 2017, 65.6% of assets were under management at the top 10 firms, five of which were bank-owned. This level of concentration has not varied materially in the past five years and suggests that the momentum of consolidation has been stalled by the entry and success of prominent new entrants, including major foreign managers.

The next 10 largest firms managed 17.6% of total industry assets as at the end of 2017. The other 129 firms, which comprised approximately 86% of the firms in the Canadian wealth management industry, were left to manage 17% of the total. Examining concentration through a different lens, seven firms managed over \$100 billion and 10 others managed between \$25 billion and \$100 billion.

Deposit-taker firms build share

Competition at the corporate level is, essentially, between three distinct groups of managers: the managers owned by deposit-taking institutions; vertically-integrated firms that are not owned by deposit-takers and own their own distribution capability (or have some level of access to distribution); and independent firms that rely on third-party channels for product distribution.

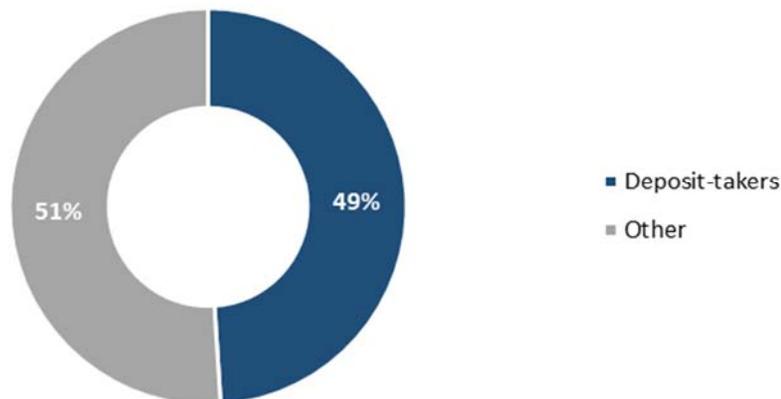
Of the three groups identified above, the deposit-taking institutions represented the group with the largest share of AUM. At the end of 2018, this group held 49.4% of AUM, representing an increase of 3.3 percentage points from the share held at the end of 2012. Going back 10 years to 2007, the share held by this group, which was dominated by the Big Six major banks, stood at 35.9%. While there were important acquisitions by the banks during that period, the growth in share of AUM was primarily driven by the development of large, embedded sales forces, combined with competitive offerings in terms of both breadth of product and price. Also axiomatic is the preference of bank clients to deal with their primary financial institutions for reasons of stability and, importantly, convenience.

²⁸ E. P. Neufeld. 1972. *The Financial System of Canada*. Macmillan Company of Canada.

²⁹ Ibid.

Figure 4.2: Focus on deposit-takers

Long-term mutual funds market share at the end of 2018



Over the last few years, the major banks have invested heavily in their retail and private wealth management businesses and, as a result, have gained share in key sectors. For example, Scotiabank purchased DundeeWealth in 2011, ING Direct in 2012 and Jarislowsky Fraser and MD Financial Management in 2018; CIBC purchased the private investment counsel (PIC) business of McLean Budden in 2012; and TD purchased Epoch Investment Partners, a New York-based asset manager, also in 2012. These acquisitions, among many others, have strengthened the banks' product range and broadened their base of wealth management clients.

Given the multiplicity of organizations and regulatory bodies, the costs of compliance and regulatory fees can deter new firms from entering an already crowded marketplace. In this light, increasing industry regulation in Canada may lead to greater compliance costs, which may, in turn, disproportionately impact smaller firms. With fewer firms and funds, the availability of efficiently priced and suitable products may be impacted. The capital required to make strategic acquisitions is significant, a fact which also places a limit on the ability of mid-sized firms to take full advantage of market opportunities.

Data from the MFDA Client Research study indicated that of all households served by MFDA dealers, 71%, were through the deposit-taker (banks and credit unions) dealers, even though they represented only 54% of total MFDA assets administered³⁰. Although advisors located in credit union branches and some bank branches have the ability to provide non-proprietary product to their clients, it is the case that well over 90% of assets held by bank clients are held in proprietary funds. Interestingly, the penetration of proprietary funds at credit unions is far lower, as most operate in an open-shelf environment with only limited system-specific products available to them.

The next group, non-deposit-takers with dedicated or aligned sales forces, such as some major insurers, is made up of nine firms of varying sizes. A third group is made up of independent firms with no dedicated delivery mechanism. These two groups of firms, combined, administered 46% of assets on behalf of 28% of fund investors serviced by MFDA dealers³¹. While relatively small in number, it is worth noting that those investors who worked through non-bank advisors were likely to carry higher balances than those that invested through branch-based advisors.

³⁰ MFDA Client Research Study, 2016.

³¹ Ibid.

Building assets through corporate actions

Business concentration is not only impacted by positive or negative net flows and market effect, but also reflects deliberate corporate actions, including mergers and acquisitions, which seek to broaden market appeal; to gain economies of scale (to protect operating margins); and to add new lines of business or to enter new markets.

Globally, there were 786 asset manager transactions in the five-year period ended December 2017, covering US\$13.1 trillion in AUM.³² Canadian asset managers were involved in 6% of the transactions recorded in 2017, a level of activity, in terms of numbers and AUM, that was higher than any of the previous 10 years.

Over the five-year period ended 2017, there were 10 transactions in the Canadian investment funds industry involving the transfer of approximately C\$23.8 billion in AUM. Of the 10 transactions, five involved Canadian publicly listed businesses and only one acquisition featured a foreign buyer. In a few cases, the transactions were driven by opportunity and not by deliberate strategic intent, while others reflected the heightened interest in alternative asset classes and the growth opportunity represented by exchange-traded funds.

With the ongoing pressure on operating margins, which result from increased operating costs and limited opportunities to adjust prices, the pace of acquisitions is unlikely to decelerate unless inflated price/earnings multiples on asset managers, coupled with higher costs of capital, join forces to make such acquisitions unattractive. That said, for the largest managers, particularly non-bank managers, continuing to build assets at an annual rate of 5%-10% only through new net sales will not be an easy goal to achieve, and many will be alert to acquisition opportunities.

New entrants

Despite the maturity of the investment funds industry in Canada and the perception that barriers to entry exist, there have been a number of successful entries into the market over the past decade. Notwithstanding the concentration of AUM, the strong position of major institutions, such as banks and insurers, and the challenges represented by a seemingly fragmented and uncertain regulatory framework, the Canadian market has continued to welcome both domestic and foreign entrants.

Between 2007 and 2017, a total of 64 new names entered the investment funds market in Canada. Some, such as Sun Life Global Investments (Canada) and ATB Investment Management, were household names before establishing a presence in the mutual fund market, while others, such as Steadyhand Investment Funds and EdgePoint Wealth Management, were new names founded by well-known industry executives who had left mature firms. In addition to domestic names, large U.S. firms, including PIMCO Capital, Vanguard Investments Canada and Wisdom Tree, joined the Canadian industry seeking to exploit their reputations and the growing interest by Canadian investors in low-cost solutions, be they index funds or ETFs. Finally, some of the new arrivals in the past decade were far from conventional. These entrants provided access to alternative asset classes and alternative strategies to enable advisors to broaden their offers and introduce retail investors to asset classes and techniques that would assist with the increasingly relevant issues of risk diversification and volatility minimization.

