Game-Changing Trends in the Asset Management Industry

Product Demand Shifts, Regulations and Talent Management Poised to Shape the Future
Greenwich Associates CEO Roundtable

Every year Greenwich Associates brings together senior executives from a diverse group of leading asset management organizations to participate in a day-long roundtable discussion focusing on the state of the industry, key change dynamics and their own experiences over the past 12 months.

Recently, Greenwich Associates hosted its fifth CEO Roundtable. Topics discussed by the CEOs included product development, alternatives, globalization, regulatory environment, operational risk, talent management, and long-term industry trends.
On April 5, 2013, senior executives from some of the asset management industry’s largest and most influential companies gathered in New York for the fifth annual Greenwich Associates CEO Roundtable to discuss the state of their industry and the road ahead.

Based on insightful and spirited conversation over the course of one day, five key themes emerged around the current and future dynamics in the asset management industry.

1. Specialty Products Will Drive Demand. As institutions shift assets to specialty products — including emerging market equity, international small cap, alternatives, and others — core equity and fixed-income strategies continue to decline. Driving this shift is a combination of historically low interest rates and the related problem of pension underfunding, which together are forcing institutions to seek out new sources of alpha. On the retail side, conference participants believe distribution platforms will give large firms an advantage in the development and sale of fast-growing “liquid alternatives,” like the so-called 40 Act funds in the United States and select UCITS in Europe and around the world.

2. Global Expansion Will Drive Growth. The CEOs agree that while the U.S. defined benefit (DB) market has entered into a period of long-term, secular decline, it will remain robust enough to sustain healthy businesses for years to come, and still presents real opportunities for growth for both large and small managers who achieve “best in class” status and for liability-driven investment (LDI) specialists. However, international markets will drive the industry’s future growth, and to capture that growth, an increasing number of investment management firms are taking on the risk and expense of decentralizing investment operations and putting investment talent, as well as distribution teams, on the ground in local markets.

3. Advisory Services Are Altering Client Relationships. Large asset management firms are looking to build new and stronger relationships with clients alongside investment consultants. Under the still-evolving strategic advisory model, “solutions groups” attempt to forge durable relationships with clients by providing objective, future-oriented advice and comprehensive solutions. In the future, the CEOs predict that their commitment to this model will create a new dynamic in which institutions maintain simultaneous relationships with consultants and a small group of asset management firms upon which they rely for advice on markets, investments and managers.

4. Industry Changes Are Raising the Bar for Client-Facing Talent. Two developments that are raising the bar for all professionals in client-facing roles are: 1) client demand for institutional salespeople who possess a much deeper knowledge of investment issues and institutional needs, and 2) upheaval in the financial services industry that has allowed asset management firms to recruit talent from investment banking, capital markets, actuarial services, and other areas.

5. New Regulations Could Pose Unintended Consequences. The CEOs describe the rule-making process around the world as rushed, fragmented and sloppy, and they fear that the lack of coordination among rule-making bodies within countries and across borders will result in dangerous unintended consequences. They lament the asset management industry’s failure to effectively respond to regulators due to a lack of organized cooperation among firms. However, the CEOs do see some opportunity to play a more constructive role by helping to educate hard-pressed regulators about the issues and markets they cover.
Specialty Products Will Drive Demand

For the second year in a row, the CEOs gathered at the Greenwich Associates CEO Roundtable discussed the “demise” of core equity and fixed-income strategies as the combination of historically low interest rates and the related problem of pension underfunding forces institutions to seek out new sources of alpha. Specialty products including emerging market equity and debt, international small cap, high yield, credit opportunities, and alternative investment products “are the key to our growth,” says the CEO of a large, multi-boutique management firm. “Core is over.”

The CEO of a bank-owned multi-boutique management firm says fixed-income multi-asset-class products have been among the biggest sellers for his firm over the past year. The CEO of another bank-owned asset manager says some of his firm’s biggest successes over the past year have come in the areas of structured solutions and income-focused products. According to that executive, the message to managers is clear: “If you are in a core business in which you do not add value, get out, and invest in specialty areas.”

Even within alternative categories like real estate, specialty products are gaining ground, with clients demanding specialized real estate strategies including mezzanine, commercial-only and global, or at least multi-regional.

However, Greenwich Associates consultant Rodger Smith raises the possibility that investors might return to core strategies in a higher interest rate environment. Even now, Smith notes, huge amounts of institutional assets remain in core strategies and certain firms continue to win mandates in core due to their status as best-in-class providers.

