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The evolving business of asset management

Disruptive pressures are forcing the asset management business to undergo transformational change

THE business of asset management (not to be confused with the skill in investing) is a business like any other, where the primary objective is to maximise the return to shareholders, and where a number of ongoing disruptions will redefine the product strategy, the organisation design and the business model of asset managers.

Performance-led disruption

With hedge funds becoming more accessible, active managers have come under greater pressure to justify their fees, by proving that they have the necessary skill to drive excess returns. Every active manager will not be able to survive this pressure.

Fee-led disruption

The proliferation of passive and smart beta products has forced down active management fees for all products, even if performance is good. This progressive decrease in revenue per unit of assets managed will create cost pressures and a greater need for inorganic mergers, especially if markets fall.

Distribution-led disruption

The traditional business model for asset managers to be a part of banks or insurance companies was challenged when it was evident that investment skill and product distribution are two different disciplines.

Most banks and insurance companies have chosen to uncouple from their asset management business and focus on distribution. Asset managers will no longer have captive clients.

Regulatory-led disruption

MiFID-II requires that the burden to pay for information will fall on the asset manager – at a time when the availability of information through big data has ballooned. This will force a rethinking on the product set that managers can compete in as it may not be feasible to have knowledge for all market segments.

Product-based disruption

We know that over 80 per cent of the risk and return of a portfolio comes from the allocation decision, and the remaining 20 per cent comes from the security or manager selection decision. Despite this, it is anomalous that over 80 per cent of the investment industry's resources, products, expertise, costs and innovation focus on security selection.

The industry seems to be focusing on the wrong investment problem.

Both asset managers and asset owners have armies to pick stocks and managers, but a single small team for allocation. In fact, if the whole investment industry (portfolio managers, analysts and traders) were to come under a bus tomorrow, the return of the asset owner wouldn't change very much.

While this won't change overnight, there will be a shift in products and resources away from security selection towards allocation space.

Asset class redefinition

Liquid hedge funds, once classified as alternatives, are now positioned as equity or bond products using leverage and shorting. Similarly, private equity which is today considered a separate asset class, may merge with public equities in the portfolio, with the additional parameters of duration and liquidity.

Benchmark redefinition

The investment industry's foundation was to link companies requiring capital with investors requiring return. Originally, this was facilitated by local exchanges in each country, as companies' businesses were local and investors were local.

Today, neither of these are true – companies listed in any country have revenues and shareholders from global sources. Hence the use of country market indices (or regional aggregates such as emerging markets) as the basis of all active and passive products seem misaligned. Moreover, the entire concept of using a market index as a benchmark seems challenged, as all asset owners need absolute return (expressed as nominal, real or liability relative) rather than market or market relative returns.

Indices can represent market performance but are perhaps inappropriate as benchmarks for products from a client perspective. The two facets of obsolescence of country indices and the desire by asset owners for absolute return will require reclassification and repositioning of all investment products towards exposure-based and absolute return-based benchmarks.

The industry is responding to these pressures by reshaping their organisations in many dimensions.

Business model evolution

Captive asset managers relying on assets from their parent insurance company, sovereign or bank have realised that running captive assets is very different from competing for third-party business.

Mid-size asset managers with vanilla products often find that they lack a sustainable edge and scale. Cost and revenue pressures will force these and other firms to choose between becoming a skill manager (focusing on investment performance) and a scale manager (focusing on low cost volume products), or to merge with another entity.

Organisation structure evolution

The focus on delivering performance has led asset managers to abandon their traditional asset class monolith silos in favour of a multi-boutique model where investment professionals are grouped in smaller teams, focusing solely on portfolio performance without responsibilities such as marketing, client support, administration and people management.

Product strategy evolution

Organisations are realising that there are only four ways they can successfully grow the business:

- Manage only products where performance is ranked within the top three compared to peers. As market psychology drives the majority of client assets to only the top three managers in any segment, any other product will likely be unprofitable.
- Manage products in segments that are likely to be in vogue in the future. When the tide comes in, even mediocre products in that segment are able to collect some business.
- Create leadership and credibility in the next generation of products. As the market evolves, clients reward the thought leader and first mover.
- Transition from a product-based to a solution-based organisation, where the focus is not on individual products but on delivering customised client solutions.

Blockchain is a game-changer

If blockchain technology were implemented in asset management, it would be a game-changer.

The investment industry has an incredible number of intermediaries, each charging fees, all for the simple exchange of ownership of securities – such as active and passive managers and hedge funds that implement investment advice, fund of funds and platforms that pool funds, private and retail banks that distribute, benchmark companies providing indices, custodians holding assets, bank payment transfer systems, pension funds and retirement platforms that pool assets, consultants who advise the pension funds, investment banks for execution services, exchanges to facilitate settlement, operational systems and pricing feeds, fund accountants to certify performance, and risk system providers that certify risk.

What if the ownership of all securities were registered globally on a blockchain? It is probable that half or more of these intermediaries would no longer be required, and the frictional cost of investing would fall dramatically.

Despite these disruptions, interest in the business of asset management has historically been strong, as it has been one of the most profitable industries for shareholders.

A recent study found that of all the S&P500 industries, investment management had among the highest ROE, and was the most closely held – shareholder return was not only the highest, but this wealth was shared among the fewest shareholders.

But it may not be as easy in the future. Robo-advisors are propagating the disruption caused by fees, distribution, regulation, and organisation and product structure using technology.

In time, the scale battle may not be between the numerous asset managers of today, but between giants like Amazon with its unparalleled distribution skill and Blackrock armed with investment scale. Everyone else will have to deliver skill to survive.

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