In the space of just seven years, the asset management industry has been hit by two of the four worst bear markets to have occurred in the past 100 years. The last one wiped out USD15 trillion in assets and destroyed 15 years of capital gains in the space of 18 months. The CREATE–Research study, co-sponsored by Citi and Principal Global Investors, sets out to determine how these events will affect client behavior going forward, how investment managers should respond, and what will differentiate winners from losers—in terms of business model and products alike.

The study is based on a three-tiered survey of investment managers involving focus groups, an electronic survey and follow-up structured interviews. In all, some 225 investment managers from 30 countries participated. They managed a combined USD18.2 trillion in assets—down from a peak of USD25.4 trillion in July 2007. The survey provided the global reach, the interviews and the subject depth. Together they provide key insights into recent events and their future impacts.

One message stands out: Once the worst of the current turmoil is over, there will be a flight to quality, simplicity and safety. Quality will be defined by consistent, risk-adjusted returns; simplicity by transparency and liquidity; and safety by capital protection. Clients’ new mantra will be “back to basics.”

Mainstream asset classes will far outweigh alternatives in client choices. Granted, there will also be periodic opportunism to capitalize on areas such as distressed debt while high-net-worth individuals will remain in the active space and seek alternative investments. However, retail clients will be drawn into products that offer capital protection and tax efficiency.

Loss aversion here will be rife—as it will be for defined benefit clients that are being forced to change the way they invest by persistent losses, covenant risk and demographic dynamics.

Three Scenarios

How will these trends affect the investment management industry? Three scenarios present themselves. At one extreme is a commoditized industry in which clients’ investment choices are largely driven by capital protection. The pace of commoditization may accelerate in the event of regulatory overdrive. Some 34% of survey respondents subscribe to the commoditization scenario, which is in line with what has already happened in Japan. However, many are not tooled up for products with low return, low risk, low volatility and high liquidity features.

The winners will be those firms capable of seeing the world through their clients’ eyes, meeting the product requirements of a changed marketplace.
At the other extreme is what one might term “a vibrant industry” in which managers put their clients’ interests first. Some 17% of respondents subscribe to this scenario. Here, the winners will be those firms that align the interests of managers and clients with a value-for-money fee structure, products that “are fit for purpose” and high-quality service.

The third scenario sits between the other two. It envisages a segmented industry with a fragmented food chain and a focus on different client segments. Nearly one in two respondents subscribes to this scenario. Each client segment is expected to have a special theme: liability-driven investment in the defined benefit space; advice in the defined contribution space; capital protection in the retail space; and active management in the high-net-worth individual space.

**Introducing a Variable Cost Base**

The starting point for dealing with the new challenges is to review the business model. That, in turn, needs to start with costs. Gross revenues across the industry fell by around 35% in 2008, with a further 15% drop in prospect in 2009. A variable cost model is essential in providing the shock absorbers capable of cushioning exceptional revenue falls. Yet, only 13% of respondents say their costs vary “to a large extent” with levels of activity.

The psychological barriers to a variable cost model are now crumbling. More firms are introducing variable pay structures and considering outsourcing elements of their front-, middle- and back-office activities to create economies of scale and scope.

Some 37% of respondents have already outsourced the back office. The number is expected to double in the future. One in five firms has outsourced the middle-office. Again, the number is expected to double.

The effect of this process is to create a distinct craft focus at the investment end, customization at the distribution end, and standardization at the administration end. Actual and virtual boutiques are being created. These moves are important in blowing away entrenched processes that have long conspired against client interests as well as operating leverage.

**Focus Is Key**

The second area is to streamline the product base to focus on core competencies. More than ever, large firms are now recognizing that they cannot be “jacks of all trades.” They are forced to make a choice between manufacturing and assembly. The latter is emerging as a major competency in its own right, underpinned by external subadvisory alliances. A new supply chain is emerging in which fees have a low fixed component and a variable component.

Some 41% of respondents have already pruned their product range. In some medium and large firms as many as 300 products have gone. Hitherto, in the absence of flexibility on the cost side, large houses had relied on an “all weather” portfolio to maintain revenue in bad times as well as good. As with outsourcing, many now recognize that product pruning has to have a strategic intent that clarifies what the core capabilities of the business are and how they can best be deployed.
Putting Clients at the Center

The third, and perhaps most vital, area of change is in client engagement. The study clearly shows that tomorrow’s winners will be those firms that espouse the “vibrant industry” scenario detailed above. That means putting the client at the center of all they do. In the past, the asset management industry has been too supply driven. Firms have sold what they have in their range, not what clients have needed. That must change. Managers have identified four sets of features for a winning business model:

1. **Investment capabilities** that center on people talent, fundamental research, disciplined replicable processes and deep insights into asset allocation, cross correlation and trade-offs between risk, return, liquidity and volatility.

2. **Clear alignment** of interest between managers and their clients. In addition to a value-for-money fee structure, this includes performance-based incentives, transparent compensation systems and execution costs, and regular inter-industry cost comparisons.

3. **Service excellence.** This means understanding client needs, selling products that are fit for purpose, giving accurate and timely information, providing periodic investment reviews and establishing internal panels to protect and further client interests.

4. **Top-level business capability.** Firms will need the executive skills to manage alliances, good customer relationship management, dedicated innovation and quality-assurance processes.

Refusing to Change Is Not an Option

The worst of the crisis is seemingly over, but it has triggered a chain reaction that will endure long after the markets recover. Of interest is the fact that a clear majority of survey respondents expect at least one more systemic crisis to occur in the coming decade. The implication of this is there will be no return to “business as usual.” Three messages emerge from the survey. Firms need to review their business model. Many have operated bloated cost bases with inflexible pay structures. Now, they must become “lean and mean.” Above all, they need to put a variable cost structure in place covering both people and processes.

Second, they need to slim down their product range and focus on core capabilities, retooling where necessary to meet changing client needs. They need to make a choice between manufacturing and assembly. Already, 17% of respondents have outsourced manufacturing and their number is expected to quadruple.

Finally, the industry needs a radical shift in governance and attitudes to align managers’ interests with those of clients — on charging, reporting, service and administration. The winners will be those firms capable of seeing the world through their clients’ eyes, meeting the product requirements of a changed marketplace. In short, investment managers need a new narrative on what they stand for and what they can deliver.