Excerpts Reprinted from Morningstar Advisor
April/May 2011

U.S. Fund Firms Learn to Speak UCITS

By Christopher Traulsen

The European market is alluring to U.S. firms, but making the jump isn't cheap or easy.

In this issue's Spotlight section (Page 38), Robert Pozen and Theresa Hamacher have much to say in favor of Europe's UCITS fund regulation. In short, they argue that U.S. fund regulations have kept the mutual fund industry from competing as effectively globally as their European counterparts, while offerings under the UCITS regime have stolen the lead in asset growth. With that in mind, we thought it would be of interest to speak with the heads of two U.S.-based fund companies that have operations in Europe for their perspective on the challenges facing the U.S. fund industry and best practices from both sides of the Atlantic.

Dodge & Cox is a well known and highly regarded firm in the United States, but it has only recently launched a foray into European markets with the establishment of a Dublin-domiciled UCITS range in late 2009. Dodge & Cox Chairman Emeritus John Gunn and COO Tom Mistele are fond of the collaborative nature of fund regulation in Europe and are excited by the growth prospects of new markets around the world.

From London, we talked to Gunn and Mistele on Feb. 25. The conversations have been edited for clarity and length.

John Gunn

Tom Mistele

Christopher Traulsen: What's the outlook for the U.S. mutual fund business?

John Gunn: We have a moderately priced market. Although unemployment is still high, corporate profits turned out to be a real bungee jump, so we're back up just about to the previous peak in corporate profits reached in June 2007. We're not quite back to the previous peak in the S&P 500. The other thing that we see—that we got interested in the 1990s and was the genesis for starting our international fund—is that we're in the midst of an amazing global economic transformation. Twenty years ago, the developing world of 4.5 billion people wasn't a significant part of the global economy. Then, with the end of the Soviet Union in 1991, free-market mechanisms and free-market economies proliferated out over the globe. The information economy accompanied it with cheaper computing power, cheaper electronic communications, ending isolation.

So, now we have 6 billion people who are, in any kind of historical economic sense, hurtling toward modernity. The fascinating thing is that our financial panic in the fall of 2008 led to an implosion in economic activity for a short period of time. In 2009, almost all of the emerging markets grew. Even Africa grew slightly. These are powerful trends. As a matter of fact, as the past six weeks in the Middle East have shown, more and more citizens are not isolated in these authoritarian countries. They in effect live in an electronic global village and see how rich people live and want a part of it.

How does that link into the whole mutual fund world? To me, it links into it because I think it's going to lead to a wide profusion of equity throughout the world. It's going to be the advantageous way to finance. Since 1980, banking has been losing share in terms of financing economic activity in the real economy. My guess is that equity is going to continue to grow very rapidly. The number of companies that might go public in China over the next four or five years is absolutely extraordinary. All of those assets are going to have to be managed in some way.

Traulsen: How does that mesh with what you're seeing in terms of investors' risk appetite? Certainly in the markets I'm in and what I'm hearing from the U.S. is that investors are far less enamored with equities than they once were, given the turmoil in markets during the financial crisis. Are you seeing that same trend?

Gunn: Well, you're right, and that's why the valuations within the equity market are extremely reasonable. After a couple of years of quite good performance in relationship to fixed income, there'll probably be more enthusiastic crowds.

Tom Mistele: One of the challenges for the entire industry in the U.S. is the stratification of fund ownership. It's heavily concentrated in U.S. investors 35 and older. Fund ownership under 35 is quite low. That's going to be a challenge for the fund industry. So, it's not surprising that you see fairly aggressive use of social media to interact with that younger investor group.

"Field of Dreams" Marketing

Traulsen: Dodge & Cox recently launched funds in Europe. I think you launched your first Dublin UCITS in December 2009. What was the appeal for you of coming over here? You'd obviously had tremendous growth and success in the U.S. Was it a case where you thought the U.S. market was saturated and that more opportunities for growth exist here?