The relative success of the 64 new entrants has been mixed. Some of them have attracted substantial assets since inception; for example, both EdgePoint and PIMCO each reported AUM slightly below \$17 billion at the end of 2017. Others, despite the unique features to their

³² Sandler O'Neill + Partners, L.P., *2017 Asset Manager Transaction Review & 2018 Forecast*, February 28, 2018.

offers, have grown more slowly, and, as indicated above, a small number of new firms, including O'Leary Funds Management, failed to make sufficient inroads into the market and became acquisition targets within a short space of time.

Of the 64 new entrants in the 10 years ended 2017, it is worth noting that 14 of those businesses, or almost one quarter, went out of business or changed their ownership.

Barriers to entry or barriers to success?

The activity described above suggests that there are fewer barriers to entry than there are barriers to success. Barriers in the latter category include the reality that the space on the shelves of investment advisors is often constrained through rigorous gatekeepers; by an advisor desire to limit the number of managers they represent; through the absence of a unique selling point or competitive advantage; and by poor leadership and management, coupled with an inability to attract talent on either the asset management side or the distribution side. That said, barriers to entry also include the dominant position of a small group of managers; pricing restrictions that may limit the ability of new firms to reach a break-even point within a reasonable period of time; and the threat of additional regulations that may, inadvertently, impose new costs on small firms perhaps unprepared to bear them.

Given the many regulatory bodies in Canada, the initial costs of gaining approval to enter the market and the ongoing costs of compliance can be sufficient to deter new firms or firms from outside Canada from establishing a presence. Increased regulation in Canada may lead to even higher compliance costs, which may disproportionately impact smaller firms and which favour entry by large wealth management or asset management firms headquartered outside Canada.

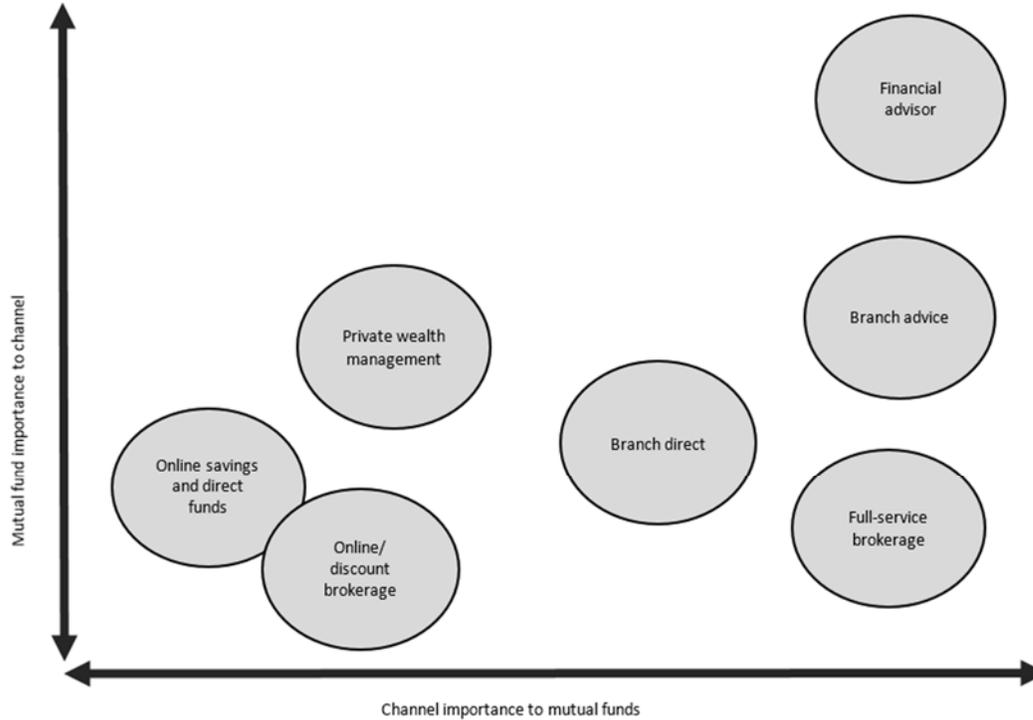
On balance, however, the level of competition within the Canadian investment funds industry may be considered in good health. Businesses, irrespective of the nature of their ownership, that are well-managed, which have reliable distribution and which meet the needs of their clients in terms of pricing and performance, are able to prosper and to deal with the numerous changes that come from capital-market events, new demands by financial consumers and regulators focused on ever-higher levels of investor protection.

Although this section of the report is primarily focused on competition among asset managers within the investment funds industry, it is appropriate to provide a brief commentary on the competitive environment both among and within the various distribution channels.

As indicated above, there are two channels that rely to a significant extent on the sale of investment funds and the ongoing management of relationships with investors that own investment funds. These are the BA channel and the FA channel. At the end of December 2017, both these channels reported approximately \$350 billion in mutual fund assets which, combined, was some \$50 billion greater than the mutual fund assets reported by the FSB channel.

The BA channel houses approximately 12,000 advisors representing major banks; smaller, regional banks; near-bank institutions, such as ATB Financial, with branch networks; and credit unions. With the exception of credit unions, the number of deposit-taking institutions with branch networks and the advisors embedded in those branches has remained relatively stable over the past few years, although the number of bank branches has declined by approximately 450 in Canada over the past three years.

Figure 4.3: Importance of mutual funds by channel



The number of credit unions and *caisses populaires* has also declined from 694 at 2014 to 567 at the end of 2017, with a reduction in the number of branches of 185 over the same period. In short, the number of physical access points has declined as branch consolidation continues and as an increasing number of consumers of financial services have elected to manage their financial affairs online. Notwithstanding the decreasing number of access points, this channel presents significant competition to the traditional dealer networks.

At the same time as the branch locations were declining in number, so were the number of mutual fund and investment dealers. At the end of 2017, there were 83 registered dealers in the FA channel, of which five had dedicated sales forces. This compared to 97 at the end of 2014 and 108 at the end of 2012, representing a reduction of 23% over a five-year time span. During the same period, the number of FSB firms also declined. At the end of 2012, there were a total of 66 FSB firms; by the close of 2017, this number had declined to 48, which was a reduction of 27%. This decline in the number of dealers was accompanied by an increase in the concentration of assets held in accounts at the top 10 firms. In both channels, the 10 leading firms accounted for over 80% of assets.

Despite these trends, which are typical of a mature industry moving out of the growth phase of the business cycle, Canadian retail investors still have considerable choice as to where they access advice and how they acquire and manage their personal investments. At the same time as the number of businesses and the size of the branch dealer networks have been in decline, the strength and breadth of alternative platforms have been increasing their penetration of retail investors seeking both convenience and value, as well as a less-customized set of solutions.

Developments and Innovation in Investment Products

Investment fund product developments have been influenced over the past decade by the same four primary factors that will likely continue into the medium-term future. These forces include the changing nature of competition and the emergence of non-traditional competitors; the implementation of regulatory changes that are increasingly focused on transparency and the education and protection of investors; the changing attitudes of investors toward risk and value; and the ongoing impact of new technologies on managers, dealers and investors.

