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Watching the asset management bottom line in a normal growth environment

An IBM Institute for Business Value executive brief

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Watching the asset management bottom line in a normal growth environment

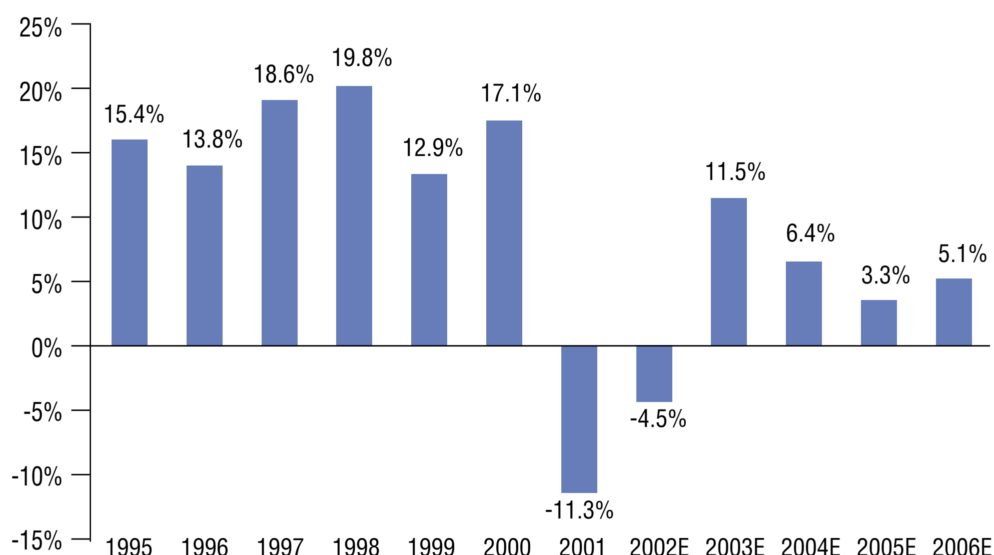
It's widely accepted that the tremendous financial asset growth of the 1990's was an anomaly. As the market returns to more normal growth, asset managers will need to focus on cost reductions rather than top-line expansion to fuel earnings. This is not a matter of simple cost cutting; merely reducing capacity will be insufficient. Instead, it requires radical reformation of the ownership of core business components and their underlying cost structures. This reshaping must start with a change of mindset – from managing assets to managing a complete portfolio of operations.

Accelerated specialization

Growth in household assets is one of the primary drivers of assets under management (AUM) in the U.S. From 1960 to 1990, growth in U.S. household assets closely matched overall growth in the U.S. gross domestic product (GDP).[1] However, throughout the 1990's, household assets grew at an average of 8.6 percent annually, while GDP grew at an average of 5.6 percent – an annual difference of 3.2 percent.[2] This tremendous ramp up in household assets was a primary driver of asset management industry revenue growth during the decade.

Since 2000, that trend has reversed. Household assets dropped 14 percent between 2000 and 2002 while GDP grew 7 percent.[3] Problematically for the industry, growth rates for household assets will likely continue to lag behind GDP as they return to the standard growth path. In short, top-line growth rates of the 1990's are unlikely to recur (see Figure 1).

Figure 1. U.S. mutual fund industry revenue growth rates (public companies), 1995 - 2006E.



Source: Economy.com; IBM Institute for Business Value analysis.

Compounding the challenge presented by the slowdown in AUM growth are a number of other threats to revenue growth and industry profitability, including industry overcapacity, process redundancies, a shift in power to distributors, commoditization and new, lower-margin products.

Despite this adversity, industry analysts predict 14 percent annual earnings growth over the next five years for public U.S. asset managers.[4,5,6] With revenues projected to grow at about half that rate, reaching that target is daunting. In fact, the only path to achieving that growth is a dramatic reduction in cost structure. Specifically, the IBM Institute for Business Value estimates that with revenue growth of 7 percent, a typical asset management firm would have to reduce costs by 16 percent in order to attain 14 percent earnings growth.[7]

How best to achieve such ambitious cost reductions? The key lies in embracing and accelerating the industry trend toward specialization. As firms specialize, they not only shed inefficient and non-differentiating pieces of their business, but they also regain the opportunity to focus on optimizing those pieces of the business they consider core and have elected to retain – those that add differentiated and sustainable value to clients.

