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Opportunity amid  
Turmoil in Asset  
Management  
*Spotlight on Business  
Model and Capabilities*



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## EXECUTIVE SUMMARY

*Asset management is facing a challenging and turbulent period. Customers are more risk-averse than ever before and want more control over their investments, while the predominant markets are shifting from defined benefit to retail and defined contribution. Meanwhile, the Internet and other low-cost channels are gaining a foothold as asset management firms struggle to remain cost competitive in a highly globalized marketplace. It's not surprising that asset managers are divided about how the future will turn out. They are facing complex unknowns involving net fund flows, the demand for alpha, the spike in retirement assets, the direction of management fees, compliance costs, and new regulations.*

*In this unsettling landscape, two characteristics are critical for success in asset management firms: a clear business model, and a robust set of underlying capabilities that go well beyond having a strong investment management team.*

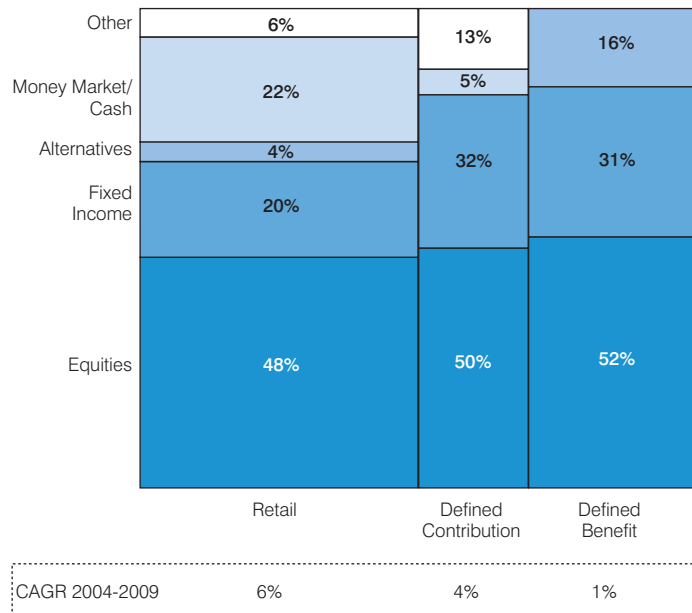
# ASSET MANAGEMENT IN FLUX

This is a period of significant transition for asset management. Consider how dramatically asset classes and client segments have evolved in just the past five years. For one thing, activity in the retail and defined

contribution sectors grew steadily (an annual average of 6 and 4 percent, respectively) between 2004 and 2009, while the defined benefit sector barely budged from year to year (*see Exhibit 1*).

**Exhibit 1**  
*Evolving Asset Mix: Retail Segment Grows While Defined Benefit Segment Lags*

**U.S. ASSET MIX (2009)**



Notes: Total AuM in US for 2009 is approximately \$39T; AuM in consideration for the asset mix is approximately \$20.3T. Asset allocation for defined benefit plan sponsors and defined contribution is derived using total allocations for top 100 pension and top 100 DC plans respectively  
Source: Investment Company Institute, Pensions & Investments, Booz & Company analysis

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In addition, even before the recession hit—and certainly since—customers have shown a greater desire for less risky investments, seeking to protect themselves against losses and looking for safer returns. This is supported by net fund flow data and AUM levels in equity versus fixed income plus money market funds in retail portfolios. Similar trends can be found in defined contribution portfolios.

Yet in the midst of this rush to safety, when much of the product innovation is focused on providing downside protection, there is a growing enthusiasm for alpha investments—which potentially generate better-than-market returns—particularly in the defined benefit segment. This is fueling the demand for hedge funds, whose net inflow of US\$42.3 billion in the first three quarters of 2010 greatly outpaced their net outflow of \$131 billion in 2009 and \$154 billion in 2008.

With this substantial rearranging, a reshaped asset management market is beginning to emerge, marked by new realities that affect the entire range of asset management activities:

- *Clients:* Retail investors are playing a greater role in managing their retirement assets, and in fact, the

recent PNC Wealth and Values Survey found that 44 percent of wealthy investors, the largest proportion, felt that their financial advisor hasn't helped them at all.