These issues, either singularly or in combination, have created a business environment that has spawned two specific, far-reaching trends: the development of fund-based solutions, including wrap products and funds-of-funds, both of which invest in units of other mutual funds, ETFs or segregated funds; and the broad development of ETFs and their positioning as both a complement and a competitor to mutual funds.

The ongoing debate

Despite an impressive growth rate over the past five years (five-year CAGR of 14.8%), assets in long-term, Canadian passive funds totalled \$125.4 billion at the end of 2018, representing a modest 8.1% share of total fund assets. Actively-managed funds, on the other hand, totalled \$1,400.9 billion at the same year end. The momentum, however, remains in favour of passive funds, as net flows into active funds represented only 76.6%, despite holding over 90% of fund assets in the five-year period. To a significant extent, the success of passive funds is intertwined with advisor practices in the FSB channel that have been conducive to the growing use of ETFs. Part of the success of the passive group has also been due to flows into strategic-beta funds.

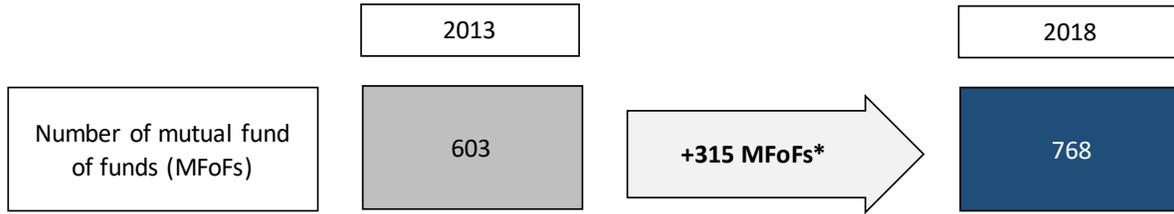
Although this debate will continue, there is every probability that the uncertain outlook for global markets will encourage investors to adopt greater conservatism and a desire to preserve capital; such conditions will favour seeking refuge through more passive strategies.

The move to packaged solutions

Packaged solutions have overtaken stand-alone funds in terms of popularity. At the end of 2013, the \$727 billion invested in stand-alone fund assets represented a 72.6% share of the mutual fund market. Five years later, although stand-alone funds had grown in absolute terms by \$169 billion, their share of the market had dropped to 62.9%. Over the same period, fund wrap and mutual fund of funds (MFoF) assets had increased by \$254 billion. The outlook, represented by *Investor Economics' Household Balance Sheet Report—Canada, 2018 Update and Rebased Forecast*, indicates that this trend is likely to continue, although growth rates for packaged solutions will continue to ease as the solutions asset base grows.

In terms of the number of new products introduced over the five-year period ended 2018, the number of packaged solutions available to the investing public increased by 27.4% and ended the period at 768 unique programs. It is worth noting that the net increase of 165 packaged solutions involved the retirement of 150 programs, a clear indication of a dynamic product development process within the fund industry that has been constantly evolving its offerings. One of the benefits of ongoing product renewal is the clear attraction that new products have to investors as fund managers seek to accurately respond to their changing needs and aspirations. Over the five-year period ended 2018, newly launched programs, on average, accounted for two thirds of net flows in the year of their respective launches, some of this flow coming from funds being phased out in favour of new offerings.

Figure 5.1: Investment fund product launches by type



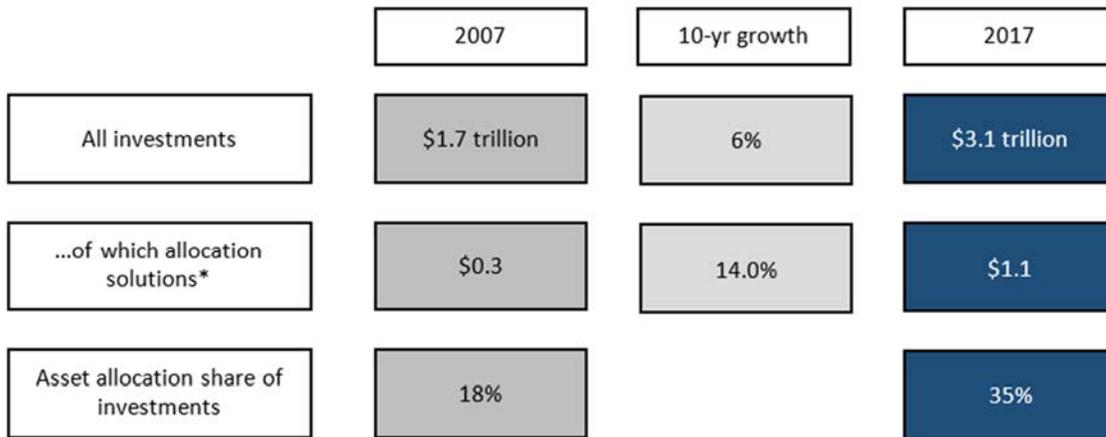
*While 315 MFOFs were launched over the five-year period, 150 were terminated, for a net effect of +165.

Asset-allocation services

Mutual fund manufacturers have increasingly seen packaged solutions as a way to deliver asset-allocation services to investors and advisors alongside traditional asset management services. Asset-allocation services, which were in the past almost the exclusive and primary responsibility of advisors, have been moved to the asset managers. This has occurred with the blessing of most dealers, who have viewed the change as an opportunity for advisors to engage more in the management of relationships than in the management of portfolios. Not only that, but some advisors have found it increasingly difficult to sustain the notion that they can match the expertise of an entire team dedicated to asset allocation.

Figure 5.2: Rise of asset allocation solutions

Assets in trillions of dollars



*Includes fund wraps, discretionary brokerage programs, SMAs and automated advice.

Taking asset allocation in its broadest sense, which goes beyond fund wraps to include discretionary brokerage programs, separately managed accounts and automated advice, total assets in these programs at the end of 2017 represented a 35% share of total investment assets, which was almost double the share held in 2007.

Lifecycle funds, or target-date funds—a category of asset allocation funds where the proportional allocation of each asset class in the portfolio is automatically adjusted and becomes more conservative as the target date of the fund approaches—have yet to take a strong foothold within the Canadian fund industry.

Although lifecycle funds grew at a CAGR of 10.7% between June 2013 and June 2017, total lifecycle fund net assets totaled \$10.2 billion at the end of June 2018, a very small share of total fund industry assets.

New fund strategies

At the same time that the shift from stand-alone to packaged solutions has been taking place, investment fund managers have been introducing new exchange-traded and mutual funds with highly specialized investment strategies. These funds employ various strategies, such as strategic-beta (which aims to enhance returns or minimize risk relative to a benchmark) and quantitative models (which use computer-based models to make buying and selling decisions), reflect a growing interest in products that assist with the management of volatility risk, the enhancement of diversification and which provide opportunities to improve returns.

Traditionally, alternative investments, which include infrastructure projects, private equity and real estate, were only available to accredited investors or large institutions. The launch of newer products has resulted in the introduction of opportunities for retail investors to broaden their diversification by including a range of *liquid alternative* investments in their portfolios. Liquid alternatives are investment products that have the primary characteristics of alternative investments, but which have the distinguishing attribute of being held in a unitized and highly liquid structure.