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— CEO, asset manager

But Greenwich Associates consultant Andrew McCollum concludes that slowing growth in the traditional long-only DB business is forcing managers to seek alternative sources of growth “in new geographic markets like Asia and Latin America, new client segments like insurance and central banks, and new products like multi-asset and alternatives.”

The CEOs say hedge funds and other alternative investment products are growing in importance among traditional asset managers as critical offerings in meeting client demands and as a tool for talent retention.

Alternative investments now comprise approximately 19% of institutional assets under management, but make up 40%–50% of asset management revenues. Both of those shares are poised to grow: About 10% of institutions participating in the Greenwich Associates 2012 U.S. Investment Management Study said they planned to hire an alternatives manager in the next 12 months; only 2% had plans to hire a core long-only manager. Already, about half of U.S. institutions invest in hedge funds and/or private equity, and 45% invest in real estate.

All of the firms represented at the Greenwich CEO Roundtable have affirmed that they want a place in the alternatives space — but perhaps not for the most obvious reasons. The CEO of a large integrated investment manager says his firm launched its first long/short equity fund in the 1990s, not in an effort to meet some specific client demand, but rather to retain talent. At the time he says the firm debated all the potential complications associated with the introduction of alternative products into a long-only firm. In the end, he says, the argument of “we are in the talent business and we need to keep that talent right here,” won out.

Once a firm decides to enter the alternatives space, structuring this new capability depends in large part on how the firm is organized. “The simplest model is total...
separation, but that ran counter to our culture,” says the CEO of the large, integrated manager. Indeed, CEOs of firms with integrated business models say they are committed to making sure the talent and capabilities they build in long/short products work to the benefit of the entire investment platform and, thereby, all clients. One CEO says his firm’s decision to integrate alternatives into the main investment platform paid off during the financial crisis, when the firm’s hedge fund managers started moving out of banks early on — a call that he says “bled over” into the long-only products.

There are pitfalls to the integrated approach. Chief among them: disruption of company culture due to pay discrepancies. Although several CEOs cited examples of the benefits of running an alternative investment team as a stand-alone operation, the CEOs of integrated firms generally accepted that hedge fund-like strategies were becoming a more standard part of the asset management product set, and as such needed to be integrated into the firms’ broad investment platforms.

In fact, several CEOs say their firms are adopting the hedge fund advisory model. Specialty consultants like Cliffwater play an important role in the alternatives market as many pension funds lack in-house expertise. In particular, “public funds have so much staff turnover that there is very little institutional knowledge,” says one CEO. This lack of internal experience creates significant opportunities for providers of hedge fund advisory services — be they consultants or the managers themselves. To capitalize on these opportunities, many of the firms participating in the Roundtable are building out fund-of-fund platforms into more comprehensive advisory businesses. Managers are maintaining sophisticated, real-time fund databases and, operating much like consultants, are building clients’ customized portfolios with real transparency to the manager level. The CEO of one large, integrated manager says his firm’s clients often start off with large portfolios of directly sourced single-manager funds. His team “comes in, breaks down the portfolio, keeps the good, eliminates the bad, and manages the portfolio.”

CEOs of firms operating under a multi-boutique model have less opportunity to marshal their capabilities into a single, comprehensive advisory offering. As a result, they are looking to distribution platforms and other strengths as drivers of their alternatives strategies. Such CEOs agree that a key driver of future growth for the industry will be “liquid alternatives,” or the packaging of alternative strategies for non-institutional markets. The distinction between long-only and alternatives is blurring — even in non-institutional channels — says one CEO, because “investors don’t distinguish between alternatives and long-only; they just want an income stream they can retire on.” That helps explain the growth of products like the so-called 40 Act funds in the United States and some UCITS in Europe and around the world. In the European Union the UCITS that fall under the “liquid alternatives” category fully use the expanded investment powers provided for under the UCITS III directive.

Many of the firms participating in the Roundtable are building out fund-of-fund platforms into more comprehensive advisory businesses.

Global Expansion Will Drive Growth

The CEOs differ when it comes to the U.S. defined benefit market. Smaller firms and LDI specialists believe they can grow their business in this traditional space, but even they recognize the market will shrink over the long term. All the CEOs, however, see international markets as critical to future growth.