- *Client interface:* Firms are increasingly considering low-cost alternative channels, including traditional online sites and social media, and are realigning service levels based on clients' size and share of wallet.
- *Investment management:* Leaders are providing lower-cost substitutes such as institutional share classes for retail funds and are focusing more investments on emerging markets and alternative asset classes.
- *Middle office:* New tools are being developed to better gauge risks as IT expenditures on risk and compliance are forecast to grow 9 percent annually from 2009 to 2012.
- *Support functions:* Asset managers are outsourcing more and more middle- and back-office functions, in part to avoid the growing costs of compliance as well as to acquire distinct capabilities, such as deriva-

tives or collateral management. Also, lean and Six Sigma programs are being adopted to improve execution speed and quality.

In light of this list, it's little wonder that asset managers speak openly these days of a very uncertain future that will be driven by—or will drive—every key aspect of asset management, from net fund flows, the demand for alpha, and the spike in retirement assets to the direction of management fees, the costs of compliance, regulatory rigor, and market appreciation.

To survive in this new, more turbulent landscape, asset managers must have the basics covered with a strong investment management team that delivers attractive risk-adjusted returns to its clients. But there are two additional characteristics that are uniquely critical in this uncertain environment:

1. The firm must have a clear business model aimed at addressing the peculiarities of today's market.
2. Asset managers and their staffs must manifest a set of underlying capabilities designed to support and sustain the chosen business model.

# THE WINNING FIRM, PART I: CLEAR BUSINESS MODEL

Forging a targeted and focused business model involves confronting a checklist of critical and probing questions (see Exhibit 2). The answers can provide a valuable road map for charting a successful business course.

Exhibit 2  
Business Model Checklist

VISION "WHO"	<b>Competitive Positioning</b>	<ul style="list-style-type: none"> <li>- Is the firm's unique focus—client service and orientation; product innovation and expertise; channel management; or global coverage, among other possibilities—clearly demonstrated in the market?</li> <li>- Is the firm's positioning sufficiently different from that of its competitors?</li> </ul>
	<b>Brand</b>	<ul style="list-style-type: none"> <li>- Does the firm have a single brand or a portfolio of brands?</li> <li>- What is the brand architecture? Is there a clear distinction between the corporate brand and geographic or product-level brands?</li> </ul>
	<b>Aspirations</b>	<ul style="list-style-type: none"> <li>- Has the firm clearly defined its short- and long-term goals relative both to the organization as a whole and to the market and the competition?</li> </ul>
	<b>Culture</b>	<ul style="list-style-type: none"> <li>- Is there a single firm culture or a hodgepodge of cultures drawn from acquisitions?</li> <li>- Is the culture complemented by the appropriate decision rights, organizational structure, performance metrics, and incentives?</li> </ul>
PORTFOLIO "WHAT"	<b>Markets</b>	<ul style="list-style-type: none"> <li>- Is it clear which markets the firm should invest in for future growth, and are they sufficiently diverse (a combination of mature, growth, and experimental)?</li> </ul>
	<b>Customers</b>	<ul style="list-style-type: none"> <li>- Is the firm's client emphasis on retail, defined benefit, or defined contribution, and is this focus aligned with the actual revenue and cost contributions from customer segments?</li> </ul>
	<b>Products and Pricing</b>	<ul style="list-style-type: none"> <li>- Has the firm determined its mix of products and asset classes based on market trends?</li> <li>- Is pricing linked to market penetration, and is there sufficient discipline to maintain prices on the rate card?</li> <li>- Have performance-based pricing approaches been adopted?</li> </ul>
	<b>Channel</b>	<ul style="list-style-type: none"> <li>- Has the firm established clear channel priorities based on market trends, revenue sharing, pricing potential, and relationships with distributors?</li> <li>- Does the firm aspire to a diversified mix across channels as well as a high "share of shelf" with select wholesalers and intermediaries?</li> </ul>
OPERATING MODEL "HOW"	<b>Delivery Model</b>	<ul style="list-style-type: none"> <li>- Is the delivery model aligned with the firm's positioning?</li> <li>- Is technology excellence viewed as a competitive advantage?</li> </ul>
	<b>Model Choices</b>	<ul style="list-style-type: none"> <li>- Does the firm make deliberate choices on how to achieve the delivery model? Has it adopted any or all of these approaches: compensation grids based on net versus gross sales; service levels aligned to client profitability; labor arbitrage and competency centers with global footprint; and commitment to lean and Six Sigma to manage capacity and quality?</li> </ul>
	<b>Implementation Planning</b>	<ul style="list-style-type: none"> <li>- Is there a clear plan for achieving the delivery model, including capital investments supported by realistic business cases; a combination of organic build and inorganic gap filling; and programmatic and phased implementation to mitigate risks?</li> </ul>
PERFORMANCE MANAGEMENT "HOW WELL"	<b>Progress Metrics</b>	<ul style="list-style-type: none"> <li>- Does the firm have a small number of metrics to measure progress in critical functions over time? Metrics should focus on distribution (net sales per sales professional, share of shelf with top three wholesaler partners), investment management (number of vehicles per investment professional, assets under management per investment professional normalized for asset mix), and operations, technology, and support (percentage of operations costs that are insourced and outsourced, support costs per assets under management).</li> </ul>
	<b>Competitor-Related</b>	<ul style="list-style-type: none"> <li>- Are benchmarks—financial and nonfinancial, global and regional—used consistently to measure progress against competitors? Benchmarks could include compensation of sales and investment professionals, pricing, cost and efficiency, and return on investment.</li> </ul>
	<b>Market-Related</b>	<ul style="list-style-type: none"> <li>- Are performance indicators (leading and lagging) used to ensure preparedness for changing market trends such as socially responsible investing or alpha-beta separation?</li> </ul>

