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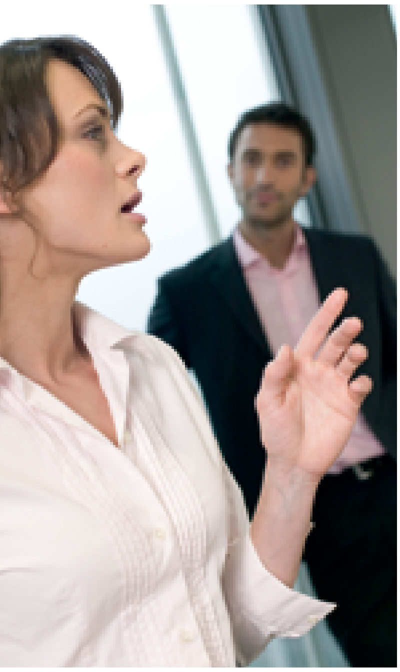
The future of the **asset management** industry

Why the average fund's manager line-up will change (a lot)

> **It is not necessary to change. Survival is not mandatory.**
>
> W. Edwards Deming



In short…

In this paper we suggest that active investment managers are facing increasing pressures on profitability. Absent a strong market rebound, there is likely to be considerable change among asset management organisations. This would disrupt asset owners' portfolios and so we suggest some actions that can be taken now to prepare for such an eventuality.

2009 will be a bad year

Forecasting is, at best, difficult. At worst, it is deceptive (the combination of random chance and actual outcome giving the appearance of skill). Assuming 2009 will fall into one of two states – 'good' or 'bad' – we could toss a coin and hope the future shows us to be gifted forecasters. Instead we will outline why we believe 2009 will be a bad year for asset managers.

The performance of asset markets over 2008 is (painfully) well known by all participants in the investment industry. If returns now stabilise, then for asset owners the worst of the pain is over but for asset managers the pain is just starting.

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As asset markets did the bulk of their 2008 decline in the fourth quarter, the impact on asset managers' revenues was relatively muted – earnings for 2008 are perhaps down 10–15 per cent from 2007 (this is our estimate of the average – some managers will have done better and others worse). However, asset managers are starting 2009 with revenue 'run rates' perhaps 30–50 per cent below the start of 2008 levels[1]. If markets are flat then asset manager earnings in 2009 will be much lower than in 2008.

Which way out?

The asset management business model is centred on ad valorem fees – charging a proportion of the value of assets under management each year. The profit 'problem' is therefore (conceptually) very easy to solve. Earnings can be increased by

- higher market returns (hard to engineer!)
- new inflows of additional assets to manage, or
- raising fee rates on remaining assets (although these are unlikely to be the easiest of conditions under which to make this option successful).

Alternatively, or in addition, costs can be reduced. For most asset managers, staff costs will account for over 50 per cent of total costs and therefore are the most obvious area to seek reductions. The options are again limited to cutting headcount and/or compensation levels.

So, with the prospect of lower earnings, what are asset managers likely to do? The first option is to do nothing. This implies a hope that markets will bounce back strongly and an acceptance that, if they do not, the manager will see reduced profits (or bigger losses). The second option is to cut costs and the third is to restore operational leverage by acquiring more assets[2].

Easy stuff first

The easiest course of action is to do nothing. If this is simply a storm that needs to be weathered then some asset managers are in a stronger position than others, by having substantial cash on their balance sheet[3] for example. The ownership structure of the asset manager is also likely to be influential in this regard.

The next easiest action is to cut out any organisational 'fat', which generally means employees in non-core roles. Our research[4] leads us to believe that, in the UK, asset managers are looking to reduce headcount by around 10 per cent and costs by around 20 per cent (either done at the end of 2008 or being undertaken currently). The picture appears to be the same in the US[5]. It was generally felt that after this point further cuts would be into 'muscle' and revenue would be reduced as well as cost.

The challenge facing asset managers is illustrated in Figure 1. The non-core staff tend to be amongst the lower paid in the organisation, so meeting the reduction in headcount target will not help that much towards the cost reduction target. Achieving the cost reduction targets requires a reduction in variable pay. One interviewee thought this was a trick that management could only pull off once (potentially storing up profit pressure for later). Another phrased the issue more bluntly – 'there will be no pay rises this year, and the bonus is that you have still got a job'. As noted above, we believe it is highly likely that the financial pain will be much greater in 2009 than 2008 and so the reductions in bonuses for the current year (paid in 2010) are almost certain to be greater.