Many of the investment strategies associated with these funds are familiar to institutional investors but have only recently been introduced into the retail sector following the modernization of National Instrument 81-102 (NI 81-102), by the Canadian Securities Administrators (CSA), with the introduction of a “liquid alternatives” regulatory regime in Canada³³. These final rules came into effect on January 3, 2019 and will permit “alternative mutual funds” to invest in physical commodities or specified derivatives or, borrow cash or engage in short selling in a manner not typically permitted for conventional “long-only” mutual funds.

The pace of growth of retail alternative investments in Canada has been slower than that seen in some other markets as a result of both regulatory and investor conservatism. In late 2018, some Canadian managers received approval from regulators to launch retail funds based on the “Alternative Funds Framework Proposal”. By the end of 2018, five different managers had launched a total of 14 funds with year-end assets totalling \$144 million. However, growth in this category is expected to accelerate over the medium term, given the probability of continued low yields on fixed income investments, recent experience with volatile equity markets and the expected demise of the post market-correction bull market. Liquid alternatives are generally managed through alternative strategies as opposed to investing in distinct alternative asset classes. There has also been little growth in funds focused on specific alternative asset classes. For example, specialty funds, such as those focused on unique resources (commodities) have actually declined in terms of assets.

³³ https://www.mcmillan.ca/Liquid-Alternatives-Now-a-Reality-Alternative-Mutual-Funds-Regime-Scheduled-to-Come-Into-Force-January-3-2019?utm_source=Mondaq&utm_medium=syndication&utm_campaign=View-Original

Figure 5.3: Emerging strategies gain momentum
 Long-term investment fund assets in billions of dollars

	Passive*	Strategic beta	Quant model	Active
December 2018 assets	\$125.4	\$17.2	\$8.2	\$1,400.9
Share of assets	8.1%	1.1%	0.5%	90.3%
5-yr CAGR	14.8%	20.2%	60.0%	7.7%
2018 net flows	\$10.8	\$1.8	—	\$4.3
Share of flows	64.0%	10.5%	-0.2%	25.7%

*Includes index funds.

Pricing considerations

As indicated in the section on *Competition of Investment Funds* of this report, fund pricing has been an issue of primary importance to most managers. Changes to aggregate MERs over the past 10 years (down an average of 25 basis points) and five years (down an average of 21 basis points) indicate that changes have been accelerating, in light of a number of influences affecting the global and Canadian fund industries.

Much of the downward pressure on aggregate MERs is driven by a change in the asset mix and a change in the fund series held by investors. In the case of the latter, the growth in the use of fee-based accounts (see the section on *Fee-based Accounts* of this report) has prompted an increase in F-series holdings. This shift in allocation has had a double impact on aggregate MERs, as not only have asset levels and share increased but, at the same time, the asset-weighted industry average MER on F-series funds has also decreased by 19 basis points over the 10-year period ended 2017.

In addition to the election by investors to move assets from commission-based to fee-based accounts, fund managers have introduced *tiered pricing* to various funds and series to recognize the levels of investment made by investors in specific funds or fund families. Following regulatory action, the process of moving clients to appropriate fee levels has become increasingly automated to ensure both adherence to the pricing schedule as laid out in the fund prospectus, and the avoidance of penalties imposed by regulatory authorities.

Changes to pricing models and practices, which have also involved adjustments to both trailing commissions and administrative fees, have been widespread within the industry and action has been taken in recent years by managers representing over 90% of Canadian mutual fund assets.

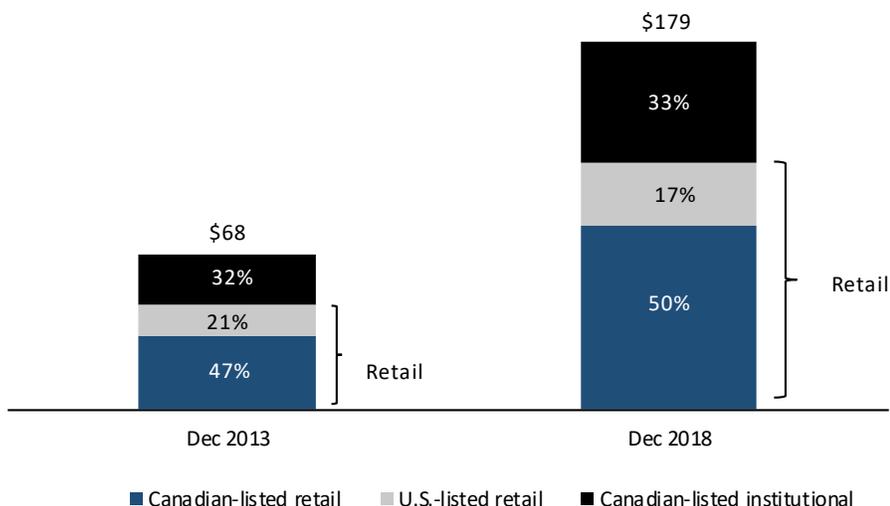
There have also been innovations in pricing models. One leading fund company has introduced a fund with a fixed management fee for the first year to be followed with a variable fee in following years that reflects the performance of the fund. Generally, however, Canadian investors have shied away from performance-driven fees on the grounds that such fees may encourage inappropriate investing and trading activity geared to short-term performance.

A new paradigm

ETF assets have grown considerably over the last decade in most of the world's major markets. In Canada, the ETF segment accounted for \$188.8 billion in assets at the end of 2018; this compared to \$79.8 billion at the end of December 2013. The asset growth and proliferation of ETFs has been strongly correlated to their ubiquity across multiple product and distribution platforms. At the end of 2018, retail ETFs—both Canadian- and U.S.-listed—accounted for 66.8% of total ETF assets held by all types of Canadian investors. In the retail channels (both direct and advice), ETFs have been gaining ground rapidly over the last five years and have expanded their reach into both emerging and existing distribution channels.

Figure 5.4: ETFs held by Canadian retail investors

Assets in billions of dollars



Brokerage channels

Within retail advice channels, the FSB channel is the main delivery platform for ETFs, with ETF assets in the channel representing almost two thirds of all retail ETF holdings. In the FSB channel, ETF holdings have expanded relatively quickly in fee-based accounts and particularly in discretionary accounts, but have recorded a modest decline in commission-based accounts. The price point of ETFs; their liquidity characteristics; their ability to provide access to highly specialized asset classes; and the fact that, like other exchange-traded securities, ETFs can be block-traded in discretionary accounts; have all been factors that have continued to resonate with FSB advisors.