Source: Booz & Company

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## THE WINNING FIRM, PART II: ROBUST CAPABILITIES

While the firm endeavors to adopt a business model that is nimble, flexible, and extremely cognizant of shifting market conditions, asset managers and their teams have an equally weighty task to undertake. The core capabilities they possess must reflect the new environment as well and must be aligned with the firm's business model. Four areas are primarily affected:

### **Financial Transparency**

Asset managers traditionally have made decisions within organizational silos with no mechanism to enforce discipline in pricing, client service, marketing expenditures, and investment strategies. But that isn't viable anymore. Asset managers can no longer neglect developing a deep understanding of the true economics and underlying drivers of revenue and profits at their firms or addressing the impact of market events and their own investment decisions on the overall business. This greater awareness

of the financial aspects of the firm should lead to broad agreement on the number of funds and the investment and operational strategies to embrace, and to merging funds that are subscale, repricing clients depending on the size of their portfolios, and adjusting service levels to match their value.

Financial transparency will also help reveal the impact of changes; for example, the SEC's proposal to more tightly regulate 12b-1 fees could have both one-time and ongoing cost implications. Other effects and decisions will be drawn from conditions in the industry and changes in technology and address questions like these: Should we push direct sales over intermediated sales? Would operations allocations go down if we merged two funds or moved to an outsourced provider?

### **Distribution Reach**

Sales channels should be carefully

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assessed and determined by such factors as the buying behavior and level of penetration of channel partners, as well as the firm's need for diversification. For example, BlackRock's acquisition of Merrill Lynch's asset management arm in 2006 gave BlackRock access to Merrill's customers and sales channels; this astute combination of like-minded firms created the number one fixed income manager in the U.S. and a top-10 asset management operation worldwide. It could have taken BlackRock many years to reach these levels without the deal.

Once the appropriate sales channels are chosen, compensation models for asset management teams should be aligned to them. Depending on the company's structure and culture, decisions have to be made about whether compensation schemes should be based on gross or net assets, as well as the appropriate balance between base pay and bonuses. In addition,

it may make sense to break up the sales team by individual product groups, with some associates focusing on equity, others on fixed income, and still others on money market. Alternatively, dividing sales teams by geography—a group focused on the Northeast, another on the Southwest, etc.—may be more desirable for firms that are offering a full plate of investment choices to all types of customers.

