Pursuing profitability: securing the future

An analysis of financial and operational performance within the fund management industry
During the market downturn of the past 2-3 years, following a decade of sustained expansion, asset managers were forced to take urgent steps. Most resorted to the softest of cost saving targets, postponing or curtailing discretionary spend and trimming headcount; highly effective for short term profit management. But few did anything significant to address their underlying operational model.

With signs of market recovery, fund managers are now beginning to take the opportunity to reassess their business strategies and operating models. Increasingly, they are reconsidering and reconstructing their business profile and value chain. The largest global asset managers, often part of wider financial services groups, are transferring operational and support functions into group enterprise functions or external service providers in search of economies of scale. And the service providers are accelerating their product and service development. In short, the industry is starting to invest again in its own future.

The advent of de-polarisation is spurring the major distributors into a second attempt to capture the elusive wealth market. Asset managers meanwhile are establishing strategic alliances and partnerships with the distributors for the benefit of both organisations and the end investor.

It is early days in a new stage of the evolution of the industry. As the purses are reopened, the key must be to remember the lessons of the recent past. Fund managers’ costs rose by 90% in four years between 1995 and 1999, that’s 65% above inflation! And hundreds of millions were invested in ambitious wealth offerings over the same period without clear, compelling customer propositions. The market growth dividend was frittered away. Easy come, easy go.

Thankfully, past performance is no guarantee of future performance.
A year of stability – the calm after the storm?

It is pleasing to report that the industry enjoyed steady profits in 2003, with margin on revenue holding at around 24%, consolidating the recovery of 2002. Even in bad years, fund managers can still make money.

This has been achieved through effective short term management of both income and costs. Revenue on funds under management, the best indicator of overall pricing, strengthened slightly to remain over 24.6 basis points (i.e. the industry generates just over £2,460 income from every £1 million of assets it manages). This despite increased competitive pressure and a transition from higher priced equity business towards more fixed income products. Positive steps have been a continuing trend of desegregation away from balanced mandates to smaller, more specialist mandates, and successful introduction of higher geared products with performance based fees (and high performance!).

Unit costs also maintained approximate parity with 2002 at 18.7 basis points, remaining lower than in 2001. Although outsourcing is on the increase, staff costs continue to account for well over half of costs for most players. As a result, cost management depends primarily on managing the activities, productivity and remuneration of people. The story here is mixed. While headcount fell by 3%, average remuneration rose by 9% on the previous year, indicating a partial recovery of bonus levels.

In absolute terms, costs edged up by 0.7% against a similar marginal growth in assets. The asset growth was driven by modest net new monies of 3% (4% in 2002) being slightly greater than an approximate 2% fall in the market values. The market fall would have been greater but for a continued significant shift from equities to other assets, most notably bonds (driven especially by revised asset allocation among the larger life funds). Equities represented just below 47% of assets in the survey during 2003 compared with 61% in 2000; the flow of hundreds of £billions between asset types has led to significant operational and staffing realignment in front, middle and back offices across the industry.
Retail strengthens while institutional business weakens

Inspection of differential performance of different product types reveals that retail business had a more impressive year than institutional and was responsible for holding up margins overall. While individual collective funds represent only 12% of asset values, they generate 43% of revenue, similar to the traditional core ‘institutional segregated’, so they are influential above their apparent weight in the industry.

2003 saw margin on revenue for retail business increasing from 25% to 27%, thereby extending its lead over institutional business where margin slipped from 22.5% to 21%. Total revenue on funds under management is up five basis points to 103, against an increase in costs of just two basis points to 75. Net new monies fell back to 5% of funds under management.

The upward trend in portfolio management fees evidenced last year has accelerated. The rise in these management fees without a corresponding rise in total revenue together with the fall in net new monies points to:

- *The lower volume of new business is being directed towards high alpha funds as the more sophisticated investor continues to invest*
- *Ongoing pressure from individuals and distributors for a greater share of the front end load.*

Apparent within the broad reaches of institutional business is the very different characteristics of segregated and collective funds which deliver 16% and 37.5% margin respectively. Many fund managers have been working to persuade clients with sub-scale accounts to sign up to pooled arrangements; this should be a win-win move as fees are lower for the client and profits are greater for the manager thanks to the greater administrative efficiency. Segregated mandates now account for just 76% of the institutional sector against 82% a year ago. Ironically, this has had a negative impact on margins in the short term, as the cost savings take longer to kick in than the revenue switch (segregated pricing has fallen by a basis point from 16 to 15).
A new imperative for change

While management reaction to tougher conditions has been commendable in protecting immediate margins, it has been largely tactical and unsustainable. Most have curtailed spending on marketing and recruitment, and deferred investment projects, but few have progressed more sustainable improvements, even relatively straightforward changes such as rationalising product ranges. It is the more fundamental and structural improvements which are now required, to secure the industry’s future health. To date, there has been no imperative to act; the order book is long and reliable, and it has been relatively easy to prosper without taking the tough steps. But the imperative may now be on its way.