The CEOs agreed that firms assessing global expansion should ask themselves: 1) Where should I compete, and 2) What is the smallest level of resources I can put on the ground in those markets and still compete?

In the chart on the following page, Greenwich Associates depicts asset management firms’ evolution as they expand...
their businesses across domestic borders. Greenwich Associates consultant Marc Haynes notes that the chart reveals one seemingly counterintuitive theme: As you move from left to right along the development path, product offerings — and the businesses that support them — actually become less global and more local in nature.

The CEOs identified lack of focus and incrementalism as pitfalls in a firm’s global expansion efforts. Marc Haynes says that “rifle-shot” strategies focused narrowly at a specific country, region or channel traditionally have been more successful than “shotgun-style approaches.” More successful still are strategies that focus even further, for example, on a specific channel or a specific set of clients within a given country.

The CEO of one large bank-owned firm says when it comes to something as expensive and risky as global expansion, companies tend to move into new areas incrementally to minimize costs. That can be a mistake. The same CEO notes that success in any market today requires not only investment prowess and the right products, but also substantial investments in IT and client service. As the CEO of another bank-owned firm says, “It’s easy to plant a lot of flags and see what pans out, but you have to be all in to truly succeed.”

Another CEO, who says his firm follows a tightly focused strategy targeting specific channels within country markets, says that the only way to marshal the resources and attention needed to succeed in a new market is to strictly prioritize. “You have to match growth opportunities to your investment strategies, and then decide ‘let’s not do some other things,’” he says.

Investment Operations: Centralized or Local?
The CEO of an integrated, multi-asset-class manager says his firm debated long and hard about whether to keep all investment operations centralized in its headquarters or to diversify globally. Today, he describes the choice to globalize the investment platform as one of the best decisions the firm has made.

Putting investment teams in foreign offices transfers firm culture, creates strong relationships between the local office and headquarters and establishes a culture of top-quality client service within the new market. The CEOs agree, however, that firms must first be careful not to dilute the function by spreading it too thinly around the world. Also, they must be willing to invest the resources required to make geographic diversification work. Robust IT systems that facilitate communication and collaboration are critical to success. Firms must deploy established senior executives as culture carriers, as opposed to younger and more junior professionals who might be more eager to live abroad and considered more “expendable” at the home office. “Don’t send people, send the right people,” one CEO says.

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Global Focus: Sovereign Wealth Funds
When asset managers assess foreign markets they turn eventually to sovereign wealth funds (SWFs) without recognizing the accompanying demands. The CEOs spent much time discussing the “intellectual capital transfers” demanded by SWFs in return for their assets. Several CEOs say they are consistently surprised by the number of days of staff training SWFs include in every contractual agreement. These requirements impose real demands on managers’ resources and time — especially since some of the trainees sent to Western firms speak less-than-fluent English. The contractual demands also force managers to wrestle with questions of compliance and confidentiality since trainees want to sit on the desk alongside the managers’ investment and trading staff.

Advisory Services Are Altering Client Relationships
Since the inception of the Greenwich Associates CEO Roundtable in 2009, every year has included a discussion about asset management firms’ efforts to transform themselves from manufacturers of individual investment products into trusted advisors and providers of solutions to institutions’ clients. In past years, this discussion was mostly aspirational. While CEOs of some of the largest asset management firms described the challenges they faced building and gaining traction with relatively new “solutions groups,” executives from smaller firms wondered how these initiatives would ever pay for themselves in practical terms.

“I tell the solutions team that their top three priorities are: fiduciary, fiduciary and fiduciary,” says the CEO of one integrated provider. “I don’t want to hear that they’ve made any decision based on pressure from internal teams.”

This year it became apparent that the industry has made significant strides in defining what it means to be a solutions provider and in building an operational infrastructure to incorporate the advisory mentality into the sales process and overall business model. The concept is simple: Asset management firms want to strengthen their relationships with clients in order to better retain existing business and to sell additional products and services.

A growing share of industry assets and revenues are coming from clients with whom managers maintain multi-product relationships. In the United States, about 21% of relationships between institutional investors and asset managers cover more than one product. Multi-product relationships now account for approximately 36% of institutional assets under management and 34% of revenues in the institutional space.

Greenwich Associates consultant Goran Hagegard says asset managers are experimenting with a variety of methods designed to form deep, multi-product relationships by creating value for clients “through both investment and non-investment alpha.” They are offering a mix of products and services ranging from individual investment products and asset allocation products, to customized solutions such as comprehensive LDI strategies and, ultimately, to discretionary outsourcing.

