The Industrial Organization of the Global Asset Management Business (a summary)

Ingo Walter
Stern School of Business, New York University
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Summary prepared by Ingo Walter

The global asset management industry is anything but simple. The key fiduciaries acting for the ultimate beneficiaries include pension funds, endowed institutions, sovereign wealth funds, and individuals. Asset managers—the agents—include investment management firms, insurance companies, mutual funds, and alternative asset firms (e.g., hedge funds and private equity firms).

The dynamics of the asset management business are both complex and geographically diverse. Products and vendors compete within and across clients and markets and often shade into each other. Regulation also can differ dramatically across financial systems and functions, even when pursuing the same objectives of efficiency, growth, and stability on the "buy side" of the financial architecture.

The asset management industry is likely to be one of the largest and most dynamic segments of the global financial services industry in the years ahead. As of early 2015, the global total of assets under management was estimated at close to US$74 trillion including pension fund assets and funds managed by the insurance industry, mutual fund assets, and alternative investment vehicles and private wealth management, but excluding sovereign wealth funds and external reserves of central banks. Not only is this already massive industry likely to grow faster than other parts of the financial services sector, but also cross-border volume—both regional and global—is likely to take an increasing share of that activity.

Within this high-growth context, asset management attracts competitors from an extraordinarily broad range of strategic groups: commercial and universal banks, investment banks, trust companies, insurance companies, private banks, captive and independent pension fund managers, mutual fund companies, and various types of specialist firms. This rich array of contenders—marked by very different starting points, skill sets, competitive resources, and strategic objectives—is likely to render the asset management market highly competitive, even though one can foresee a certain amount of consolidation in some sectors around the world.

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This book provides an overview of the global institutional asset management industry. It includes a discussion of the competitive structure, conduct, and performance of the asset management industry as well as an assessment of the impact of institutional asset management on global capital markets.

Living Down the Recent Past

With the passing of the global financial crisis, many things have changed in finance, particularly the asset management industry. As we now know, major financial shocks can no longer be contained. They spread with amazing speed, both geographically and across asset classes and financial intermediaries. Financial interconnectedness can bring great benefits, but it also generates large systemic risks, and there are few places to seek refuge from its consequences. Nor is the real economy spared, with the global aftereffects of the deepest and longest recession since the 1930s still (almost a decade after the Lehman Brothers collapse that arguably defined the peak of the crisis) reflected in sluggish economic growth in many developed countries, delayed capital expenditures, persistently high unemployment, and intractable fiscal deficits among countries in Europe and among states and municipalities elsewhere.

As expected, the asset management industry has not been spared. Massive losses starting in 2007 affected the size of assets managed by almost all fund managers except for a few hedge funds that correctly bet against the asset classes that declined. As we now know, banks were heavily exposed to the toxic assets they were intermediating, assuming "warehousing risk" as investors in addition to "pipeline risk exposure" as financial intermediaries.

Why? Because the "carry trade" was at the time highly profitable given the low regulatory risk weightings assigned to the higher tranches of these structured securities. This became the main source of the banking "crisis," which then led to forced mergers, nationalizations, and taxpayer bailouts—ironically sparing the asset management industry even greater losses—the impact of which continues today.

For the asset management business as a whole, the most pressing challenge is the loss of investor confidence resulting from the financial crisis. In addition, there is increased competition from low-cost providers, including "liquid alternative" providers that claim to deliver hedge fund–like returns without the liquidity limitations of traditional hedge funds. In addition, managers face increased government regulation and intervention in the markets. The opportunity for growth lies with those enterprises that are most able to meet these challenges by providing transparency to their clients, their stakeholders, and, in particular, their regulators. Those that can meet these

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challenges will be the most effective in the future. Specifically, the industry's challenges can be grouped into three categories: growth, risk management, and cost control.

The Pension Sector

Challenges associated with risk, cost, and growth are interrelated and affect pension funds and pension-related insurance funds to varying degrees. Changing demographics will alter pension-funding patterns, creating both cost challenges and growth opportunities for pension funds, insurance reserves, and those who manage these asset pools.

Greater market volatility, increased financial instability, and material regulatory changes will affect business risk, cost, and growth, respectively, creating challenges as well as opportunities that are not necessarily always equally important. The main drivers of success will be flexibility in strategic targeting and implementation, together with the adaptability of operations.

Scale, internationalization, and the right choice of operational platform are key determinants in promoting growth, mitigating risk, and controlling costs. Functional breadth in terms of retirement products is important, but large size (in terms of assets under management) is also advantageous. Not only the investment side but also the transaction side and the information platform need to be well managed in terms of client services, risk management, and cost efficiency.

