THE FUTURE OF ASSET MANAGEMENT

A few key trends may be signs of things to come

By Maha Khan Phillips

A lot can change in a decade. In 2002, asset managers were still smarting from the fact that Yahoo! did not, in fact, take over the world. Institutional investors were firing balanced managers and replacing them with specialized ones. Liability-driven investing was just a buzz word, and exchange-traded funds (ETFs) were a new, niche product area with little potential. Private equity and hedge funds were hot, and consultants insisted that funds of hedge funds were the best model for investors. Spreading risk through the use of structured vehicles like collateralized debt obligations was considered to lower risk, not increase it. And it was generally agreed that Alan Greenspan was the wisest man in the world.

Of course, things look different now. It is safe to say that very few people saw this decade coming. But where does that leave asset managers who want to ensure that they are prepared for the next 10 years? A few key trends may be signals of things to come.

MARGIN COMPRESSION

According to Casey Quirk, a U.S.-based consultancy firm for investment management firms worldwide, operating margins have still not returned to their 2007 level but have recovered from their 2009 lows, with a median of 32% in 2011. So, asset management remains profitable, but not as much as in the past. "This is an industry where revenues have gone up year in, year out for a very long time. Our view is that revenues are not going to grow nearly as fast as they have and margins in this business will become compressed," says Kevin Quirk, founding partner of Casey Quirk. The firm has partnered with Institutional Investor's U.S. Institute and McLagan (provider of compensation consulting services for the investment management industry) to conduct a survey of 96 fund managers worldwide overseeing US$21 trillion in assets. It found that profit margins since the financial crisis have been managed by controlling compensation and benefits expense.

Global consultancy Cerulli Associates points out that, although asset management revenues were set to exceed US$200 billion by 2015, this achievement now looks unlikely. "There is a dramatic shift out of higher-margin products into lower-margin products," says Shiv Taneja, managing director of Cerulli Associates. "The share of equity on a global basis is falling. This has two significant impacts. If clients are getting out of higher-margin products and into lower-margin products, that will have an impact on fund managers' profitability. In the past, we've also said that owning stocks and stock investments will get you to your retirement quicker. That is not the case anymore."

So, what do increased competition and lower margins mean for product development?

For one thing, the ETF market will continue to grow and so will passive strategies as a whole. ETFs already account for over US$1.3 trillion in assets, according to Cerulli. Enhanced indexation, or engineered beta, will take on market share, growing from its current estimated market share of US$200 billion. A report released in June 2012 called "Innovation in the Age of Volatility" by asset management advisory

CREATE-Research and Principal Global Investors predicts growth in products that will serve the defined-contribution scheme market. The study forecasts that target-date funds will see significant innovation and morph into a more comprehensive solution.

If the financial crisis has been kind to ETFs, it has been less so to hedge funds, which charge higher fees. Five years ago, hedge funds were widely expected to reach US$5 trillion in assets under management by now, but in 2011, the industry had US$2.46 trillion in assets under management "The asset management industry as a whole is changing, and the fund-of-hedge-funds sector is going through a transition as well. We see adjusting business models and consolidation amongst the players," says Lisa Fridman, CFA, head of European research at fund-of-hedge-funds investment firm PAAMCO. "In general, the traditional 'select and compile' approach is being put under pressure as end investors are developing their own hedge fund programs."

Quirk believes that successful asset managers will have to offer either unique alpha or unique, cheap betas. Firms that offer whole solutions provision (that is, advice, portfolio management, asset allocation strategies, and customized solutions) also will benefit.

Illustration by Timothy Cook

RISE OF THE FIDUCIARY

These trends explain why fiduciary managers are posting significant gains in assets. Nearly two dozen European fiduciary managers have seen a €110 billion increase in assets under management as of October 2012, according to an annual survey conducted by *Investments & Pensions Europe* magazine.

In general terms, fiduciary management refers to the outsourcing of pension fund management to a single third party that takes control of the fund or part of the fund from the scheme's trustees, providing advice on manager selection, investment strategy, and portfolio services. It is an area where traditional investment consultants like Towers Watson and Mercer have established businesses and where boutique consultants are also drawing market share.