Gunn: If you look at us right now, we have about $200 billion under management. A little over a third of it is fixed income. About a third of it is domestic equity. And a little less than a third is ownership of companies domiciled outside the U.S. We're building a presence there. We're long-term holders of a lot of these companies. We wanted to trail that and build up a client base outside the U.S. In our fashion, we believe in the kind of investment-management service that is low turnover, emphasizes stock selection, and charges low fees. We're doing "Field of Dreams" marketing. You build it and they will come—so we hope. It's always a little problematic. But we started the international fund, which is not quite 10 years old, with $8 million from the board of directors. It's now a $45 billion fund.

Traulsen: It does raise a good question, because distribution here is different than in the U.S. Here, we have a lot more products competing for a smaller pool of assets. How are you dealing with this distribution challenge? Or is it just a case of building your business the same way you did in the U.S.—do well, and people will notice you.

Mistele: Our assumption when we embarked on the study of this venture was that we would continue with our current investment style and process and scale based on existing systems. We're using the same investment committees, research process, global custodian, administrator, pricing agent, and global transfer agent—those were givens. Back in September 2009, as we looked at the market, I recalled seeing a survey on the criteria that European investors relied on in picking investment managers. The top five factors were clarity of investment process, performance, risk control, stability of the investment team, and investment management fees. Well, I thought I was reading one of our slides. Those have been fundamental principles for this firm since its inception. And we're relying on these principles to tell our story to non-U.S. investors.

Gunn: In the late 1970s, we hired the only consultant that we have ever had. Charlie Ellis of Greenwich Research came in and looked at our whole operation. His notion at that time, which I thought was very good, was that investment management is a very large business, but it's highly fragmented. In that case, you want to present a distinct profile in a fragmented business. So, we spent a lot of time just thinking what our distinct profile was and explaining it in many different ways. The idea is that you have a distinct profile, and maybe you turn off 80% of the market.

It doesn't make any difference because the remaining 20% is huge.

The reason that not many people follow this strategy is that—I don't care how good you are—investment management has an enormously high error rate. So, if you have a distinct profile, every so often you're going to look like the dog's breakfast. We've had those periods, but we keep on coming through and coming back. That's the notion.

Mistele: We started out in the U.K. primarily because of its retail distribution review, which is essentially going to ban commissions in the U.K. It will drive distribution toward the advice-driven model. That plays to our strength. We're very aware of the strong headwind we face in terms of retrocessions that are paid overseas, which Dodge & Cox doesn't pay. In some cases, they have a stranglehold of some fund platforms.

Traulsen: It's fairly typical for a large-cap global fund in Europe and the U.K. to carry anywhere from a 1.6% to a 2.0% total expense ratio. You're at, what, 0.7% or something?

Mistele: 0.7%, yes.

Traulsen: That is something that certainly sets you apart here. It's very clear you're not paying for shelf space, as has been the norm here.

Mistele: That's right. To John's point, as they say in real estate, it's location, location, location. In our case, it's differentiation, differentiation, differentiation.

Gunn: If you're going to build a long-term successful business, you need long-term satisfied customers. If we would start over today, our fee level would be the same. It'd be the same everywhere, because to us it is a fair amount, and we believe that after the payment of fees, the shareholder will be left with an investment that outperforms most indexes over a long time period. If the fee levels at 1.5% to 2.0%, I think it's going to be very difficult to sustain.

The picture of investing today is totally different than it was 10 years ago. The mega-cap companies have probably never been cheaper in relationship to the broad market. If you take the top, the largest companies in the U.S., they have about 1.5 to 2 P/E multiple lower than the rest of the companies. We can see it in the equal-weighted S&P, which has outperformed the S&P nine out of the past 11 years. In effect, it has doubled over 11 years while the S&P has gone nowhere. So we look out to a global economy that has a significant probability of growing at a historically high rate, led by the developing world, and we think that the overall returns of equities will be very large in relationship to fixed income. It may be very surprising how well the large companies do, which means, if you follow the logic chain, it's going to be very difficult to beat the indexes. Alternative investments in private equity, in hedge funds, with 2 and 20, I don't know how they do it. That's just a huge load to carry.

Doing What We Do

Traulsen: So, you think the ground will shift even more in favor of lower-cost fund companies, even in markets where that hasn't been the norm.