Similarly, marketing and branding communications must also reflect key channel and client segments. Highlight near-term performance and portfolio manager profiles for retail investors, as Fidelity does when publicizing its Morningstar five-star-rated funds and their portfolio managers; emphasize the quality and the stability of the investment process and the asset management team as well as the stock-picking prowess of the organization for institutional investors; and focus on relationship and collabora-

tion for intermediaries, such as investment consultants, fund platforms, and advisors. For example, Capital Group, which is well respected by institutional investors, tends to promote four strong components of its investment process: research, communications, decision making, and portfolio risk control.

#### **Business Agility**

Access to strong and penetrating research and analytics is absolutely essential for understanding trends and events in the market, channels, and client segments well enough to quickly snatch up available opportunities. Product innovation depends on (1) a deep knowledge of the marketplace; (2) replicating competitors' products where profit potential still exists (in some product classes, such as exchange-traded funds, there is significant first-mover advantage and coming in second could reduce likely market share to as little as 10 percent); (3) customizing products for

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specific segments, such as retirement, an area that will see a large influx of money over the coming years; and (4) quickly entering new and emerging markets, potentially in partnerships.

In-depth analysis can unearth opportunities that may not be immediately obvious. For example, Bridgewater Associates has used a potent combination of strong research and an innovative culture to pioneer hedge funds with a unique approach to alpha creation.

Often the best approach to encourage new ideas, products, and services is to localize innovation in the parts of the business where it is most needed—for example, among portfolio managers and investment specialists—and not throughout the organization.

#### **Attention to Hygiene Factors**

Cost-effective delivery of support services begins with outsourcing noncore capabilities—for example, back-office

functions such as fund accounting and net asset value (NAV) calculations, as well as, in many cases, middle-office post-trade functions. But it increasingly includes more aggressive activities such as applying lean principles to drive out waste; indeed, asset managers have achieved upward of 25 percent cost savings through lean techniques.

The use of lean strategies is not required, but they can be extremely helpful in deploying tools and techniques to promote quality. Among the approaches that should be considered (whether or not a full-fledged lean strategy is implemented) are simple checklists for fund setup and similar account support activities; root cause analysis for issues such as NAV errors, management fee calculation and fund setup issues, as well as periodic back-testing of critical outputs and controls; and assessment protocols to flag variances and allow corrective actions to be taken. In the

assessment of each of these operational aspects, “near misses” and their root causes should ideally be identified as well to prevent potential problems in the future.

However, focusing on quality is not sufficient if customers do not see the improvements. As a result, it’s imperative to simultaneously restructure the client service organization to improve proximity to clients and set up rigid business continuity procedures that deliver cost reduction, better turn-around times for calculating NAVs and other outputs, and flexible staff capabilities so that employees can easily be shifted to virtually any aspects of investment operations as needed. These benefits can be realized through a mix of internal resources and outsourcing. To adopt these high performance standards and instill them throughout the asset management team often requires significant functional cross-training and regular routine test cycles.

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## HIGHLIGHTS

- Asset management is facing substantial challenges: Customers fear risk and want to control their investments, even as retail and defined contribution are becoming the predominant markets.
- The precise future of asset management holds a lot of unknowns involving net fund flows, the demand for alpha, increases in retirement assets, the direction of management fees, the costs of compliance, and new regulations.
- To thrive amid the turbulence, asset management firms must embody two critical characteristics: a precise business model, and underlying capabilities that go well beyond a strong investment management team and are aimed at sustaining the business model.

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## CONCLUSION

Clearly, asset managers and their firms will face very real trials during the next decade. Although the landscape is changing and becoming more challenging, the pathway to success—a good business model and complementary capabilities—is not all that different. Yet with so much new competition and anything but stable money flows, the chances of success this time around are lower than ever before—unless this pathway is followed.

*Though the landscape is becoming more challenging, the path to success remains a good business model and complementary capabilities.*

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