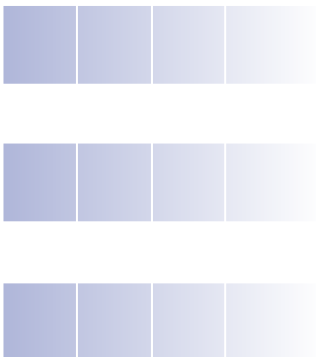
To better understand the marketplace trends impacting future asset management strategies, IBM Institute for Business Value interviewed 51 executives from a variety of players in the asset management industry, including mutual fund complexes, institutional managers, hedge funds, pension funds, endowments, industry associations, investment banks and investment consultants.[8] These firms are based in Hong Kong, Japan, Singapore, England, Germany, Scotland and the U.S. Analysis of their industry perspectives suggests several key trends affecting asset managers.

Cyclical revenue pressures

Most of the revenue pressures asset managers currently face are *cyclical*. Ironically, knowing that they are cyclical complicates the question of how to address them, due to uncertainty about their duration. Two such forces are sapping revenue growth for the industry. The first is the overall drop in industry AUM and the second is a shift of existing assets into nontraditional asset classes.

Drop in total AUM

The largest and most obvious influence on the overall level of AUM is shrinkage due to the drop in the stock market. In this extended bear market, the global asset management industry has lost approximately US$1 trillion since its peak in 2000.[9] But there are also forces dampening the inflow of new funds. Since corporate America shifted so strongly toward defined contribution plans, one of the largest



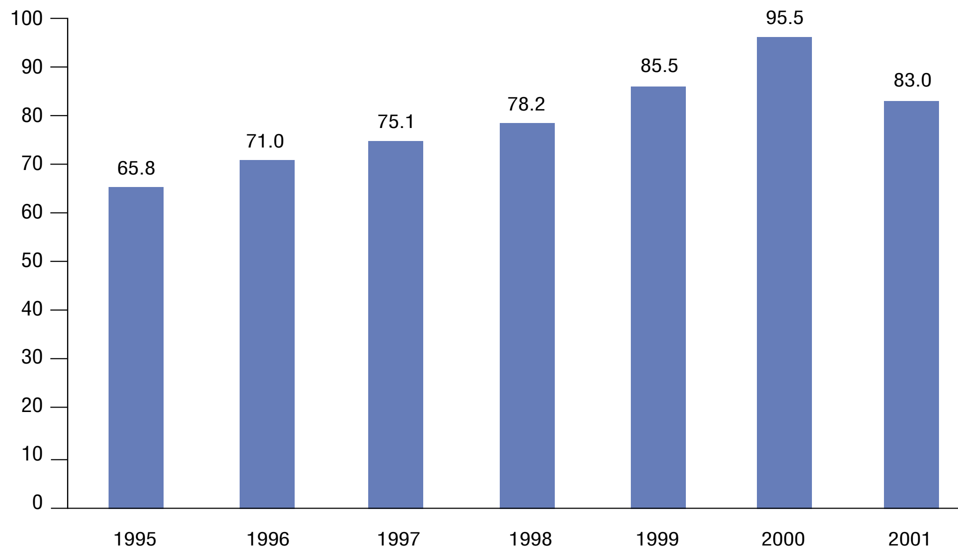
drivers of new assets in the mutual fund industry has been job creation. New employees open up new 401(k) accounts, and the lack of new jobs in the U.S. economy has hampered the inflow of new AUM. To further depress growth, participation in 401(k) plans has started to decline for the first time in 10 years – worse yet, those who do participate are lowering their contribution rates.[10]

Regular savings has also been adversely affected by the economic environment. The amount of funds being invested in real estate has left the U.S. mortgage debt service burden at its highest level in over 20 years.[11] In 2002, the percentage of disposable income earmarked for servicing mortgage debt was around 6 percent, up from about 4.5 percent in 1980.[12] As a greater percentage of consumers' disposable income is allotted for housing, less can be put into securities, even when the market turns around.

The shift into different asset classes

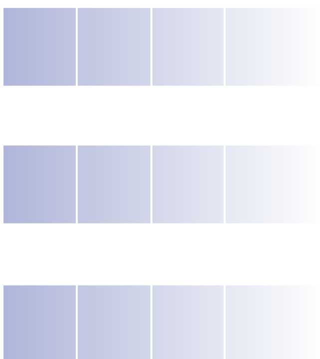
Not only has the extended bear market reduced total AUM, it has also driven many remaining assets into lower margin asset classes. As investors became increasingly risk-averse, much of the remaining asset base shifted from equity to lower margin assets such as bond and money market funds. As a result, the revenue per currency unit managed has dwindled (see Figure 2).