Can I follow up on that? When I think of Dodge & Cox, I think of value, quality, and long-term focus. You come to Europe, and investors here are not necessarily that interested in carving up the U.S. into a style box. They want something that can keep up with the S&P 500 year in, year out. Do you note that difference in this market as you try to explain to people what you do and to get the right kind of investors that will stick with you?

Mistele: We take every opportunity to remind investors of our three- to five-year investment horizon. You'd be hard-pressed to find a shareholders report that didn't stress that point. There is a trend toward a shorter time frame that we've run into as we speak to potential investors and consultants. Volatility is on people's minds. But we think it's important to stress this investment horizon. We also remind investors repeatedly that we're bottom-up investors and often deviate significantly from the S&P based on this bottom-up process.

Gunn: If you look at what people want out over a long time period, they want to have the purchasing power of their wealth preserved and, we hope, enhanced out over a five- to 10-year time frame. If people's objectives are to make as much money as possible without losing any—well, that's pleasant, but we can't do it. I don't know how to do that on a short-term basis. In fact, the only person I know who really built a very successful business advocating that was Bernie Madoff, but that didn't seem to work out.

In terms of alternative investments and all that, there's been all kinds of people advocating for them, and then they seem to explode every so often. So, our view of it is that, yeah, there's going to be volatility, but we are owners of companies that we think have management expertise and a strong business franchise, and we bought them at a reasonable to low value; they will continue to look at the changing economic environment and make adjustments, seeking opportunities and avoiding risk. At the end of the day, we think that the ownership of those companies is going to be a very rewarding experience. Our risk control is basically our individual stock selection.

Traulsen: But do you find that there's more resistance to that message in Europe?

Mistele: Yes, we do get some of that in meetings with institutional investors in Europe. We get questions like, How much are you going to beat the S&P in the next two or three years? That's not a typical question we would hear in the U.S. and not a question we would want to answer, because we don't know the answer. We're driven by our bottom-up investment process.

Gunn: I go back to the Charlie Ellis example. In Europe, maybe we turn off 90% of the people. I don't have the faintest idea. Not to sound arrogant about it, but it doesn't make too much difference, because we can't do anything else other than what we're doing. If we had a way of avoiding volatility and creating superior return, of course that's what we would do.

Flexible Regulatory Model

Traulsen: Having recently launched a Dublin UCITS, was there any thing about the UCITS regime that you find interesting or appealing that you wish applied in the U.S., or vice versa? Are there '40 Act rules that you think would be well applied in Europe?

Mistele: The UCITS regime is much more flexible. I was impressed in the very beginning with the dialogue that we had with the Irish regulators. We went in and met with them across the table. They asked very thoughtful questions. They'd clearly done their homework and knew of our firm. We often don't see that with the SEC, maybe because of its size or just their regulatory model. In Ireland, it was collaborative and less formal. The UCITS structure—being accepted in more than 50 countries—makes it really the global brand. The U.S. Investment Company Act model is really stilted by its structure and the current tax and regulatory environment. It's U.S.-bound, and I don't see any potential for it as a global brand. It's unfortunate, but many have tried to alter the structure to take it offshore, but they've been unsuccessful.

Traulsen: Are there other markets other than the U.K. on your radar?

Mistele: Yes. We started out in the U.K., because the retail distribution review there plays into our strong suit in the U.S. We're currently looking at the Nordic countries and primarily Switzerland, because of the institutional client base and the private banking relationships. The last estimate I saw was that in the U.K. 90% of the defined-benefit plans are no longer taking participants. We see similar trends in the Nordic countries and in some other European countries. They're moving more toward a defined-contribution model. What that'll look like is hard to say at this point in time. There've been many pension-reform proposals.

I don't think it'll look truly like the U.S. 401(k) model, which has been an area of growth for Dodge & Cox over the past 20 years. It'll have some of the same elements, however. M

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The sections on Greg Johnson, CEO of Franklin Templeton Investments have been omitted for reprint purposes. To view the full article, please visit www.advisor.morningstar.com