"We understand client needs because we come from a consulting background," comments Andrew Drake, CFA, managing director of P-Solve, an investment advisory and fiduciary manager. He suggests that "contemporary," or future-focused, asset managers are realizing that they have to put their clients first and then work backwards, starting with what clients need and then creating suitable products for them, which will make customization a key ingredient for the next decade. With a plethora of boutique consultant/fiduciary management firms on the market, it seems inevitable that the large, mainstream asset managers will buy the solutions-driven expertise they need rather than build it in-house. In a low-fundraising environment, however, any M&A activity might take a while, given that managers might struggle to find the capital to make big purchases in the near future.

FEES

In a low-return environment, fee structures also will continue to come under pressure. "We have a lot of big challenges ahead of us if we are going to do a decent job for our clients. If we are going to be in a world of nominal returns, we've got to make sure the level of charges our clients are paying is kept reasonable. If returns are just going to be, on average, 6–7%, you can't have 150 basis points taken out in charges. It's too much of the pot," says Alan Brown, FSIP, senior adviser to Schroder Investment Management and governor of the Wellcome Trust. Brown is also a member of the 300 Club, a group of senior investment professionals from around the globe who have "joined together to respond to an urgent need to raise uncomfortable and fundamental questions about the very foundations of the investment industry and investing."

Brown has many concerns about the future, particularly about educating investors. "In a world that is increasingly dominated by defined contribution," he says. "I am very worried about how we manage the real-world outcomes for individuals. We are heading for a generation who will face a fairly miserable retirement."

Brown also points out that not everyone missed the crisis. Bill White, a Canadian economist who served as head of the economic and monetary department at the Bank for International Settlements, predicted the crisis before the subprime market collapse. In 2003, he famously argued directly with Alan Greenspan at the Federal Reserve Bank of Kansas City's annual meeting in Jackson Hole, Wyoming. White contended that interest rates ought to be raised when credit expands too fast, forcing banks to build up cash cushions for leaner times. The argument fell on deaf ears.

Some industry participants envisage a world in which mainstream asset management has hedge fund–type fee structures, where the bulk of the charge is based on performance. "I'm a bit ambivalent about fee structures. One way that they could change is to become more performance related so you end up paying if the value add is achieved," says Andy Barber, partner in Mercer's investment consulting business.

The idea may be good in theory but doesn't sit well with investors at the moment. "The idea of getting paid more if your assets go up is an interesting one," says Drake. "We've tried a number of different, innovative ways of potentially charging our clients. But they have basically said, 'That's interesting but we'll just carry on as we have been.'"

THE TRUST BETWEEN ASSET MANAGERS AND CLIENTS IS SO BAD THAT CLIENTS CAN'T EVEN SPELL THE WORD TRUST.

Barber believes that demand for less-constrained strategies will continue to grow. "There is some academic evidence to suggest that less-constrained managers do better on any kind of risk-adjusted basis, so the days of index plus 1 or 1.5 are gone," he says. "People are no longer expecting their managers to hold BP because it is a big part of the benchmark."

Andreas Utermann, global chief investment officer and co-head of Allianz Global Investors, agrees. "There is going to be a return to more fundamental investing. There will be less benchmark-driven investing," he says. He also points out that lower fees have other implications. "We are in a low-return environment with margin compression in the industry, making it less lucrative."

SKILL

This change, according to some participants, can only be good news. As the flow of assets from active funds to passive funds suggests, investors do not believe that all active managers have skill. "The rapid industrialization of asset management has supressed its craft heritage," says Amin Rajan, chief executive officer of CREATE-Research. "History tells us that the only time to make money is to buy when others are selling. Many asset managers just can't do that. They don't have the skills to buy on the dips and get the timing right. The other thing is that clients won't allow them to do it because clients have become very suspicious of managers having lost money in the past. The trust between asset managers and clients is so bad that clients can't even spell the word trust," he says.

"If an asset manager wants to be a truly global business with repeatable processes and the ability to attract and develop talent, it has to use analytics to get behind that track record and truly measure what makes a manager skillful. Increasingly, the end client is demanding this level of scrutiny and transparency," says Rick di Mascio, CEO of Inalytics, a U.K.-based firm that provides evidenced based measures of skill to both asset managers and pension funds.

Investor goodwill is key to the success of any asset management firm that wants longevity, according to Katherine Garrett-Cox, ASIP, chief executive officer of Alliance Trust, one of the oldest and (at £2.8 billion in assets under management, largest U.K. investment trusts). "Trust and transparency have to be at the heart of investing," she says. "Trust in financial services has been pretty rocked. But the investment management industry can play an important role in delivering it. Part of delivering it is delivering on your promises."