The pace of change is being set by investors and their advisors. Most notable is a trend towards value for money and transparency. The last decade has seen a gradual transition away from active towards passive mandates, commanding much lower management fees, driven by dissatisfaction in paying ever increasing fees for what was perceived as a commodity service. More recently, we have seen a big increase in the take up and marketing of hedge funds and other alternative products with higher risk profiles and much greater fee rates. Clients are increasingly signing up to performance based fee arrangements (5% of mandates are currently under such arrangements, three times the penetration 2 years ago). All part of a trend away from large, composite, balanced mandates towards more granular, specialist arrangements.

But why stop here? If you are reluctant to pay an active fee for passive management, why pay any management fee for that proportion of large portfolios which doesn’t move at all in the medium term? Perhaps we will see the emergence of a new ‘static’ management style where the investor pays the manager nothing more than a basic administrative handling fee. And a continued expansion of higher alpha products at the other end of the spectrum.

Figure 5: Increased penetration of performance fees

<table>
<thead>
<tr>
<th>Year</th>
<th>Percentage of mandates with performance-related fees</th>
</tr>
</thead>
<tbody>
<tr>
<td>2003</td>
<td>1%</td>
</tr>
<tr>
<td>2001</td>
<td>2%</td>
</tr>
<tr>
<td>2002</td>
<td>3%</td>
</tr>
<tr>
<td>2003</td>
<td>5%</td>
</tr>
</tbody>
</table>

Figure 6: Assets by management style – where next?

<table>
<thead>
<tr>
<th>Year</th>
<th>Hyperactive</th>
<th>Active</th>
<th>Passive</th>
<th>Static</th>
</tr>
</thead>
<tbody>
<tr>
<td>1993</td>
<td>20%</td>
<td>35%</td>
<td>40%</td>
<td>25%</td>
</tr>
<tr>
<td>2003</td>
<td>20%</td>
<td>35%</td>
<td>40%</td>
<td>25%</td>
</tr>
<tr>
<td>2013</td>
<td>20%</td>
<td>35%</td>
<td>40%</td>
<td>25%</td>
</tr>
</tbody>
</table>
If the industry continues to listen to its clients, this momentum will be maintained. But how far will it go, and how quickly? Predicting the eventual proportions of assets which will be managed under each style, and the typical fees that each will command (ignoring the differences for different asset types) is a matter for crystal balls. A number of scenarios can be foreseen. All share some common implications for revenue:

- **Overall income is reduced, perhaps by as much as 25%, especially from traditional core products**
- **The income which remains is subject to much greater uncertainty, with perhaps upwards of 40% of budgeted revenue being dependent on performance and hence at risk**
- **The unbundling of the balanced mandate will reduce switching barriers for the component portfolios, allowing clients to re-tender more frequently, challenging further the annuity revenue streams currently enjoyed by the industry.**

Uncertain revenue breeds lean, responsive industries, and both responses will be essential for fund managers:

- **Lean** – making money from the larger scale core products of static, passive and basic active business will require genuine scale economy and productivity as a basic entry level requirement
- **Responsive** – with large proportions of income at risk, operations will have to be viable without it, leading to far more flexibility to respond to fluctuations in demand.

So there is a need to combine scale economies with flexibility and agility. A number of managers have already begun to look at various market and performance scenarios and the impact these may have.

Operational functions are being re-configured to deliver cost effective service on a demand basis, ensuring scale economies are pursued across geographies and within the wider enterprise. Where scale and demand based efficiencies cannot be sourced internally the managers are turning to external providers. Outsourcing costs as a percentage of total costs are growing, but it remains very early outside custody and transfer agency operations, and still accounts for less than 10% of overall costs.