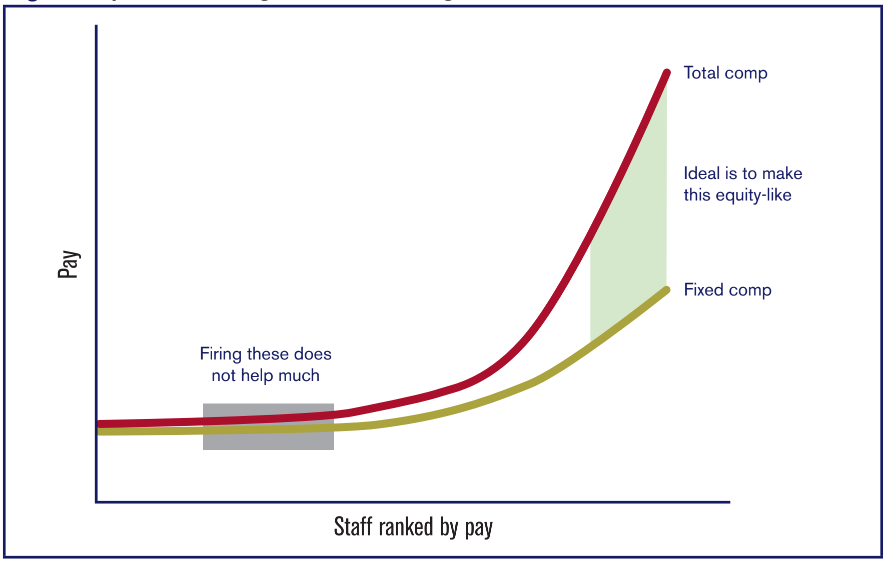
What about people turnover?

A reduction in compensation would ordinarily trigger concerns about the departure of key talent. This time around there are two mitigating factors:

- as the majority of asset managers are in the same boat, compensation is unlikely to be higher elsewhere
- the hedge fund route is effectively closed (see panel).

That said, there is anecdotal evidence that some headhunters are busy recruiting for some large firms that see this as a good opportunity

Figure 1 | Cost challenge in asset management



Hedge funds

The problems faced by hedge funds are conceptually similar to traditional asset managers, but greater in degree. We are not willing to estimate how far the average revenue run rate has fallen but we believe it is significantly worse than for traditional managers:

- assets under management are down around 20 per cent due to performance
- performance fees are well below high water marks
- redemptions have reduced assets under management further
- availability of leverage is significantly reduced.

Against this background, our research suggests that headcount is being reduced by around 20 per cent. The issue is then whether the hedge fund has the cash to survive until performance fees resume. On this basis, the media reports that 50-80 per cent of hedge funds will close do not look unreasonable. We would expect many to go private, with the core group of partners terminating all staff and continuing to run their own money. We would also expect fee rates to begin to give ground.

This environment also means that the attraction of setting up a hedge fund by employees of asset managers is reduced, largely as the support offered by prime brokers and other intermediaries has been significantly reduced.

Funds of hedge funds (FoHFs)

The problems faced by FoHFs are further compounded. They have been caught by liquidity issues (offering redemptions on more favourable terms than those of the underlying hedge funds) and many have been tainted by the Madoff scandal. We see the FoHF business model as extremely stressed. Larger investors already have direct relationships with hedge funds and this trend will continue. We would expect smaller investors to split between FoHFs fulfilling an 'administrator' role at a significantly reduced fee, and those offering a value added proposition at a higher fee (for example, performance relative to a hedge fund index, or fraud insurance).

1 The impact on revenue comes from a number of factors: (a) a fall in assets under management due to market falls, (b) the balance of inflows and outflows, (c) any shift in asset mix (for example, from higher revenue equities to lower revenue bonds), (d) the currency mix of the assets and whether they are hedged (for example, sterling's weakness in 2008 would have meant domestic assets suffered larger falls than unhedged ex-UK assets) and (e) the exposure to absolute performance fees (for example, traditional managers with alternatives divisions). So, for example, fixed income managers with strong inflows may not have seen any reduction in the revenue run rate.

2 The future path of the markets is largely a matter of beliefs – we believe the economic problems will be protracted and therefore do not expect elevated market levels in the near term. At a high level we also believe new inflows (to higher margin equities at least) will be restricted for a number of reasons. At a lower level, it is clear that some managers will see inflows whereas others will see outflows.

3 Business decisions by asset managers can be thought of in terms of 'real options'. There is a cost (premium) associated with keeping alternatives open, but in an uncertain environment the value of that option is higher.

4 In addition to our normal manager research activities, the Thinking Ahead Group conducted six interviews in January and February 2009 with asset management CEOs/CIOs, specifically to explore the impact of the financial crisis.

5 In a survey of 47 US managers by Greenwich Associates, the workforce was being reduced by 11 per cent and costs by 22 per cent. Source: eFinancial News, 29 January 2009.

to invest, and some boutiques will also see this as an opportunity to entice talent out of the larger houses. On balance, therefore, we would expect to see some continuation in the rotation of talent around the industry.