The future of the industry will be based on "intellectual capital," says Garrett-Cox: "It will be about getting relatively small groups of people together in a much more entrepreneurial way. If you can't pay people as well as you could 10 years ago, at least you can give them a sense of ownership of what they are doing."

BUSINESS MODELS

But skill is only one factor at play. As part of its report, CREATE-Research surveyed 289 asset managers, pension consultants, and fund distributors in 29 countries with combined assets under management of US$25.2 trillion. It found that in an era of prolonged volatility, only 7% of respondents expect no more systemic crises over the rest of this decade; 27% expect one crisis; 35%, two crises; 21%, three crises; and 10%, four or more crises. "When you see some of the numbers in the report, you'll be quite horrified," says Rajan. "So, nimbleness in the operating model becomes very important."

But managers have identified areas where they need to improve. Of those responding to the CREATE-Research survey, 58% of respondents expect to develop better "shock absorbers," 41% will restructure the skill sets of their talent pools, 40% will enhance execution capabilities, 38% will revamp their corporate culture, and 35% plan to hire or develop leaders who can embrace volatility.

Quirk believes managers must have one of the following value drivers: the ability to add alpha, deliver cheap betas, provide comprehensive solutions, or focus on the distribution side of the business as opposed to the manufacturing one. “There are winners and losers here,” he says. “We see big money managers with broad investment capabilities in multiple markets who are looking at their business models and saying, ‘Are we really in a strong position for our future?’ The answer is no. Firms that are pretty strongly orientated around the value drivers I mentioned are probably in the driving seat right now. Other firms, especially larger firms, are thinking about how they turn their super tanker around, where they go from a business model that has a dated value proposition to something new.”

Others argue that the boutiques will be more against the wall, particularly if their investment styles are not in favor or delivering returns. Rajan believes the key will not be size but evolution. Organizations that are quick to adapt to a changing market environment will fare the best.

WE ARE CURRENTLY ENGAGED IN THE REGULATORY REFORM DEBATE OF A LIFETIME. THE RULEBOOK THAT RESULTS WILL FRAME THE FINANCIAL SYSTEM FOR DECADES TO COME.

In some cases, the battle may already be lost. The ETF market is dominated by a few players, such as State Street, Vanguard, Barclays, Deutsche Bank, and Legal & General. “This is not going to be a business where there are going to be 50 players,” says Quirk. “So, that is going to limit new players.”

REGULATION

The past few years have brought a wave of regulation around the world, and some of it will have an impact on the global banking model. Whether reforms will lead to a complete separation of retail and investment banking is difficult to predict, but many market participants believe that asset managers need to get more involved in the debate. Speaking at the CFA Society of the UK’s annual chairman’s dinner in October 2012, Bob Jenkins, a member of the

Making Future Predictions

Tim Hodgson, ASIP, is head of the Thinking Ahead Group at investment consultancy Towers Watson. As early as 2002, the group warned that debt would affect growth in the future. That prediction may have come too early, but it was prescient. Hodgson talks about forecasting the future.

How easy is it to "think ahead" and make predictions about the future?
There is a tendency for people to overestimate how much is going to happen over 1 year but seriously underestimate how much change is going to happen over 10 years. We’ve been using our complexity model to look at the future of the industry, but the humbling thing about complex adaptive systems is that you have to be able to give up the pretence of being able to make predictions. I don’t know what the industry will look like in 10 years’ time, and if anyone thinks they can tell you, then send them to see me. After saying that, though, it’s not going to stop me from trying!

So, what trends can you identify?
I think there is already a nascent trend toward lower fees. In banking, you can already see that remuneration is under pressure and that the pressure might have started to spread to asset management. We are definitely also seeing an upswell of money going into smart beta. The move into passive makes sense, and more money in smart beta will reduce the fee take of the industry. You should probably expect remuneration to fall further.

Will that affect the type of people coming into this market?
Yes. The number of graduates heading to Wall Street from U.S. business schools is declining. Personally, I think it is kind of ridiculous [that] the best and the brightest of society were overwhelmingly choosing finance as a career when society needs really bright medics and engineers and what-have-you.