The CEO of one large bank-owned management firm says the basic function of solutions groups is to act as “translators of client needs into the firm’s products and strategies.” As such, his firm and many of the firms represented in the Roundtable have structured their solutions teams as product agnostic, reporting to the CEO and the CIO. Indeed, several of the executives stressed the need for advisory groups to operate like investment consultants — independent from the investment teams and providing completely objective advice to clients.

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There is no standard template for an advisory business model. Integrated, multi-asset-class managers are deploying solutions groups to advise clients on all aspects
of their investment portfolios and fund management functions. Multi-boutique firms and single-product specialists are looking to target specific products or families of products. For example, a growth equity manager will advise clients on relative opportunities across large-cap, mid-cap and small-cap growth.

Regardless of model, however, all managements must change their mindsets from those of product manufacturers to solutions providers. The chart on this page illustrates the process through which asset management firms should assess and develop a solutions-based strategy. One CEO points out that, at some point, firms often reach an inflection point in this process. They can try to “play the solutions” game and grow, he says, or they can stay at their current size — or even shrink — to be “true product players.” At the opposite end of the spectrum, some large, integrated asset management firms are competing for outsourced chief investment officer (OCIO) mandates in which they assume discretionary control and, usually, fiduciary responsibility for part or all of a client’s investment portfolio.

### Investment Consultants: Conflicts and Cooperation

As in past years’ discussions, the CEOs acknowledged that the development of advisory capabilities set the stage for conflicts with consultants. In some ways, however, those conflicts are precisely the point. “You cannot let consultants own the clients,” says the CEO of a fully integrated management firm. “Those days are over. We have every right to sit at the table alongside the consultants.”

The CEO of a large bank-owned manager agrees that the nature of client relationships has changed significantly over the past five years as investment managers built and refined their advisory capabilities and sought to move past their previous role of product sellers. “Consultants don’t control access anymore,” he says. “We have direct relationships with the clients and we work with the consultants.” In fact, the CEO says it is common for consultants to come to conduct due diligence on orders from a client.

### Industry Changes Are Raising the Bar for Client-Facing Talent

Two important trends dominated the CEOs’ discussion about managing talent: the changing requirements for client-facing professionals and the perpetual question of how best to compensate investment teams.

The CEOs spoke at length about the dramatic changes in client-facing functions and in the skill sets required. “It’s no longer even a sales role; it’s client advisory,” says one CEO. Another CEO adds that while institutional sales professionals could get by on their personalities in the past, today all client-facing investment management professionals require “four pillars”:

1. Capital markets expertise;
2. Understanding of client structure, including actuary and other pension issues;
3. Expertise in the broad universe of financial products and solutions available to institutions;
4. Deep knowledge of the internal menu of the firm’s investment products.
This change in requirements has corresponded with upheavals in the financial services industry that have allowed asset management firms to recruit talent from non-traditional backgrounds and sources. Since the banking crisis, many firms have been hiring from the investment-banking industry, capital markets and even actuarial services. People with an investment banking background “are much more used to dealing with broad, multi-competency relationships,” the CEO says.

One CEO gave a compelling example of how these changes are playing out in practice. His fully integrated firm is moving away from the traditional relationship manager model and adding investment experts who have a firm understanding of client needs but do not manage money. This new coverage model should provide clients with exceptionally high-value service and can deliver two potential benefits: 1) It can strengthen client relationships by providing institutions with expertise and ideas; 2) The deployment of professionals with deep investment experience as part of client service teams can limit the demands on the firm’s investment talent.

On how best to manage investment talent, several of the CEOs cited autonomy. In fact, three of the CEOs mentioned giving autonomy to their investment teams as their best recent decisions. As Greenwich Associates consultant Kurt Schoknecht notes, the challenge is how to provide that autonomy while also growing the business and keeping a firm hand on risk.

Compensation structures are at the heart of that challenge. “If you compensate strictly on investment performance you will end up with bad results,” says the CEO of a large multi-boutique manager, because the investment teams will work on products and strategies that work best for themselves, not for clients. For that reason, he says, compensation based on the income statement is a better model. The CEO of one bank-owned firm notes that incentives based on P&L have their own drawbacks: “When assets aren’t flowing, portfolio managers get distracted by sales and distribution.” One CEO says his firm starts out by using consultants to benchmark industry compensation norms for “small teams not yet up to scale” and then switching to a revenue-based model as the product achieves more success. Several CEOs agree that the best model of deferred compensation for investment teams is investment in the fund itself. “Clients like it, and so do the portfolio managers,” says one executive. Most of the CEOs seem to rely on a blend of investment and P&L incentives for investment team compensation.