Adding assets

As noted above, profit pressure can be countered by adding new assets to the existing cost base. Consequently we believe that we will see an increase in the number of asset management acquisitions. Unfortunately, acquired assets tend to come with their own cost base, meaning that there is still a management challenge to choose carefully and execute well ('why would you buy someone else's problems in a people business?').

The pressure to acquire will intensify should markets continue to fall, which raises an issue in our minds. The merging of entities in such conditions would make business sense, but there is a danger that an early acquirer may pay too high a price and therefore damage rather than enhance their sustainability. Equally, in a poor market environment we are likely to see an increase in the number of 'slow motion deaths' as the lack of profitability causes cash to run out, resulting in closure of the business.

So what will the asset management industry look like?

While it is tempting to predict widespread industry consolidation ('what should happen'), all previous predictions of this sort have come to nothing. Instead we make the rather mild prediction that in future there will be great boutiques, great mid-size firms, good large firms and many in flux between them. However, we are expecting the nameplates of existing asset managers to change substantially over the next few years. In the past, there may have been a generally negative bias against a change in ownership. In the new environment, we believe we must remain open minded as some of these changes could be materially positive for the survivorship of a firm or a team within a firm.

Consolidation is not necessarily bad

Stripping investment back to basics, investors receive the return generated by their assets less any costs they pay to intermediaries for help in managing the assets. The macro-consistent position is for all investors to hold a share in the same global portfolio. If it helps, imagine a warehouse into which we truck all of the world's equities, bonds (sovereign and corporate) and real estate. Periodically, the warehouse door opens and a forklift truck delivers a pile of cash (dividends, coupons and rents), which is distributed among all the investors according to their share.

However, as soon as one investor (or set of investors) decides that they would like to do better than the other investors they need to hire (and pay) someone to select the 'good stuff' from the warehouse and leave the 'rubbish' for the others. Now when the warehouse door opens and the cash is delivered (same amount), the hired hand strolls up and takes his cut before the remainder is shared out between the investors (unequally now). This is likely to spark retaliation and the hiring of further help by other investors. It is clear that there can be no net gain from this activity – the cash delivered by the warehouse remains the same but less and less of it gets through to the investors as the overheads of the hired help rise[6].

Of course, the above is a simplification. The contents of the warehouse are not static and we do need hired help (active managers) to efficiently allocate new capital (to decide what gets into the warehouse, and at what price). How many managers does the industry need? We do not believe there is a correct answer to this question, and hence no 'correct' industry structure – but we do believe there is such a thing as 'too much active management'. Reducing the number of asset managers in the industry would not change the odds of achieving positive alpha (still less than 50 per cent), but it would mean that less of the underlying asset return would be spent on the pursuit of alpha.

However, as already noted, we do not think widespread consolidation is the most likely outcome, but some rationalisation (particularly amongst hedge funds) is to be expected.

Regulation is coming

We predicted last year that there would be new regulation coming, possibly in 2009 ('The force for change will be the financial sector's

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equivalent of Sarbanes-Oxley.')[7]. This prediction currently remains on track. However, for the purposes of our discussion we need to be more specific – will the regulation negatively affect asset managers and therefore increase the likelihood of change to a fund's line-up? At present the vitriol of the 'angry citizenry' is predominantly aimed at the banks, and the Madoff and Stanford scandals will pull regulatory action in that direction. The (relatively) clean hands of asset management should mean an escape from additional regulation – but there is a chance that asset managers could get caught by regulation aimed at banks and that there could be a move to better protect retail investors. Consequently, we see a possibility of higher compliance costs, further damaging asset managers' margins, although this would not be our central expectation.

So what should an asset owner do?

If our view of substantial change among asset managers turns out to be correct, what could asset owners do to prepare themselves? Forewarned is only forearmed when action can be taken to mitigate future damage. We suggest the following:

Focus on sustainability

When we talk of 'sustainability' there is a natural urge to think 'big is beautiful'. However, as already noted, we think there will also be great boutiques in future. The key is for the manager to have the scale appropriate to what they are trying to achieve and to have the cost base appropriate to that scale. Sustainability is therefore about the way the business is run, not just the size of the firm.

Using the Watson Wyatt manager research triad of business, people and process, we would argue that

So what should an asset owner do?

- Focus on sustainability.
- Diversify the manager line-up.
- Renegotiate fees.
- Think through the 'what ifs'.
- Revisit the passive/active split.

"If our view of substantial change among asset managers turns out to be correct, what could asset owners do to prepare themselves?"

6 This is adapted from the story of the Gotrocks family by Warren Buffett. For the more elegant version see the chairman's letter of the 'Berkshire Hathaway Annual Report 2005, or Chapter 1 of The Little Book of Common Sense Investing' by John Bogle (Wiley, 2007).