Figure 2. Revenue per dollar managed for selected U.S. firms,[A] 1995 - 2001, basis points.



Note: (A) Selected asset management companies include: Affiliated Managers Group, Atalanta Sosnoff Capital, BKF Capital Group, Blackrock, Eaton Vance, Federated Investors, Franklin Resources, Gabelli AM, John Nuveen, Neuberger Berman, T. Rowe Price, Stilwell Financial, WP Stewart, Waddell & Reed.

Source: IBM Institute for Business Value analysis.



Secular margin pressures

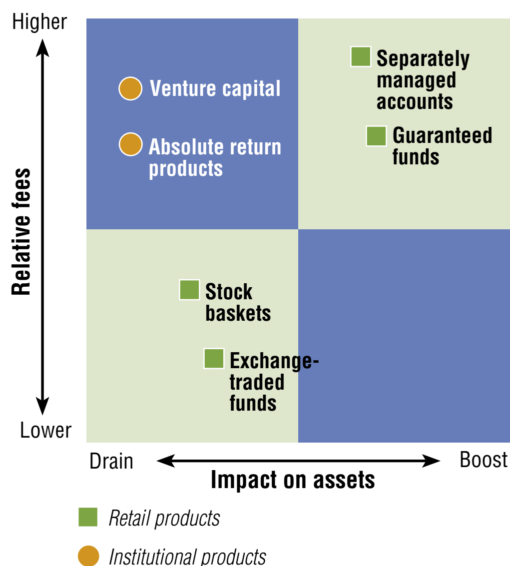
Industry earnings growth is further threatened by several factors that challenge asset management industry margins. Unlike the revenue pressures, these margin pressures tend to be *secular* rather than cyclical. As such, they're not likely to go away, even during a period of recovery. Secular forces such as AUM movement from traditional to alternative asset classes and the shift in power along the value chain are putting a steady strain on margins.

Alternative products

During the bear market, conventional asset allocation strategies have not delivered expected returns, forcing consideration of other investment opportunities. Besides the switch to traditional, lower-margin products, asset managers also now face a wide array of alternative products that threaten to attract significant assets and sap revenue of the traditional managers.

As a result, many institutional investors, fund firms and high net worth (HNW) investors are raising their exposure to these alternative asset classes, especially absolute return products such as hedge funds. Additionally, new, low-cost alternative products have been introduced to the marketplace, shifting the asset base away from traditional retail and institutional asset managers (see Figure 3). This in turn reduces these firms' margins as their cost structures do not shift down to compensate for the loss in revenues.

Figure 3. Impact of new products on traditional managers.



Firm implications

- **Exchange-traded funds**: Potential exists for revenue cannibalization, as investors shift assets into this lower fee-producing class
- **Stock baskets**: Price-based differentiation pressures management fees
- **Venture capital**: Present market conditions temporarily mute this threat, though institutional and high net worth (HNW) assets continue to flow into this class
- **Absolute return products**: While beneficial to industry profitability, these compete with traditional HNW offerings and demand that asset management firms expand line to include these products
- **Guaranteed funds**: Higher sales loads and management fees relative to traditional funds counteract negative margin pressures
- **Separately managed accounts**: Success based on scale and upfront investments are significant.

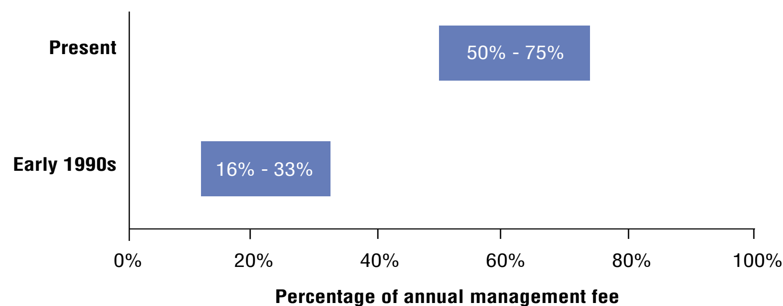
Source: IBM Institute for Business Value analysis.

