

Asset Management – an Industry at a Crossroad

by Peter Koenig

Assets under Management for the US mutual fund industry shrunk by 6% between the peak in 2000 and 2002, and by 9% for European UCITS funds. More important, during that period high margin equity fund assets decreased by 30% in the US, and by 26% in Europe. According to a recent study by the IBM Institute for Business Value, revenues per Assets under Management have decreased by 13% in 2001 for a group of representative US asset managers, after increases between 4% and 12% in the years before. By and large, this all can be regarded as a reflection of the equity markets bubble and its bursting, which then also put respective pressure on gross revenues in the fund management industry. Beginning in 2001, firms have reacted with cutting costs, where in most cases this was and still is merely a correction of the buildup of excess resources in the boom years of the late 1990s.

So, is it all only cyclical, and the industry will see healthy growth rates in assets and revenues again, once the hangover from the big party has gone away? Or are there also some secular forces at work, like the often-referred sharing out of the market among large firms and small specialist boutiques? Is the noted optimism shown for hedge funds operations part of that trend? And, will large firms simply grow larger, while mid-sized firms will be forced out of the market automatically? To get a better idea of those trends, it may be worthwhile to have another look at some very fundamental characteristics of the asset management industry.

Beginning with Harry Markowitz's work in the 1950s, asset managers have concentrated on the production side of their business. Efficient frontiers calculate optimal portfolios based on risk and return expectations of assets, and over the last years we have seen significant refinements of that approach, leading to the development of very specific product categories and investment styles, benchmarks and the concept of relative risk. Asset management as a relatively young industry – in Europe we can speak of an industry since not more than 10 years – has thereby developed a very wide range of products and services. And, even assuming a positive attitude towards product development and innovation, it would be fair to state that we need to streamline production not only on the back of sluggish demand in recent past. The cost arguments behind that are typically used to explain the trend of asset concentration with large managers.

On the other hand, any economist would come to the conclusion that this is only half the story. It is simply impossible to solve the model and come to a meaningful match of supply and demand without a proper specification of the demand side, which in asset management is given by some sort of investors' utility functions. To implement such a specification in real life is an enormous challenge, since the asset management product is what we call 'intangible'. While most buyers of cars will know from a certain point in their decision making process what size and color and other technical equipment they prefer their car to have, it is much more difficult to find out if an investor in a fund - institutional or retail - prefers more risk or less. And, often times, even the basic definition of risk and return expectations may be ambiguous from the start. While fund managers have adopted a more technical and tactical view, investors are rather coming from the satisfaction of other preferences: matching cash-flows and liabilities in a corporation or a pension fund, or servicing a credit or mortgage payments for a retail investor. Those all do not easily translate into figures of monthly volatility and return, if at all.

Unfortunately, these difficulties so far led the industry to stick to its product focus, and also induced it to react to the exogenous boom in demand with the creation of more products and not really with a profound and deeper penetration of its customer base. They also explain why small boutiques seem not to have such a problem with the required identification of investor preferences. The answer is that they simply don't try from the beginning. After having identified a very basic demand for their product, they concentrate on production only, knowing also quite distinctively what they stand for. The simplicity implied in that approach is what makes those small firms very effective in a market for intangible products, and at the same time makes them attractive for people with specialist expertise on the production side. The downside is the business risk they face in the medium term: Client preferences change over time, as do capital market structures, and a well-specified product may thus fall out of favor after a few years of success. That is the natural tradeoff between being very specialized and being diversified.

Large firms, however, have to try hard to deal with the identification of their many clients' demands. In today's individualistic world, we cannot realistically assume that clients or investors will still accept Henry Ford's view from the 1920s about the color of his cars. The only way a large firm can satisfy the different needs of many clients is by offering many different products and variations thereof. In addition, service levels and comfort of clients add more dimensions to the traditional risk/return view. Strategies aimed at the creation of so-called 'global products' for all types of clients, also internationally, will run the risk associated with the strong product focus of the past and the resulting lack of respect for clients needs. Even if a product is superior in a narrow production side definition, it will require customization to local client preferences. After all, cars designed for the US market are different from those designed for Europe, where we can even find different make-ups country by country.

But because customization is costly, rationalization must come in somewhere. The introduction of intelligent platform techniques as they exist today in other more developed industries like automobiles can be regarded as the biggest challenge, in particular in mid-sized to large firms (small firms, though, may be faced with the same issues once they start co-operating with other small firms in order to diversify their business risks). The quality of those platforms will then ultimately determine the level of penetration on the demand side. When designing their platforms, large firms will have to invest heavily into gaining more insights from their many different clients, which simply is a reflection of their costs for being large. How shall we go about building these platforms? As a study by Sector Analysis recently concluded, very well-managed firms ask their clients to find out their clients' needs, and well-managed firms ask their client relationship managers.

The IBM study showed an average Return on Equity for Asset Managers of 28% for the period 1993 to 2001, compared to 16% for Securities Firms, or 12% for National Commercial Banks. For the future, secular trends in the economy promise increased demand for skills in managing financial assets long-term, in particular the overdue build-up of pensions capital in most industrialized countries. This all should make asset management a very attractive business, also for large banks and insurance companies as owners of an asset management division. But in the years to come, we can expect challenges of higher importance than the ones imposed by the current cyclical downturn. The picture looks pretty clear for small firms, but large firms will not simply prosper because they are large. The reference to numbers of Assets under Management may thus be misleading, and should not throw mid-sized firms into desperation. As in any other industry, to distinguish between well-managed firms and others may be the relevant benchmark for success, no matter what their size is.