Indeed, the operational platform is a common thread running through all the themes related to pension fund asset management. This platform is critical in promoting flexibility and in creating barriers to entry and exit that are central in determining the organization of the industry.

Mutual Funds

Mutual funds emerged from the financial turbulence of 2007–2009 with their reputations among clients severely stressed. Almost all had failed to protect their investors from the broad market decline and increased volatility that accompanied the crisis. This outcome was perceived by many investors as a disaster, despite the stated intentions of many of the funds to move with the overall market, including in periods of decline.

Some funds incorporated structured financial products that they themselves failed to understand—and could not explain adequately to clients—while several major funds prevented their customers from redeeming their shares to avoid having to sell the underlying securities in disorderly markets. Others were lacking in the key areas of due diligence and risk management.

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The asset management industry as a whole was found deficient in transparency, effective risk control, and operating efficiency, compounding the traditional challenge of producing significant and durable excess returns.

Consequently, the postcrisis era began with the industry facing skeptical, sharp-eyed, and cost-conscious investors who had not forgotten their recent experience, together with low-cost asset management alternatives and demanding regulatory changes.

So, the initial challenge has been to rebuild confidence in mutual funds and other collective investment vehicles while dealing with intensified competition from several quarters and formulating a constructive set of responses to the inevitable increase in regulatory pressure—some of which remains highly uncertain. The emphasis is on improved transparency at all levels—products, processes, costs, and compliance—and a fundamental reconsideration by top management of these issues as sources of competitive advantage rather than as purely defensive challenges.

Mutual funds able to meet these challenges—in the face of competition from passive funds, hedge funds, and a number of nontraditional competitors—are likely to be most prominent among the winners in a world where business as usual is unlikely to produce the kind of growth, risk profile, or operating efficiency the industry has enjoyed in the past.

The mutual fund management industry also needs to prepare for still further pressure on fees. Active managers in particular are under fee pressure from index funds and exchange-traded funds (ETFs), from government regulation, and from alternative investments. Passive index funds and ETFs guarantee "beta" returns for very low fees, whereas alternatives provide the opportunity to access "alpha" returns at high fees. So, active mutual funds that charge high fees and produce little (or negative) alpha but plenty of beta are caught in the middle. And there seems to be a certain amount of convergence, with some active funds cutting fees and producing market returns and some passive funds and ETFs promising "index plus" returns, using sector selection approaches, and charging higher fees for the added value.

Alternative Assets

This book focuses on two components of the alternative assets sector: hedge funds and private equity funds. Some other asset classes are usually considered alternatives, including real estate and commodities. Here we emphasize the hedge fund industry because of its global growth and its size in terms of assets under management, as well as the performance and regulatory issues that confront the industry. Besides wealthy individuals, institutions have

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become large investors in both types of alternatives, although high fees and disclosure problems have moderated their participation of late.

Hedge funds may or may not hedge. The classic model of a hedge fund is one that invests in long positions in assets that the manager thinks will rise in price and short positions in those thought likely to fall—a "long–short" strategy (which may or may not be market-neutral, that is, balanced so that the overall fund is insensitive to market movements). This model persists, but it is only one of many hedge fund strategies, and unlike the long–short strategy, they may or may not involve hedging.

In the wake of the global financial crisis, the hedge fund industry has made a concerted effort to restore investor confidence while dealing with intensified competition from several quarters and formulating a constructive set of responses to the increased regulatory pressure that inevitably follows financial trauma. Much of the emphasis will have to be on improved transparency at all levels—products, processes, costs, and compliance—and a fundamental reconsideration by top management of these issues as sources of competitive advantage rather than purely defensive measures.

A particular area of concern is operational risk. Operational risk issues reached their peak in the Bernie Madoff and Bear Stearns episodes, including the need for serious external audits by firms exposed to high levels of reputational risk, stress testing for both liquidity and earnings streams, the structure of incentives, and the problem of risk aggregation in its transmission to senior management and boards.

Legal and regulatory risks are part of this mosaic, as is the application of a good dose of common sense alongside traditional and proprietary risk modeling. Equally important are rigorous cost-accounting discipline—an area in which firms have often been found wanting in their rush to boost assets under management—and operating leverage in the face of high fixed costs and variable revenues as well as trading costs and uncertainty about the importance of economies of scale.