7 'Defining moments', Watson Wyatt July 2008. The quote is from page 27.

the weight given to business issues should rise (and therefore must fall for one or both of the others). While this is a very broad area, we would pick out:

- Management vision and focus – is there a clearly articulated vision of what the business will be, and not be? Is there evidence to suggest commitment to this vision (or a history of loss of focus)?
- Risk platform – are your assets operationally safe, and is the portfolio appropriately structured?
- Ownership structure – does the way the business is owned give confidence that it will still be around in a decade or two?

With respect to ownership, there was a strong preference among our interviewees for a partnership ownership structure (none worked for a partnership). Failing that, the desire would be for a large owner ('backer') that had the knowledge and patience to be in the game for the long term[8]. In essence, the desire was to be free of short-term pressures to deliver results to a disparate shareholder base. Whatever the ownership structure, corporate governance needs to be excellent – even a partnership will fail if management is not governed well.

In terms of what to do next, asset owners could audit their existing asset managers for sustainability. Hopefully future changes to the asset strategy or manager line-up could permit the replacement of those managers thought to have the least sustainable model by those thought to have greater staying power.

Diversify the manager line-up

Our current advice to asset owners pursuing an active management approach is to widely diversify the number of managers. This is also appropriate for reducing the disruption to the overall portfolio from changes in ownership. By increasing the number of managers, however, it does raise the odds of being affected by ownership problems – but this is compensated for by the problem affecting less of the portfolio.

Renegotiate fees (and terms)

We suggest this as a possible course of action with some hesitation. The logic is straightforward: asset managers need assets under management (or rather, revenue) and so it is likely to be preferable in the current circumstances to retain a proportion of the current revenue associated with an account rather than risk losing all of it. This would be particularly true if the fee reduction was compensated for by a 'lock-up' (an undertaking not to remove the assets for a period of X years). Taking the logic further, the negotiating power of the asset owners would be enhanced if they acted in collaboration.

Alternatively, or in addition to the quantum of the fee, the 'shape' of the fee could be renegotiated. A simple shift would be to a performance-related fee[9], while more complex arrangements could be structured to reflect a clawback of fee in the event of key departures or a change of ownership.

While the logic has merit, particularly for an individual asset owner, we are hesitant that this is necessarily optimal at the aggregate level. Seeking to reduce asset manager fees when they are already under significant profit pressure is likely to have consequences. History teaches us to be wary of unintended consequences. At best, such action could prompt a rationalisation of the industry and improve the value proposition for asset owners. At worst[10] it would inflict chaos on the industry and introduce an unhelpful adversarial element to relationships.

Think through 'what ifs'

Given the heightened uncertainty at present, we believe there should be more planning for eventualities (or scenario testing) – in 'this' environment (however defined), what would happen? The approach could be applied at the individual manager level, perhaps as part of an audit of the existing line-up. For example, what impact would losing another 5 per cent of assets under management have? Would it make a difference if it was caused by market movements or losing a single large account? Equally, scenarios could be constructed to explore the macro level issues. For example, to date we have seen four or so rounds of 'final' bank rescues. Could we see multiple rounds of firing of asset manager employees if equity markets 'do a Japan'? The point of conducting such an exercise is to be pre-prepared, and therefore able to respond quickly should the need arise.

Revisit the active/passive split

The final possible course of action is to consider whether the current extent of active management remains appropriate for the fund. We do believe that pursuing active returns is a worthwhile activity, provided that the resources exist to have a competitive advantage in identifying, hiring and terminating active managers[11]. Equally, we have written and talked extensively about the virtues of passive management and, because of the macro issues discussed above (under 'Consolidation is not necessarily bad…'), we continue to believe this is the more appropriate route for the majority of funds.

Conclusion

We have presented the case for why we think there will be significant change amongst active managers over the next few years. Consequently, we believe most asset owners will be confronted with changes to their manager line-up. In the light of this, we have suggested some actions that asset owners can start to consider now to prepare for that eventuality. Of course, a strong rebound in the markets will mean that much of our reasoning will be wrong. Let us hope that that will be the case – but act as though it will not.

Watson Wyatt Limited Investment Consulting Thinking Ahead

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Carole Judd
carole.judd@watsonwyatt.com
+ 44 (0) 1737 274329

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8 This is likely to exclude most, but not all, banks and insurance companies. Being an asset management subsidiary of a bank in trouble is likely to be an unsettling experience in the short term at least (we repeat, not all banks and insurance companies are in trouble).

9 We prefer rolling three- to five-year periods. For a fuller description please see ‘Defining moments’, Watson Wyatt, July 2008.

10 We use this as a literary term. With unintended consequences the ‘worst’ is not known in advance.

11 Please note we have a conflict of interests here – more active manager selections generally means higher remuneration for us.

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