Technology, Innovations Offer Investors Silver Lining

by Peter McManus, AIF®

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The financial world has been rocked by the transformative nature of technology and innovation, but these changes offer positive news for today's investors. While the past decade has been a difficult one for many, several innovation trends have converged for the benefit of investors big and small.

- Transaction costs have dropped sharply; the rise in popularity of Exchange Traded Funds (ETFs) has made low-cost indexing available to everyone.
- The use of an annual charge instead of a per-transaction commission has gained increased acceptance and has usually reduced investor costs.
- The move by many hedge funds to use a mutual fund structure has enabled individual investors to access previously unavailable strategies.

Portfolio managers and hedge funds invested heavily in technology and have developed new strategies, styles and techniques which were not possible before. Individuals can now have portfolios with better liquidity, diversification, and lower costs than were available even ten years ago.

The popular annual wrap fee has greatly enhanced the ability of an investor to build a portfolio. Until recently, costs for mutual funds and individual securities were tied to the transaction. Investors had to commit to a long holding period, or stay largely with one fund family, to avoid higher fees. Having one charge for the entire portfolio separates the costs from the investment selection, resulting in more liquidity and a greater ability to diversify. Advisors can now construct highly customized portfolios accessing some of the best strategies and managers. Portfolios can be assembled with a focus on overall risk management by using asset classes with low correlation to each other, resulting in reduced volatility.

Technology's effects are also forcing investment managers to adjust their pricing. Historically, the typical hedge fund had a "2 and 20" fee structure. Investors paid a 2% management fee and shared 20% of the profits. The hedge funds limited liquidity, typically with withdrawals allowed only quarterly. Distribution was also expensive.

The market selloff of 2008–9 intensified pressure to address these issues. Many investors grew frustrated with their inability to sell while substantial losses piled up. Demand for change led many investment managers to see the mutual fund model as a solution. Participating hedge funds have undergone a sea change, with pricing moving from a performance-based revenue model to one based on volume and assets under management. Lower management fees on bigger balances still ensure that portfolio managers remain well paid.

The mutual fund model may not offer a perfect solution, as additional rules and regulations may apply. For example, many of these strategies rely on leverage to generate excess returns. Mutual funds regulated under the 1940 Act have stricter limits on using borrowed money than the relatively less-regulated hedge funds. Some investment strategies may not do as well in a mutual fund wrapper as they did previously.

Disruptive changes will continue as more well-funded investment firms spend heavily on technology. On the investment side, a technological edge can be lucrative. For distribution, a technological edge can bring cost reductions and offer a competitive advantage. Investment managers and advisors can use these new realities to better serve their clients. These trends have now enabled smaller individual investors to enjoy institutional-style portfolios while reducing costs.

The increased penetration of technology has made the world more interconnected, and more complex. Successfully investing in such a world requires investors to take a long-term perspective, while remaining nimble enough to react quickly. With these new tools and methods, both are possible.