Increasing power of distributors

Additionally, power is shifting away from fund manufacturers to fund distributors in both the retail and institutional arenas. On the retail side, fewer individuals are buying directly from the fund complexes. Instead, more customers are purchasing assets through brokers, financial planners or other indirect distribution channels.

As the share of fund sales sold by distributors continues to rise and distributors are able to dictate more favorable terms from funds, the profits of manufacturers erode. Their increasing clout gives distributors more control of customers as well as a higher share of the profit (see Figure 4).

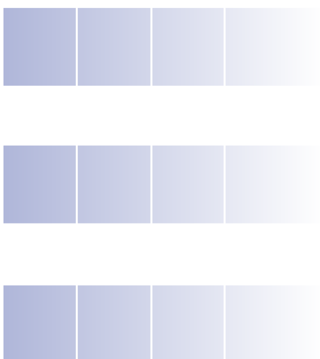
Figure 4. Distributor share of annual fund management fee in Europe.



Source: Wall Street Journal Europe, 20 Feb 2002.

For example, in Europe, 50-75 percent of a fund's management fee is channeled to the distributor, up from 16-33 percent a decade ago. In the U.S., mutual funds pay an estimated US$2 billion annually in revenue-sharing agreements to brokerages in comparison to advertising expenditures in the US$500 million range.[13]

While distribution models vary widely, most markets operate under an intermediary-led structure, with banks typically functioning as the dominant fund channel. However, preferential channel placement is increasingly expensive for funds. For example, Franklin Resources reports that its underwriting and distribution profit has declined 14.2 percent annually since 1998.[14,15]



Across the board, asset managers are feeling increasing margin pressure as intermediaries grow more powerful. On the retail side, asset management products such as mutual funds continue to be sold, not bought. The result is lower margins for manufacturers and greater separation from retail clients.

On the institutional side, firms are parsing out the gatekeeper function to consultants, and taking on a "manager of managers" role. Institutional investors are increasingly using investment consultants to analyze and select fund managers. Consultants offer robust databases about institutional managers that can help in this time-consuming process. As a result, major consultants influence annual investment decisions worth over US$10 trillion, up nearly 30 percent in the last two years.[16,17]

"Choosing managers is more difficult than choosing stocks."
– European institutional manager[18]

Whether or not a consultant is used, the bear market has forced institutional investors to become more rigorous in their manager selection process. Institutional clients are scrutinizing more than just fund performance – buying decisions are based upon qualitative factors such as having transparent, repeatable investment processes, responsive and expert support teams and automated back office operations.

Steps to effect change

In this difficult operating environment, merely waiting for a market rebound is not an acceptable strategy for global asset managers. Wall Street has erected uncompromising expectations. Even if the industry should succeed in returning to its historical revenue growth levels, firms will face a shortfall in achieving the earnings target of 14 percent annually over the next five years. Therefore, asset managers must focus where they have the most direct influence – cost structure and operational productivity.

Given the challenges they face, traditional capacity reduction initiatives will be insufficient to yield double-digit earnings growth. Instead, global asset managers should use this opportunity to respond more comprehensively to the cyclical *and* secular forces crimping profitability. Consequently, firms should reassess their business models and make the appropriate structural changes to their organizations to cope with existing market conditions and gird for future developments.

To do this, asset managers must undertake the process of rationalizing their business models across three critical levels – strategy and planning, tactics and execution (see Figure 5).

