INDEFI

February 7, 2022

PERSPECTIVES

THE GREAT OVERHAUL: HOW MIFID SUSTAINABILITY PREFERENCES WILL CHALLENGE THE EUROPEAN FUND MANAGEMENT INDUSTRY

In April 2021, a MiFID amendment extended suitability requirements to include clients' sustainability preferences in portfolio management and advice on financial instruments. This amendment is the first application of the much-anticipated SFDR and the EU taxonomy to end-investors.

By August 2022, retail investors will be expected to specify whether they wish to invest, and in what proportion, in:

1) environmentally sustainable investments (according to the Taxonomy),

2) SFDR Article 9 sustainable products, and

3) products that consider Principal Adverse Impacts (PAIs).

The implications of this amendment extend well beyond sustainability. They are yet another blow to the traditional open architecture model and could even, in due course, derail the hallmark of European asset management: the pooled fund (UCITS).

Distributors taking back control

This amendment confirms the breadth of application of the European Commission's push on sustainable finance. All financial market participants are subject to the SFDR's new transparency guidelines and to the definitions set forth by the EU Taxonomy. It is therefore no longer entirely up to asset managers to define the playing field and its measuring sticks. Distributors and institutional investors must now provide and assess the information shared by their asset management partners.

With this MiFID revision, not only will advisers be required to gather and understand their clients' sustainability preferences (a vast challenge in itself); they will also be required to have the policies and procedures in place to understand the sustainability factors of the investment products they recommend to clients.

For distributors, the (analytical) resources required to undertake this task will be daunting. For many, this comes as further confirmation of the need to take back control of their product strategy through offer rationalization and strategic partnerships with asset managers. Doing so not only reduces the analytical burden; it repositions them as true (ESG) gatekeepers. This will further fuel the trends observed in the European market (e.g. meteoric rise of sub-advisory) and jeopardize open architecture.

Industry individualization

The next decade of asset management will be driven by the individual investor[1]. In Europe, the shift towards DC pension, the rise of unit-linked insurance and the boom of D2C channels are cementing the place of the retail investor at the heart of the industry's future. The MiFID amendment corroborates this through sustainability.

According to the latest MiFID guidelines currently under consultation, each client will be able to express which of the Principle Adverse Impact indicators should be considered. This means, for instance, a client should be able to determine the maximum carbon footprint of their underlying funds; decide to exclude all companies breaching the UN Global Compact; or choose to invest only in companies with lower gender pay gap than its benchmark.

The inherent complexity induced by such individualization calls into question the future role of the collective investment vehicle. Asset managers will either need to expand their product range to unmanageable proportions or seek an alternative.

Technology as the industry future

This alternative may already be here. In fact, it has been around for decades across the Atlantic and has only recently garnered new interest: the Separately Managed Account (SMA). These individualized baskets of securities allow distributors to offer their clients access to best-in-breed investment strategies while delivering personalized tax-loss harvesting or allowing the expression of personal investment beliefs.

Historically reserved for high-net-worth clients, technological advancements have since brought this offering to mass-affluent and retail clients. One such technology is custom indexing whereby SMAs replicate low-cost indices while maintaining the ability for clients to express personal beliefs by tilting the portfolio towards a particular ESG metric or excluding a specific sector or company. Its application to European clients falling under the MiFID II guidelines may only be a question of time.

As SMAs continue to soar in the United States, asset management behemoths are already securing access to this technology through a wave of acquisitions of custom indexing specialists. They may also have secured their success in Europe's next asset management revolution.

Indefi, with headquarters in Paris and New York, is a leading strategy advisor for the global investment management business. Established in 2007, Indefi helps asset managers shape their business strategies and build a sustainable competitive advantage. The firm's expertise spans public and private markets, including infrastructure, private credit and equity, and real estate. A pioneer in advising asset managers on ESG development and integration strategies, Indefi is a PRI signatory. For more information, please visit www.indefi.com.

1. See Indefi, "The Future is Now", to be released in February 2022.