The other channel that has built a material presence in the ETF market is the ODB channel. At the end of December 2013, this channel accounted for \$19.5 billion in retail ETF assets. By the end of 2018, even though the share of ETF assets had declined from 36.0% to 32.3%, total holdings in the ODB channel had risen to \$40.8 billion. Contributing to this growth has been the increasing product awareness of ETFs among retail investors; the proliferation of tools

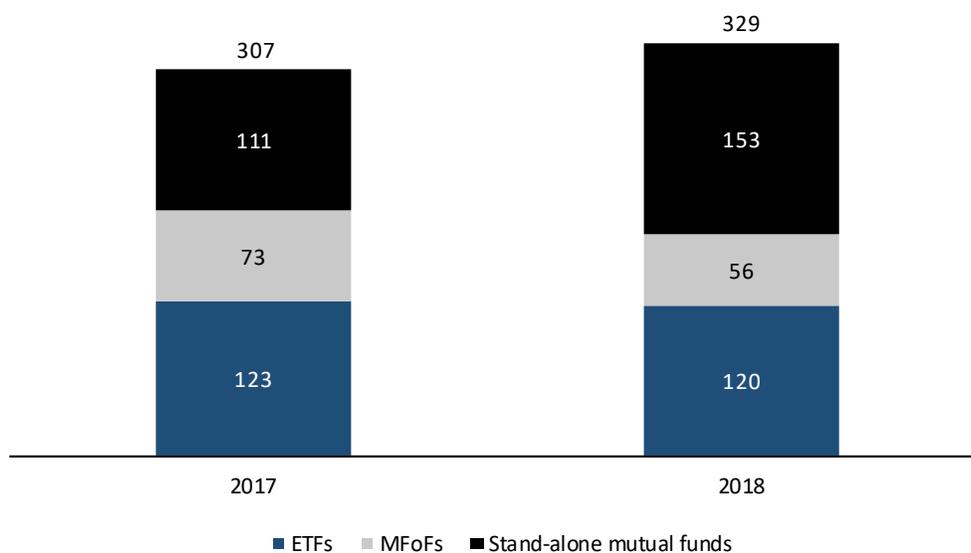
(such as portfolio allocation models); and the commission-free trading of ETFs offered by some online brokerage firms. More recently, the emergence of online wealth managers (often referred to as robo-advisors) in Canada has expanded the horizons for ETF providers in terms of distribution channels. ETFs are the cornerstone of the robo-advice platforms. While robo-advice assets in Canada are still relatively modest, the potential for future growth is significant.

Another opportunity for ETF providers is through access to the financial advisory networks of MFDA dealer firms. Although modest in number, the number of advisors who are executing their asset-allocation models with ETFs is expanding. The opportunity for ETF providers could grow further if a greater number of the 30,000 MFDA-licensed financial advisors in Canada had access to ETF products. Advisors in the FA channel that are currently active users of ETFs are almost exclusively those who are registered with IIROC.

Product development

Over the past two years, both the relative novelty and the rapid proliferation of ETFs within the Canadian investment fund landscape have resulted in an increasingly influential role for product development in shaping the segment. While mutual funds launched between January 2017 and December 2018 accounted for just 378 of the 3,190 funds available at the end of the period, ETFs launched over the same time period amounted to 245 new funds, representing over a third of the 660 ETF offerings on the market as of December 2018. Equity mandates dominated new ETF issues, with 157 new funds. It is notable that sector-equity ETFs played an outsized role in product development—namely via financials, technology and healthcare-focused mandates—which launched 346 funds over the period, despite accounting for just 9.6% of assets at the beginning of the period. This was due to the growing demand for thematic investment solutions in newsworthy trends, such as blockchain, robotics and marijuana.

Figure 5.5: Number of investment fund launches



Fixed income mandates placed second in launches between January 2017 and December 2018, with 458 of 469 funds launched coming from investment-grade bond funds. Multi-asset class ETFs were also present on the product development front over the two-year period, with 16 fund launches. Contrary to sales activity on the mutual fund front, investors have not figured an overwhelming preference for newly launched ETFs over mature issues.

This dynamic was especially evident in 2016, when newly launched ETFs comprised just 11.0% of the \$16.4 billion in total ETF net creations generated over the year. The relatively weak sales figures attributed to new funds reflected the fact that a high portion of ETF sales gravitated toward a small number of older ETFs with established, and often large, asset bases. In 2018, for example, the top 15 best-selling ETFs accounted for 48.2% of total yearly net creations, and only four of the 15 funds were launched after 2015.

Future product development in the Canadian investing marketplace is likely to continue unabated as factors such as developments in AI; the implementation of the new regulatory regime for liquid alternatives; the emergence of fee-based accounts in the MFDA-licensed world; and the growing sophistication of solutions combine to create the conditions for innovation in the investment funds industry.

ETF fees

Fees associated with ETFs vary from sponsor to sponsor and tend to reflect the complexity of the factors used in the specific strategy employed by the fund manager. Irrespective of the category into which the fund may fall, the general trend in fees for all categories, with the exception of actively-managed ETFs, is down.

Passive ETFs, on average at the end of 2018, carried fees of 26 basis points, a decline from the average of 35 basis points reported in 2013. The costliest ETFs are those that are actively-managed, and the category is the only one which did not record a decrease in fees in 2018. Whatever the category, the average fees charged to the fund were at least 30 basis points below the average MER of an F-series fund at the end of 2017. However, the gap between the two competing products is narrowing as an increasing number of actively-managed F-series mutual funds are available with MERs in the 40-60 basis point range.

ETFs and mutual fund companies

In the initial stages of development of the ETF segment in Canada, the product was viewed as a direct competitor to index mutual funds in terms of both investor usage and cost. Since that time, and particularly in the past five years, a number of mutual fund companies have recognized that ETFs are better seen as a complementary product and one that should be embraced by the mutual fund community.

Several fund companies operating in Canada are now active issuers of ETFs. These companies have recognized that many of the investment and professional skills needed to manage and offer mutual funds mirror those required to manufacture ETFs. In addition, it has been realized that offering a range of listed and unlisted fund products that reflect the widest range of investor interests will encourage both investor and advisor loyalty. At the end of 2018, 30 companies sponsored ETFs listed in Canada, 18 of which were traditional mutual fund companies.

As was mentioned earlier in the report, FSB firms are the most productive distributors of ETFs at this point in time, thanks in part to the growth of fee-based accounts. The introduction of fee-based accounts in both the FA and BA channels raises both challenges and opportunities, as these channels are the most active distributors of mutual funds and are the most recent adoptees of fee-based accounts. Fund companies that do not offer a choice of fund types run the risk of sacrificing advisor loyalty, a critical success factor at a time when advisor shelves are shortening and more dealer proprietary products are becoming available.

ETFs also represent an *additional*, not a *replacement* revenue stream that will permit fund companies to leverage their brands. At the same time, in order to avoid product cannibalization, fund companies have put more emphasis on clearly differentiating the value

propositions of their mutual fund and ETF offerings on the basis that both have unique features and benefits, and one should not be viewed as a straightforward substitution for the other.

Finally, but of no less importance, is the increasing use being made of ETFs as underlying portfolio investments by mutual fund managers. At the end of 2018, data available to Investor Economics indicated that a total of 74 distinct mutual funds, with combined balances of \$13.5 billion, invested exclusively in ETFs and that a total of 62 fund wrap programs housed \$18.9 billion in ETFs.

The challenges ahead

Despite the encouraging growth experience and positive prospects for the future, the ETF segment and its providers face a number of challenges. A leading challenge is that of scale, an important consideration for most companies, but a particularly pressing issue for providers of low-cost products or services. While growth opportunities abound, reaching a level of assets that can transform an ETF operation into a profitable business is difficult. Mounting pricing pressures (management fees for several ETFs are now below 10 basis points) make building a viable and self-sustaining ETF operation challenging. Further, ETFs, as with some mutual funds, may not be suitable to every individual as the product is subject to market risk (they track the market going up and down), liquidity risk (there may not be an active market for niche ETFs with a limited following) and concentration risk (they may not be invested in a fully diversified pool of companies).³⁴

Compounding the issue of scale for ETF providers is competition. Over the last five years, a growing number of companies have launched ETFs in Canada. In addition to the products listed on the domestic exchange, Canadian ETF providers compete against ETFs listed in the U.S., most of which are available to Canadian investors through both advice-based and direct distribution conduits. Product proliferation and commoditization (firms tend to imitate each other's winning formulas) are making it increasingly difficult for ETF firms to differentiate their offerings.