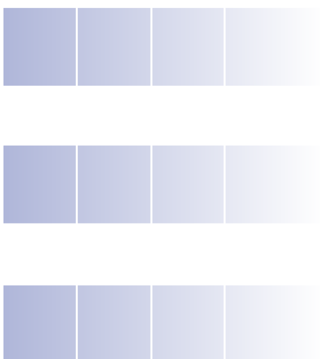
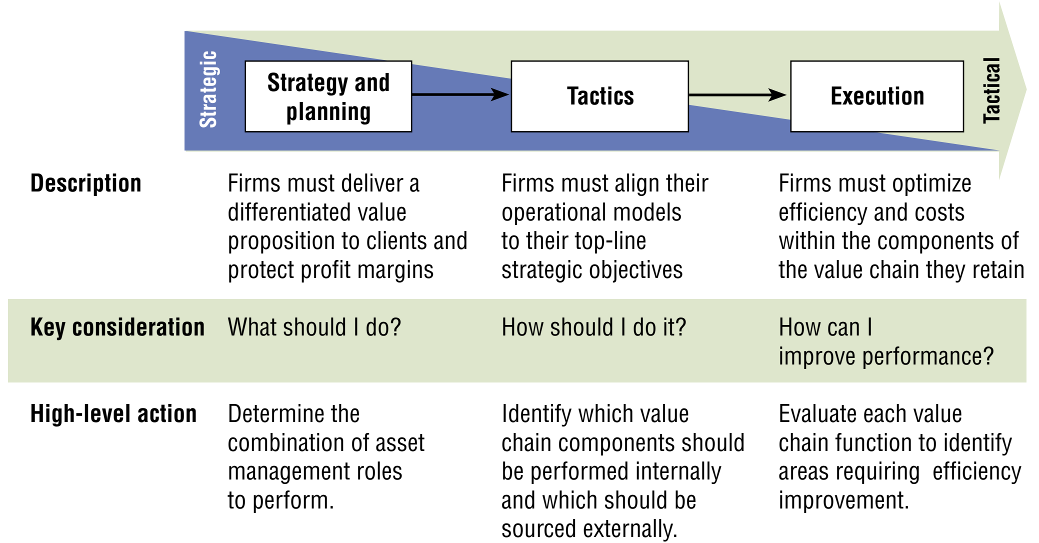


Figure 5. Business rationalization.



Description	Firms must deliver a differentiated value proposition to clients and protect profit margins	Firms must align their operational models to their top-line strategic objectives	Firms must optimize efficiency and costs within the components of the value chain they retain
Key consideration	What should I do?	How should I do it?	How can I improve performance?
High-level action	Determine the combination of asset management roles to perform.	Identify which value chain components should be performed internally and which should be sourced externally.	Evaluate each value chain function to identify areas requiring efficiency improvement.

Source: IBM Institute for Business Value analysis.

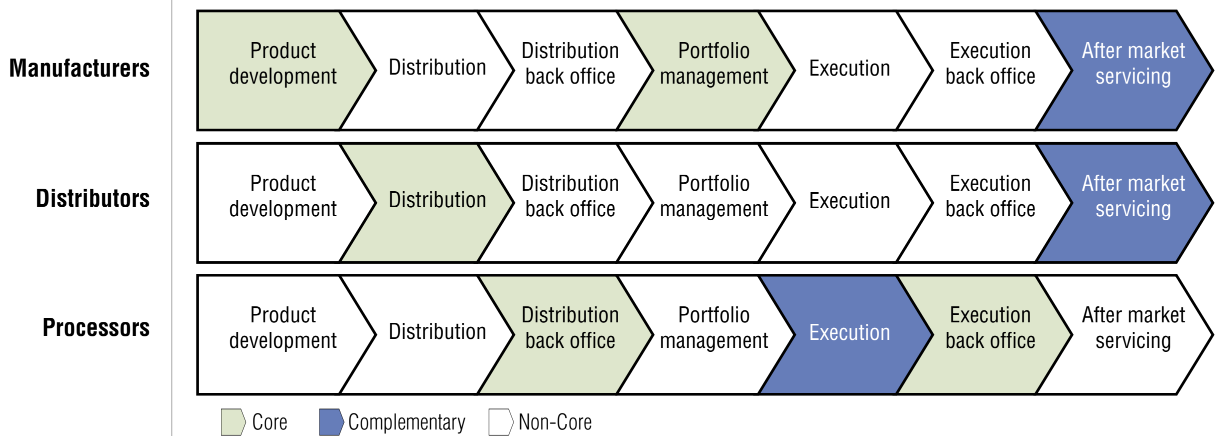
The goals of completing these three steps are:

- A reaffirmed value proposition within the industry, across any combination of the core asset management roles
- An operating model that is tightly aligned with the firm's strategic objectives
- Optimized performance of core and non-core business activities.

Strategy and planning

In the initial step, firms validate their positioning in the marketplace around the key asset management roles of *manufacturing, distribution* and *processing* (see Figure 6).

Figure 6. Core functional requirements by industry role.



Source: IBM Institute for Business Value analysis.

Throughout the bull market, firms aggressively expanded their offerings to provide clients with a full suite of investment products. However, the underlying economics of the full-line service provider make that play untenable for many firms that lack the necessary scale and reach.