What will happen to asset management business models?
You would expect to see consolidation and closures. If you look at market share, even the largest managers in the P&I/Towers Watson list of top asset managers are tiny compared with other industries. Blackrock is only 3–4% of the market, with around US$2 trillion. So, why could you not have some very-low-cost, big asset managers managing around US$10 trillion or more?

If you can't make accurate predictions, how do you plan for the future?
When looking over 10-year horizons, I think you have to use scenarios. I would encourage people to make some of their scenarios very wild—wild on the upside and downside. You can't predict the future, but you can say, "What would I do if the world was heading in that direction?"

Bank of England's Financial Policy Committee, told attendees that they must act on the core issues of banking reform, particularly in regard to putting a limit on the use of leverage.

"We are currently engaged in the regulatory reform debate of a lifetime. The rulebook that results will frame the financial system for decades to come," he said, calling asset managers the "missing piece" of the equation—one that was staying silent. To the public at large, he observed, there is no difference between asset managers and investment bankers. Asset managers who think that investment banking regulations don't apply to them should think again.

Garrett-Cox agrees. "I do think that once you accept that regulation is a thing of the future, then it becomes important not to be blindsided by it," she says. "From our point of view, particularly as the biggest investment trust in our sector, we actively engage with industry bodies and the FSA."

And getting involved would be one way in which asset managers can shape the decade to come.

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Chief Executive 2.0?

The past few years have seen a plethora of high-profile banking executives come under intense scrutiny for mismanagement or misdeeds. Fred Goodwin, who resigned from the Royal Bank of Scotland in 2008—one month before the firm announced a loss of £24.1 billion—was the first in a series of high-profile departures. More recent high-profile resignations included Bob Diamond, chief executive of Barclays (who departed because of the LIBOR rate-setting scandal), and Kenichi Watanabe, chief executive of Nomura (who left after accusations of insider trading at the firm). In the midst of all the finger pointing, asset management CEOs have managed to hold on to their seats a bit more firmly, but their roles are changing too.

"Perhaps in the last few years, some CEOs have lost their compass and reacted to short-term events," suggests Marylin Prince, partner at the financial executive recruitment firm Prince Houston Group in New York City. "CEOs need to get back to the basics and remember the qualities that define strong leaders—integrity, strategic vision, good judgement, and an ability to attract great talent to complement themselves."

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But how easy will this be, in practice? Sarah Dudney, founder of London-based career advisory firm Ignite, suggests that five years of staff cuts have taken their toll and that this will affect the caliber of future executives. "The staff cuts which people have made in this business have gone through the fat, muscle, and the bone, which will affect the pool of candidates for leadership in 10 years' time. So, you have to hope that people have made the right decisions."

Dudney also suggests that chief executives of the future will have to be more versatile and adaptable. "Nowadays, politicians think that they run markets. CEOs will have to have rapid access to governments and understanding of how things work on a supranational level." They will also, she suggests, have to get used to a life in the spotlight because public scrutiny will only continue going forward.

Michael Castine, chairman for asset and wealth management at Korn/Ferry International in New York, believes the role of a CEO is becoming even more complicated. "A CEO needs to be an operations person and a financial person but also needs to be a visionary and be out in the market. It goes even beyond political sheen; you have to deal with politicians and regulatory bodies, but you also have to be conversant in international business. Many funds are looking at the sovereign wealth fund opportunities that didn't exist 15 years ago, and so you need to be able to wear a global hat. In the words of [hockey player] Wayne Gretzky, they will have to skate to where the puck is going, not where it has been."

But does this perfect new breed of potential chief executives really exist? Consultants seem to agree that it is about internal succession planning. Many firms have succession plans in place; others haven't spent enough time considering the issues. Some firms, whether they like it or not, are carried by the name on the door, according to some consultants. Take GMO's Jeremy Grantham and Fidelity's Ned Johnson, both very well-respected figures who are likely to retire in the next 10 years and whose firms were built around their personalities. Both firms have succession plans.

Ultimately, though, the newly formed "chief executive 2.0" will have to remember one thing. "Post the financial crisis, clients have experienced a lack of trust and confidence, and therefore, CEOs of financial organizations must be more transparent and responsive to the changing environment," argues Jim Houston, partner at Prince Houston Group.

Those who lack these attributes might find themselves heading to the door pretty quickly.