Consolidation is the inevitable consequence of the rapid adoption of ETFs by investors and advisors, a development which has prompted a number of asset managers, including relatively large mutual fund companies, to enter the segment.

³⁴ Patricia Meredith and James L. Darroch, *Stumbling Giants: Transforming Canada's Banks for the Information Age*, (Toronto: Rotman-UTP Publishing, 2017), 103-104.

Impact of Technology

Asset managers, such as investment fund manufacturers, recognize that technology is an essential part of the infrastructure of the investment process, irrespective of whether the application of technology is in the area of research, investment selection, trading, risk management, operations or client servicing. With some justification, however, the asset management and wealth management industries have been criticised in some quarters as being slow to adopt to new technologies.

Slow to respond

In response to criticisms, asset managers point to the extensive use being made of social media, significant website improvements and online client-facing portals for document delivery and access on the positive side, and the difficulties of grafting new technology onto often decades-old legacy systems—despite continued investments in operational improvements—on the other side. Considering both managers and manufacturers, there is evidence that wealth managers who deal with individual clients, including digitally-minded millennials who are accumulating wealth, have made greater strides in the implementation of new technologies than have the manufacturers of investment products. The focus of wealth managers has progressively moved up the value chain, landing on the individual and their objectives in the digital age.

The pressure to accelerate change has been exerted through a combination of factors, including growing cost pressures that are challenging traditional operating margins; tougher regulations (often cited as the biggest challenge of all); and the rise of low-cost, passive investments prompted, in part, by good returns from constantly rising markets. In addition, investors and their advisors are demanding greater value for the services provided at a time when their digital service expectations are growing and the opportunity to become more self-directed is increasing.

Warding off disruptors

Outside of these pressures, there is also the threat to these industries, often viewed as somewhat traditional, from game-changing disruptors. Google, for example, is known to have commissioned research into the asset management industry, while Apple and Facebook have ventured into the world of payments made through mobile devices. Likewise, Amazon has become a formidable player in the financial services industry through its various services, including lending, insurance, and more recently, chequing accounts. On the demand side of the equation, there is also convincing evidence that the emergence of non-traditional competitors will be welcomed by some investors. A recent survey³⁵ indicated that 74% of respondents would consider a non-traditional competitor on the grounds of a wider range of products (the Amazon influence) and the probability of lower transactional costs (the Costco influence).

If there are built-in barriers to entry, however, they are connected to the complexity of the industries themselves, as well as the changing regulatory environment in Canada. Canada is one of the few developed countries without a national securities regulator and a country with more than one organization governing the behaviour and obligations of financial advisors.

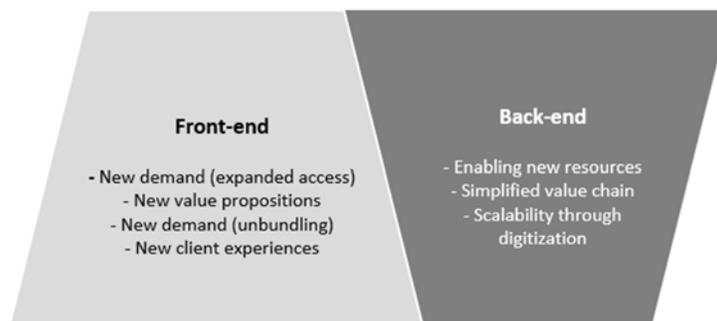
³⁵ Accenture Consulting, *The New Face of Wealth Management In The Era Of Hybrid Advice*, 2017.

A multi-faceted focus

There is a general acceptance by participants, large and small, that the various components of the wealth management and financial services industries have to change to remain both profitable and relevant to their increasingly tech-savvy clients. The focus is multi-faceted and not singular and is concentrated on operational efficiency and cost savings; the development of digital channels—such as robo-advisors—to enable penetration of emerging client segments; and on product development, such as the introduction of further enhancements to low-cost products (ETFs).

The biggest potential cost lever is automation and the better, deeper use of data and analytics. Data teams at asset managers are being enlarged and the use of artificial intelligence (AI) is being promoted in terms of strategic priorities, a move that, while costly over the near term, is viewed as an essential investment in the future. Conventional investment-selection techniques are being complemented by the use of quantitative and analytical techniques, such as AI, and alternative data sources, such as social media sentiment and “web-crawled” data, that are able to provide unique insights into both the needs of the existing clientele and the success rate of fulfilling those needs.

Figure 6.1: Growth driven by technology



Despite the widespread acknowledgement that technological applications of the types mentioned above are worthwhile, in a recent survey³⁶, a majority of asset management firms admitted that their firms did not have a clear digital strategy and almost two thirds of respondents admitted to under-resourcing various digital initiatives.

Distribution first

The distribution side of the business may be the initial beneficiary of the industry’s attention to data management. Firms have begun to analyze client cohorts and to generate predictive analytics for both assets and clients at risk in an intensely competitive, fee-compressed environment in which retention is a critical business strategy. Irrespective of which tools are employed, these types of developments require capital and there is every indication that, despite the arrival of innovative start-ups, the larger firms will be favoured, if only through their sheer size and, ultimately, their deeper pockets. It is also evident, notwithstanding the arrival of robo-advisors, that many investors are reluctant to move from a purely advisor-based model to a technology platform that offers limited advice. In the medium-term horizon, distributors in Canada will be challenged to offer multiple service models in order to attract and retain the widest range of investors.

Even ahead of the great wave of change brought on by millennial investors—56% of whom question the value of advisors³⁷—digital tools have proven to be able to provide opportunities

³⁶ Deloitte, *2018 Investment Management Outlook: Vision and Focus to Drive Success*, 2018.

³⁷ Accenture Consulting, *The New Face of Wealth Management In The Era Of Hybrid Advice*, 2017.

for advisors to change the nature of their client relationships. Account summaries, online comparisons between active and passive strategies and computer-generated investment recommendations are now available to investors, leaving the advisor with more time to provide guidance on complex issues, such as estate planning.

Cyber-threats

Operational sophistication in both the middle- and back-offices, improved investment selection and multi-platform distribution are all advantages that will accrue to the asset and wealth management industries through the adoption of technology. One area of risk associated with technology that is coming to the forefront for both asset managers and their clients are cyber-security risks, which are now recognized as one of the leading risks that have to be managed. Data breaches and cyber-attacks that result in the loss of personal information attract attention, and sometimes penalties, from regulators, not to mention awkward and justified questions from investors and the media. Failure to adequately guard a firm's data can inflict long-term reputational damage.

It is unlikely that the potential for such security ruptures will lessen as the perpetrators themselves, as in the nature of an arms race, become more sophisticated. As a result, asset managers and the distributors that house sensitive client data are stepping up investments in technology designed to combat such attacks. The need for investments of this type, coupled with the need to acquire insurance to cover cyber-attacks, adds operational costs and, as in other areas, places small- to mid-sized firms at a disadvantage.