The firms take a similar approach to compensation on the distribution side. Several of the CEOs say their firms are moving away from compensation structures dominated by flow-based commissions. Instead, they are emphasizing larger discretionary awards and bonuses based on the performance of the broader unit or firm overall. “The goal is to make it more of a team effort with longer duration relationships,” says one Roundtable participant.

The CEOs also stress the need to balance autonomy and risk control. Kurt Schoknecht defines talent management in the asset management industry as the art of encouraging talented performers to be entrepreneurial, while still keeping control of risk. The goal is to allow a high degree of autonomy in investing, while also instilling accountability, one CEO says. “Trust, but verify.”

Overall, the CEOs agree that the traditional relationship between asset management compensation and pay levels in capital markets, sales and trading has reversed itself, and that buy-side professionals are now out-earning their sell-side counterparts. In general, compensation levels are on the rise.

**New Regulations Can Pose Unintended Consequences**

Sweeping changes in regulation are affecting nearly every aspect of the investment management industry, “from products, services and operational processes to business models and cost structures,” says Greenwich Associates consultant Lydia Vitalis. And the CEOs were pessimistic about regulation. In virtually every business line and geographic area, the CEOs complained about the high levels of uncertainty associated with a regulatory process that is ongoing and opaque. The rules are being “written too quickly,” by “too many different regulatory bodies,” with “no reconciliation” among different regulators within individual countries and among different countries and regions, the executives say. “As [legislators] wrote the nearly 900 pages of Dodd-Frank it got sloppier and sloppier by the page, and asset management comes near the end,” says one CEO.

Regulators could actually create new and bigger problems for global markets, the executives say. Several of the CEOs feared a new liquidity crunch could be triggered by a mandated change to floating NAV for money market funds. One CEO says that a proposed bonus cap on UCITS providers that began as a “ploy” in political bargaining in Germany but somehow gained traction could seriously impact the industry in Europe.
“It’s not that existing players will leave London or Zurich,” he says, “but talent that would have otherwise come to Europe will instead go to New York and other markets. It will be a natural attrition.” Another CEO notes that the spate of rules is creating new barriers of entry. In the 1990s, he says, it was relatively easy to start a hedge fund. With new rules making it much more expensive and complicated, assets are flowing to large, established hedge funds with the resources to absorb new compliance demands.

The executives agree that asset managers have missed opportunities to put the rule-making process on a better course in large part because the industry is more fragmented than the banking industry and is less effective at consolidating its clout through industry organizations. “The industry needs to be more cooperative and work in partnership to be more constructive,” says one CEO.

Several of the CEOs agree that the best way for asset managers to have a positive impact on the regulatory process is to band together in an attempt to educate regulators. “We have to move beyond lobbying,” says one CEO. “The best approach is engagement through education.” That education would consist in large part of managers explaining to regulators the potential consequences of their decisions. “Turnover among regulators is a huge problem, especially in Europe,” notes one CEO. As a result, he says, incoming regulatory staff are often much more open than one might expect to advice from the industry. “They are desperate for intelligence, but they have to be able to access that intelligence in such a way that they don’t seem captive.”

Conclusion

During the course of the conversation, the CEOs participating in the 2013 Greenwich Associates CEO Roundtable agreed that the one factor distinguishing the asset management firms that have struggled since the start of the global financial crisis from those that have emerged as industry leaders is the ability to listen to clients and respond to changes in their needs. Many firms that remain committed to the traditional core equity and fixed-income strategies that had sustained them in the past will continue to struggle as their clients’ preferences shift to specialty products. At the other end of the spectrum, firms that have managed to evolve with changing markets and client preferences have established “non-commoditized” relationships with their clients. Because these managers were able to provide real value through some combination of specialty products, advisory services or other offerings, they have retained and expanded on existing relationships. As one CEO explains, these firms understand that “leadership is a rented space.”

Consultants Goran Hagglund, Marc Haynes, Andrew McCollum, Kurt Schoknecht, Rodger Smith, and Lydia Vitalis provide advisory services to asset managers in the U.S. and globally.