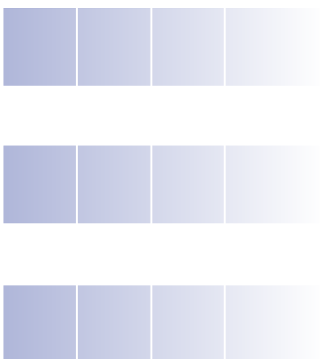
Revenue shortfalls and declining profitability are accelerating the long-heralded concept of role specialization in the asset management industry. While the trend is more pronounced with small- and mid-sized asset managers, even global players are beginning to exit non-core roles in favor of a more focused approach. For each industry role, there are significant factors accelerating specialization decisions:

"We've exited the passive business, and have chosen to focus on higher margin actively managed businesses."
– Chief Operating Officer, U.K. investment manager[19]

- Manufacturing – Market acceptance of the open architecture model prevents manufacturers from ignoring the distribution specialists, such as mutual fund supermarkets. With very few exceptions, manufacturers who do not develop an indirect channel network significantly compromise their customer reach.
- Distribution – Firms embracing the distribution function must consider other forces. As clients become more sophisticated and their needs become streamlined, they will be more likely to adopt a best-of-breed sourcing approach. Distributors that are unable to deliver offering breadth will be at a competitive disadvantage.
- Processing – Optimal performance depends almost entirely upon scale, a requirement which automatically excludes most small- and mid-sized asset managers.

Tactics

Make no mistake – most firms won't exclusively be manufacturers, distributors or processors. But asset managers will tend to focus on one of these roles to add truly differentiated value to their customers. Functions which are ancillary to a firm's central mission are good candidates for being performed by third parties, leaving the firm free to concentrate on the functions it does best.



Although few firms can profitably own the entire value chain, many retain ownership of unnecessary components, driving up operational costs unnecessarily. Understanding the key success factors associated with different components of the value chain is vital to making these tactical choices about specialization (see Figure 7).

Figure 7. Success across the value chain requires unique capabilities within each component.

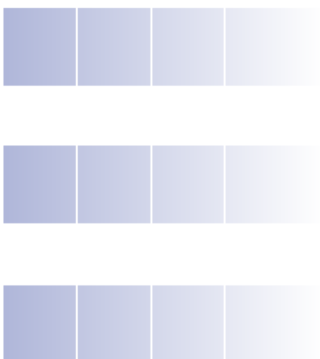
	Product development	Distribution	Distribution back office	Portfolio management	Execution	Execution back office	After market servicing
Key success factors	• Innovation	• Superior value proposition to intermediaries and customers	• Operational excellence	• Performance	• Market knowledge • Trading capabilities	• Scale	• Convenience
Additional success factors	• Speed to market • Product differentiation	• Scale • Breadth • Multi-channel delivery • Automation	• Automation • Convenience • Reputation • Flexibility	• Reputation • Resources • Experience	• Accuracy • Performance • Delivery • Automation	• Automation • Straight-through processing • Accuracy • Transparency	• Trust • Accuracy • Flexibility • Automation • Multi-channel delivery • Responsiveness

Source: IBM Institute for Business Value analysis.

As specialization increases, the industry landscape will change. Extensive hybridization will occur among large- and mid-sized funds. And, lacking scale, small players are unlikely to retain distribution and processing.

Execution

After a firm identifies the core functions that it will retain, management must adapt the operational model to support the firm's strategy by addressing redundancies and inefficiencies. For each activity, executives should evaluate supporting sub-activities to reveal when external partnering could be more efficient – keeping in mind, of course, that certain functions may be too critical to cede to others, even if they don't truly add value, because of the risk of catastrophic loss.

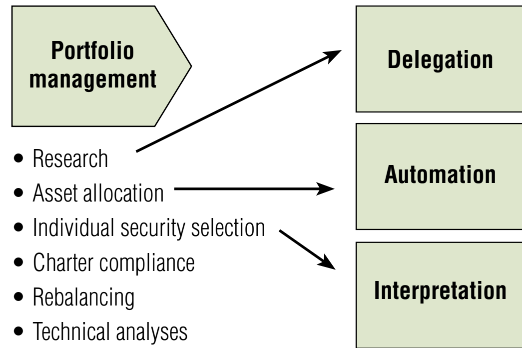


Asset managers can choose from three non-exclusive methods to optimize performance of a particular sub-activity:

- *Delegation* – Reallocating control of processes to partners
- *Automation* – Performing clerical tasks with technology
- *Interpretation* – Executing analytical tasks through technology.