The outlook

Both the application of technology and the expanded use of digital tools and channels have some fundamental implications for the Canadian asset and wealth management industries. Firstly, larger firms are and will remain more likely to be able to make the necessary capital investments in technology than will their smaller or more specialized counterparts, although they may face constraints from legacy systems and considerable momentum required at all levels of the organization.

Secondly, universal access to technology and the use of AI, analytics and automated order-execution have the potential to limit the ability of managers to differentiate themselves through product design. At the same time, technology has found its way into product manufacturing through AI-managed products and has created opportunities for better advice. For example, AI has the potential to augment the supply of advice by human advisors, rather than to take away from human advisors, thereby reaching better outcomes for their clients³⁸.

Thirdly, although the application of technology is likely to reduce costs over time through the displacement of personnel, the immediate impact of the implementation of a technology strategy is likely to create higher operational costs.

Finally, there is a risk that the asset and wealth management industries will attract the attention of technology-based businesses, which will be attracted by the slow-to-adopt nature of the industries, as well as the positive outlook for growth and the limited capital requirements when compared to other sectors of the financial services industry, such as banking. This may lead to a fresh round of acquisition and consolidation in the ranks of the undercapitalized smaller players unable to pay the technology piper.

³⁸ Chuck Grace, Amelia Young, and Andrew Sarta with Romina Maurino, *Financial Advice In Canada: A Way Forward*, November 15, 2017.

Conclusions and Outlook

At the end of 2012, investment funds, which include ETFs and segregated funds, represented 30.8% of personal financial wealth in Canada, a share that was slightly less than that held by spread-based assets, such as GICs. By the end of 2017, the share held by investment funds had increased to 36.1% and, by 2026, through growth in absolute terms of an estimated \$1.2 trillion, the share is projected to reach 37.8%.

Figure 7.1: Canadian financial wealth forecast
Assets in trillions of dollars

	Assets		Change in assets	2017-2026 CAGR
	2017	2026		
Financial wealth	\$4.5	\$7.4	\$3.0	5.8%
Deposits	\$1.3	\$1.9	\$0.6	3.7%
Investment funds*	\$1.6	\$2.8	\$1.2	6.3%

*Includes mutual funds, ETFs and individual segregated funds.

While this growth is projected to occur at a far slower rate than was achieved by the fund industry in the five-year period of 2006–2011, it is expected to be realized despite various headwinds in the form of regulatory change; flat, if not declining, operating margins; the need to invest heavily in technology; and, importantly, the changing demographics of investors. These headwinds also point to the change in the composition of investment funds in Canada.

Influence of demographics

The medium-term future of the Canadian investment fund industry is partly reliant on the ability of the industry to anticipate and respond to the financial needs and expectations of two diverse segments – millennials and baby-boomers. As already discussed in this report, baby-boomers seek to protect the approximately \$2 trillion in personal wealth that they had amassed by the end of 2017 and to use those savings – held in deposits, investment funds and individual securities – to finance their retirements. Inevitably, as the baby-boomers age and seek to maintain a comfortable lifestyle, they will erode their savings through regular or occasional capital withdrawals to meet day-to-day and/or extraordinary living expenses or to assist younger family members in acquiring long-term assets, such as real estate, or valuable skills through higher education.

The expected outcome of this shift by baby-boomers from being prudential financial hoarders to aging spenders and wealth transferors will be a rate of growth in personal wealth that will be at or slightly below the 5.8% overall rate of growth projected for 2017-2026. This growth will be fueled, to a great extent, by asset value inflation rather than by increased flows into savings vehicles.

At the other end of the Canadian wealth spectrum are Millennials, a cohort in which the oldest members are now 38 years old. While the older members of this segment are settling into their peak earning years and should be turning their financial attention to saving for retirement, the reality is that debt management and elimination is as much a priority for this group as it is for younger Millennials. The difference is that the older group are dealing with record levels of mortgage debt while the younger group are seeking to rid themselves of student loan obligations and credit card debt.

But debt levels and types of debt are not the only difference. Millennials have very dissimilar attitudes towards savings and investments from their parents or grandparents. The differences are threefold. First, for Millennials saving for retirement is not an immediate priority and ranks behind debt reduction and the acquisition of a house resulting in only modest flows into savings. Second, there is evidence from surveys in both Canada and the United States that Millennial investors are less likely to use a financial advisor than their parents and more likely to use technology-based platforms over an advisor, and, as a result, far more likely to invest in exchange-traded funds than mutual funds. Finally, millennial investors are keen to make a social statement through their investments and are more focused on environmental, social and governance-aligned investments, irrespective of the impact on portfolio returns, than older investors.

In the medium-term, notwithstanding the limited flows that are expected, the sheer size of the baby-boomer cohort and the wealth that they currently control will offset any negative impact on the investment fund industry brought about by the new attitudes to savings and investment being introduced by value-seeking and values-driven millennials.

The outcome, at least over the medium term, will be further, if muted, growth for the investment fund industry with a clear move away from mutual funds in favour of exchange traded funds and a companion move from across-the-desk advice to do-it-yourself electronic platforms.

ETFs and fund wraps set to grow

In 2012, ETFs represented a modest 6.1% of total fund assets. By 2017, the share had grown to 9.1%, and by 2026, the share is expected to reach 14.5%. The doubling over the decade will be fuelled by ongoing investor interest in cost containment, a cooling of enthusiasm for active management and the shift in investor preferences brought on by technology-wise millennials.

The other outcome of the projected decline in share of stand-alone mutual funds over the nine-year period ending 2026 will be the steady rise in popularity of packaged solutions. Fund wraps, the driver of the change in asset-allocation responsibilities from advisor to fund manager, are expected to hold a 42.1% share at the end of 2026, an increase of four percentage points from the level seen at the end of 2017.

Look for the expansion of non-traditional channels

Even as the investment funds mix has changed, with more change expected over the medium term, the channels through which funds will be distributed are also going to evolve. Do-it-yourself channels, online advice and direct-to-investor channels, as well as hybrid channels that combine elements of digital- and advisor-based channels, are all set to expand at far higher rates than will the conventional bricks-and-mortar networks.

The influence of the banks

The banks' participation in both the manufacturing and distribution of funds of all types has had a major influence on all channels, and the extent of their penetration is expected to

increase as developments, such as the introduction of fee-based accounts at the branch level and the active issuance of ETFs, take hold. At the same time, the banks have also concentrated on identifying clients early on and engaging them through the provision of financial advice, which has further improved their positions in the marketplace.

Although insurers and major independent firms make worthy competitors, the sheer reach and size of the Big Six banks in Canada, as well as the access they have to investors in all retail investor segments, makes them difficult to dislodge and, in some areas, effectively challenge. Their ability to move fee levels lower, thanks to the benefits they enjoy through economies of scale, also provides the banks with a competitive advantage which may be harmful to some independent firms that have been unable to bring their operating margins down to pre-recession levels.