Given the difficulty of persistent outperformance in any management structure, including hedge funds, costs are a critical competitive element and require imaginative outsourcing, application of world-class technology, and, in some cases, serious conversations with clients about appropriate fee structures. Asset management has bright growth prospects worldwide. But unless risk and efficiency are addressed more effectively than in the past at a given firm, its competitors could be the main beneficiary of that growth.

Hedge funds and other alternative asset managers able to meet these challenges in the face of stiff, nontraditional competition are likely to be most prominent among the winners in a world where business as usual is unlikely

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to produce the kind of growth, risk profile, or operating efficiency that hedge funds have enjoyed in the past.

Before the financial crisis, the alternative asset management enterprise was very different from what it is today. Businesses were able to survive with very high cost structures. Now, we are seeing a need to control costs and a need to be transparent within the organization regarding the nature of the products being sold and the magnitude of the costs necessary to offer those products.

Private Clients

Global individual wealth can take a variety of forms, encompassing financial assets (currency, bank balances, stocks, bonds, etc.) and real assets—commodities, precious stones, *objets d'art*, real estate, and other asset classes that have some sort of actual or potential market value. These assets range across the entire liquidity, risk, and return spectrum, from cash to real estate to private equity investments. The ability to measure wealth at any point in time depends on the existence of a market for each asset (hence, the importance of liquidity) and the ability to "mark to market." Because wealthy individuals' assets are often held in illiquid form, global wealth estimates tend to be somewhat inaccurate. A variety of intermediaries are engaged in wealth management, including trust companies, major banks and financial conglomerates, investment banks, private banks and boutiques, individual financial advisers, and single- and multi-family offices. Market shares are highly fragmented, and wealthy investors have plenty of choice.

The essential factor is to offer a truly personal service that focuses on the asset side and sometimes on the liability side of the client's balance sheet. Moreover, owing to the highly personal nature of private banking, clients generally prefer to "stay with" a particular firm, if possible, resulting in a lower price and performance sensitivity, facilitating product cross-selling, and enabling institutions to compete on qualitative variables instead of pricing alone. The business is "capital light," with favorable cost-to-income ratios and the capability to realize significant economies of scale in transaction-processing and portfolio management activities.

The bundling of private wealth management services makes it difficult to evaluate the value/cost relationship of each component, potentially allowing the firm to extract higher fees. And the client is likely to be less price sensitive with respect to the purchase of bundled services than with respect to the purchase of each service separately.

Although other areas of banking have been subject to a general unbundling of services as a result of a proliferation of new financial products and techniques, private banking remains an area where bundling may retain value

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for some time to come. And owing to the existence of economies of scope, a bank can often provide several services more economically than it can provide a single service—an important rationale for the cross-selling of bank products. Since the fiduciary nature of the private wealth management relationship gives the bank access to a rich vein of client-specific information, it may retain an advantage in servicing the private client that competitors find difficult to penetrate.

The apex of private wealth management is arguably the "family office," which manages investment and trust assets for a single family, staffed by professionals in various aspects of wealth management committed to the family's (often complex and changing) financial objectives. A variant is the multiple-family office, which serves several wealthy families in managing segregated, but sometimes pooled, investment accounts. Key issues include intergenerational wealth transfers, fiduciary obligations in trust relationships, fees paid to external asset managers, and tax efficiency. Traditional family offices may also provide such personal services as managing household staff and making travel arrangements. Other services typically handled by the traditional family office include property management, accounting and payroll functions, and management of legal affairs. Family offices often handle philanthropy activities as well.

Performance Issues

What is required to excel in the asset management industry? Significant distribution in leading markets, product breadth and consistency, global money management expertise, and capital strength lie at the core. Also needed are technology capability, marketing and customer service skills, defensible pricing, low-cost production, and a strong brand. All this must be rooted in an affirmative culture, cohesive senior management, and a talented and motivated staff.

Despite the complexity reflected throughout this book, the common threads that run through the discussion—growth, risk, and cost—cannot be ignored by asset managers hoping to be sustainable in the market. Sustainable competitive performance for firms in the asset management business may involve accessing sometimes unfamiliar markets to generate growth, managing all kinds of risk (market, credit, and liquidity risk as well as sovereign, operational, and reputational risk), and paying careful attention to cost control in an environment where persistent outperformance is exceedingly difficult. Still, the future looks bright. Each year, massive investable funds arise that have to be deployed in the best interests of their owners—the core mandate of this industry.

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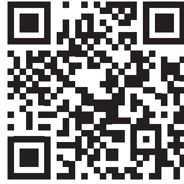
The complete book can be found at
http://www.cfapubs.org/toc/rf/2015/2015/7.



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