Consider, for example, the manufacturing competency. Three financial services firms have each followed one of these paths to increase the efficiency of sub-activities within their own portfolio management functions (see Figure 8).

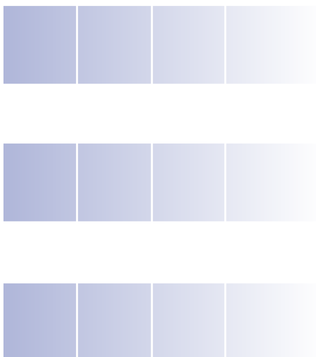
Figure 8. Optimizing portfolio management performance.



Source: IBM Institute for Business Value analysis.

For example, the asset management division of a global bank delegated the execution of some market research. The company supplements its internally-generated research by leveraging an external network of journalists and market researchers with broad areas of expertise to produce customized reports at the request of portfolio managers to support their investment decisions.

A major North American asset manager examined its back office operations and went through the process of making faxes and manual processes "STP-enabled," – allowing straight through processing of trades without manual intervention. By employing automation in this manner, the company now handles 10 times the volume with 80 percent of the staff.



A mid-sized institutional asset manager uses technology to optimize data interpretation as part of its asset allocation function. To do this, the firm uses a proprietary portfolio optimizer that analyzes the end-of-day status of its portfolios, and then generates a program of trades that need to be executed on the next trading day to rebalance through individual security selection.

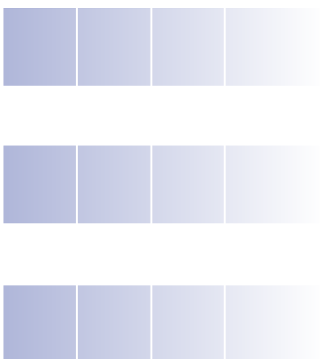
As firms begin to pay more attention to productivity measures, rather than simply growing the top-line, determining the best way to effect this cultural change assumes enormous importance. For example, compensation, often the biggest expense for asset managers, should be examined carefully – more highly differentiated pay between top and bottom performers may be in order. For executives who are accustomed to focusing on asset growth, cost reduction will require a new way of managing, calling for incentives that reward bottom-line, not just top-line, focus.

Size up your operations

How proactively are you addressing the forces buffeting the asset management industry today? Here are some questions to help jumpstart your thinking:

- What are your goals for long-term earnings growth? How heavily do they rely on returning to double digit revenue growth?
- What are your chosen competencies? How much progress have you made in consolidating redundant processes and divesting non-core functions?
- How are you positioned to compete with alternative products, now and in the future?
- How much effort are you devoting to revamping your overall cost structure, from operations to compensation?
- How will the impending increase in clients who want financial counsel impact your business? Have you determined how to benefit from it?
- Are you prepared to respond flexibly to unexpected shocks, like sudden shifts in consumer demand for product or new regulations?

If asset managers are going to meet the ambitious earnings targets set for them, they have no choice but to focus on fundamentally restructuring their cost base. They will have to acknowledge that they aren't best in class in all areas of asset management, use third parties when appropriate and focus on functions where they bring sustainable, differentiated value to their clients. As firms undergo this assessment of their business models, nothing should be out of bounds – incentives, operations and infrastructure are all fair game and should be examined with a critical eye.



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About the authors

John Raposo is a Senior Consultant with the IBM Financial Services Sector. John can be reached at *raposo@us.ibm.com*.

Ian Watson is a Managing Consultant with the IBM Financial Services Sector. Ian can be contacted at *iwatson@us.ibm.com*.

Daniel Latimore is the Global Financial Services Sector Lead for the IBM Institute for Business Value. He can be reached at *dwlat@us.ibm.com*.

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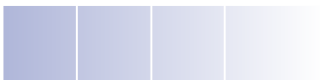

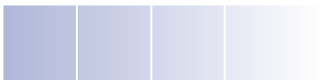

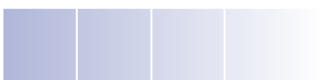

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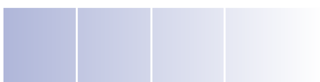

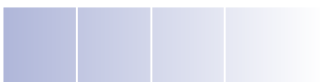

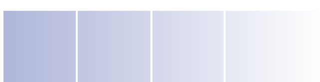

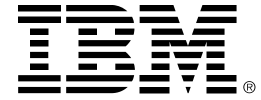

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