Falling MERs

MERs have fallen in recent years as a result of a change in the mix of funds, the appeal of passive funds, the benefits of scale and encouragement from investors and regulators. Average MERs are likely to fall further as the movement toward fee-based accounts gathers momentum in all advice-based channels. The forecasted change in the value of assets held in fee-based accounts—which include securities other than units of investment funds—is game-changing. Total assets held in non-discretionary, fee-based accounts in the three main advice channels were reported as \$321 billion at 2017 and are forecasted to be approximately \$1.2 trillion by 2026, which will be some \$300 billion more than discretionary assets in the same channels.

Although the material migration to fee-based accounts will lower MERs, it will not necessarily reduce the cost of investing to all investors and may, in fact, result in higher costs to some investors with more modest accounts and the elimination of advice to others.

The price of maturity

The pressure on asset manager margins, which reflects both investors seeking value and regulatory actions, may lead to a further contraction in the number of major participants in the industry over the medium term. This will be in spite of an interest by both investors and regulators in having as wide a selection of fund manufacturers as possible. However, as has been pointed out earlier in this report, the Canadian fund industry has matured and is set to move through a period of relative stability and consolidation, rather than a period of rapid expansion.

Figure 7.2: Client-centric wealth management approach



The aging of Canadian households, at least for the next two decades, will also have a significant impact on product design and features, the nature of advice and the willingness of investors to make radical changes to how they purchase investment products and services. The focus of Canadians in or entering retirement will be on capital preservation, not accumulation, and the generation of inflation-proof income over a relatively long and, demographically speaking, even increasing periods of retirement. Fund managers and distributors are therefore faced with a dilemma: How can they meet the needs of the “Silver Segment” (those over 65 years of age) who seek face-to-face contact with an experienced and qualified advisor even as they retool themselves to attract the attention of millennials (those born after 1992) who need accumulation products and expect immediate and intelligent online access? Many firms will be tempted to opt for one segment over another, just as some dealers have opted to focus on the HNW segment and abandon the mass affluent cohort. Others, recognizing the cost implications of such a strategy, will seek to provide comprehensive solutions that tick many of the boxes for multiple segments in order to maintain the broadest clientele.

Pressure from outside

If there is an impetus for change, it will come from outside the industry. ETF developments are coming from within, as mutual fund managers expand their product shelves and, while pushing existing independent ETF issuers to respond, the flourishing of ETFs cannot be considered to be disruptive. The same is true for online managers, whose assets are set to climb at a pace far faster than any other channel and to reach approximately \$70 billion by 2026. While disruptive in their early days, they have since become an additional distribution channel for some low-cost funds and ETFs, including those issued by both banks and traditional fund companies.

If there are new and powerful competitors, they will come from outside the industry and, as Uber did with personal transportation and Airbnb has done with lodging, they will be technology-based and attractive to those accumulating and inheriting wealth, but not necessarily to those demographic cohorts which have moved beyond those life stages.

If these forces of change do emerge, advisors will be forced to adapt to new business models that will see them utilize, and not shun, technology to enable some of their simpler and/or time-consuming tasks to be automated and to enable their clients to play a more direct role in the management of their portfolios.

On the assumption that the headwinds of change are fully recognized, and are addressed via the introduction of innovative strategies and a willingness to invest in technology and digital solutions at all stages, the outlook for many manufacturers and distributors is positive in terms of growth. However, growth in assets and expansion of the business generally is not expected to be accompanied by widening margins. Asset managers, particularly, will need to realize that with maturity comes the requirement to be consistent and the necessity to place the needs of the client at the very top of the business pyramid.

Disclaimer

Canadian Investment Funds Industry: Recent Developments and Outlook

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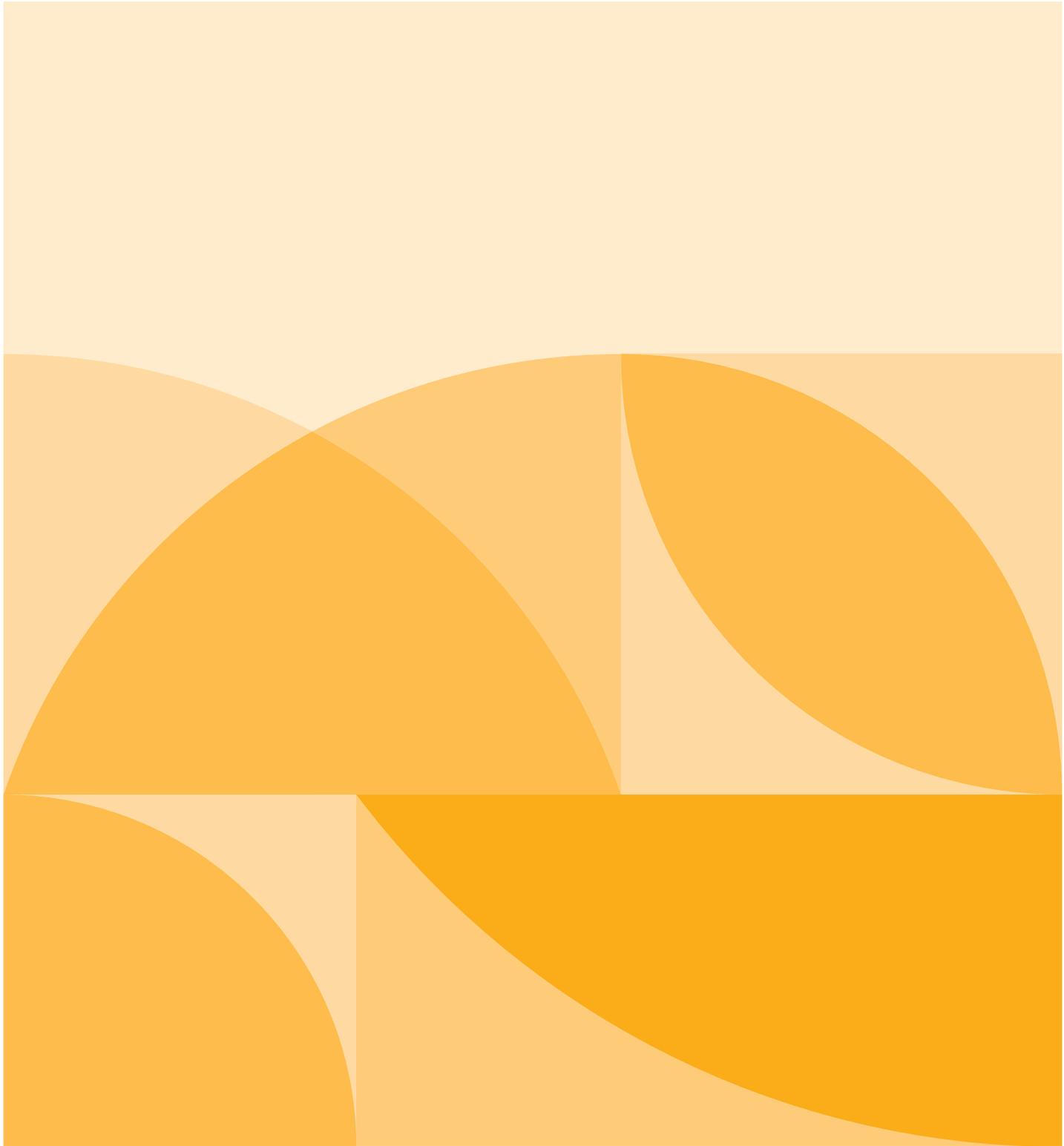
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