# MERRIL FEE CUTS CHALLENGE MANAGER MARGINS

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Merrill Lynch is cutting fees to managers on its retail managed account platform, say industry sources. The news may well force managers to reassess their approaches to the managed account business; a process that could mean less outreach to advisors, migration to smaller but better-paying distribution channels or, in extreme cases, abandoning managed accounts altogether.

It could also heighten the barrier to entering the managed account business for emerging managers. “This will weed out the smaller players in favor of managers with multiple product lines and large, centralized distribution platforms,” says a manager who asked not to be named. Because of the sensitivity of the topic, sources requested anonymity, but confirmation of the fee cuts came from three different sources with knowledge of the matter.

Speaking through a company representative, Merrill says it has no comment on any aspect of its managed account business.

Merrill told managers its was cutting fees last week, in writing, just as the industry participants were gathering for the Money Management Institute’s *2004 Fall Conference* in New York, according to a source who requested anonymity. The cuts are supposed to take effect on January 1, 2005. Merrill will trim fees for large-cap U.S. equity from 41 basis points to 38 basis points, according to several sources. The brokerage is further trimming fixed-income fees from 28 basis points to 25 basis points. In effect, say those sources, the reduction amounts to Merrill removing a “plus 3” basis points incentive to managers.

That incentive grew out of Merrill’s desire in the early days of the industry to ensure that regulators didn’t mistake its consultative managed account platform for an unregistered mutual fund, says a source. With that in mind it conferred fiduciary status on its managers, which compelled them to report performance directly to Merrill’s clients once a quarter. Despite that requirement, however, Merrill rejected its wirehouse rivals’ practice of supplying managers with proprietary portfolio accounting systems to facilitate communication between the two halves of the business. Instead it paid managers a few extra basis points to make up for money they had to pay outside vendors – most frequently Norcross, Ga.-based CheckFree Investment Services – for connectivity services.

But now with Merrill said to have improved its in-house communication system, the brokerage has taken its “plus 3” off the table, according to industry sources. In addition to removing the incentive payment to managers, Merrill retains its “most-favored nation” status. That obliges managers to let Merrill pay them fees as low as the lowest paying sponsor they work with – provided the styles and asset classes match. In other words, if manager X has a domestic large-cap value strategy on Merrill’s platform and on sponsor Y’s platform, and sponsor Y pays manager X 37 basis points, then Merrill retains the right under contract to pay manager X 37 basis points as well – even if its stated fee for domestic large-cap is higher.

Merrill’s fee cut comes about a year after Smith Barney reportedly trimmed its pay-out for large-cap U.S. equity management from 38 basis points to 36 basis points. A Smith Barney spokesperson declines to comment.

Smith Barney is the biggest managed account sponsor with client assets of $168 billion and a 31% share of the overall market for managed account distribution as of June 30, 2004, according to Cerulli Associates, a Boston-based research company. Merrill takes the number-two slot with $122.4 billion in assets and a 22.6% market share.

Managers say both Merrill and Smith Barney cited radical technological improvements to their platforms as reasons for their fee cuts – improved connectivity in Merrill's case; a new unified managed account platform for Smith Barney. But one industry observer says those are just excuses. "This is really about taking more money to the bottom line," he says. "The attitude is, 'Why should I pay more than the next guy?'"

Another expert, Dan Seivert of Echelon, says the fee cuts could mean money *off* the bottom line for managers. Echelon is a Los Angeles-based merger-and-acquisition advisory and consulting firm. With a fee cut of three basis points, Seivert figures a manager with $2 billion on Merrill's platform stands to lose $600,000 a year. A manager with $8 billion on Merrill platform is saying good-bye to $2.4 million a year. "That lost revenue would come right from the bottom line -- unless the [manager's] costs [of doing business] are offset by the sponsor's improved technology."

In the face of declining fees from the biggest managed account sponsors, managers might seek to distribute their wares through smaller but more remunerative channels, according to Seivert. "In general, managers make 15% more outside the wirehouses – in some cases almost 25% more," he says. But, though alternative channels – banks, regional and independent brokerages and registered investment advisors – have increased their market share by about 8% over the past five years, a recent Cerulli study suggest they have a lot of ground to cover before they approach the wirehouses in distributive clout.

Still, another source at a manager agrees with Seivert in thinking that falling fees may prompt managers to view higher-paying alternatives to the wirehouses with more favor. "I could see some of them giving up broader distribution for higher fees," he says.

The same source suggests that managers may react further to lower fees by cutting back on training for wirehouse advisors. "As managers see these fee cuts they have to take steps to stop them from eroding their margins," he says. "That could mean cutting back on education and training for advisors – and sponsors really rely on managers to keep their sales forces educated."

Though trimming outreach to advisors might be an understandable reaction to declining fees, one industry veteran says that only stands to hurt the industry as a whole. "Short term, it might solve some managers' problems, but over the long run, it would be bad for the industry – in the end, it's the end client who would suffer because end clients still need a lot of attention in this business."

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