Moving to a demand-based model typically requires the manager to move away from the traditional vertical model that often replicates in different parts of the business (eg. by asset class or major client segment) and locations. A flexible model looks horizontally across the organisation and groups like functions (eg. position keeping or trade confirmations) together thus allowing these to be optimised and shared across the enterprise. Economies flow from shared infrastructure costs, a reduction in the number of applications supporting like processes, and the ability to achieve scale internally and hence manage local peaks and troughs in daily demand. The resulting simplified operating model can also reduce the development lifecycle, allowing the business greater agility to respond to market developments.
Progress

Of course, these concepts are not new. What is new is that with renewed business confidence and an eye to the future they are being put into practice, and fund managers are starting to address some of the practical barriers.

One challenge is the integration of varied businesses within a single model. Many vertical constructs exist because of legitimate differences in how the various businesses and regions are obliged to operate due to regulatory constraints or client demands. Overcoming this requires an understanding of the components making up each element of the operation. For example, the fund accounting requirements of segregated institutional and individual collective businesses are significantly different. However, both share a need for an accounting engine to accurately record position and event data. De-composing the operation will require an organisation to distinguish between:

- Global functions commonly applied across the business (eg. trade support)
- Centralised functions processed in one place on behalf of all locations (eg. data management)
- Local functions peculiar to individual businesses or markets (eg. client management)
- Local adaptation or enrichment of a centralised function (eg. client reporting).

A second challenge is the tendency towards product proliferation and complexity. Many new business development strategies are centred on multi-channel distribution, multi-manager products and alternative product manufacturing. These bring more complexity rather than less, demanding sophisticated operating models to optimise the scale economy and agility.

The changes described will, over time, have a fundamental impact on the asset manager. Operational staff will be required to partner with external organisations previously viewed as competitors, and will be required to move from a ‘doing’ mentality to a ‘managing’ capability. The manager’s IT architecture is likely to be significantly altered. Given the timescales required to deliver major systems change, this will not happen overnight. But defining an architecture that supports the business objectives and developing a route map towards this architecture is key.
Know your distributor
Prompted by de-polarisation and renewed business confidence, the wider industry is preparing its second foray into the wealth space. The ‘mass wealthy’ continues to be an appealing segment, not least because the impact of the bursting of the dot com bubble appears to have created awareness amongst this segment of the increasing need for self provision.

Manufacturers and distributors alike are challenged by:

- The government’s desire to produce a ‘joined up’ market that works for the benefit of the consumer
- The changing nature of the consumer life-stages
- The high cost associated with providing advice to this market
- Consumers’ severe lack of confidence in existing propositions.

In this market, a winning proposition will be focused on well defined segments, and is likely to combine multi-product options and advice. To make the point, it will not be an un-differentiated, product based sale. The product suite will need to address the relevant customer segment’s lifestyle needs over time, and be intelligently priced.

Few will be able to deliver this on their own. Manufacturers with aspiration to exploit this market have little choice but to partner with the larger distributors, who have the scale and resource to deliver a ‘joined up’ offering to the end consumer. The skill will be in selecting the right partnerships to invest in, and managing relationships to ensure that the two parties’ contributions are complementary, consistent and aligned.

Crucially, this is not just an additional distribution channel for a fund manager’s shelf product, but an opportunity to work together to integrate investment products within the distributor’s wider proposition – a partnership in the fullest sense. Manufacturers seeking selection will be obliged to demonstrate an ability to be responsive to the distributor as well as the end customer; a shift from Customer Relationship Management to Distributor Relationship Management.

A winning partnership

<table>
<thead>
<tr>
<th>Distributor</th>
<th>Fund manager</th>
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<tbody>
<tr>
<td>Clear and compelling customer proposition</td>
<td>Distributor relationship management</td>
</tr>
<tr>
<td>Joined-up sales and service delivery</td>
<td>Clarity of role in the distributor’s proposition</td>
</tr>
<tr>
<td>Competent and motivated people with the appropriate sales and advice training</td>
<td>Clarity of own multi-channel proposition</td>
</tr>
<tr>
<td>Organisational alignment behind the proposition</td>
<td>Organisational alignment behind the distributor’s proposition</td>
</tr>
<tr>
<td>A flexible operating model</td>
<td>Advisor support</td>
</tr>
<tr>
<td>Own brand</td>
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</table>
The manufacturer may be required to service the end customer using the distributor’s preferred modus operandi, and will be required to demonstrate a good understanding of the role their products need to fulfil within the overall proposition. The partnership will be strengthened if the manufacturer can equip the distributor’s sales teams with the necessary technical and advisory skills to allow them to appropriately market and match their product within the proposition and to the individual customer. The distributor will continue to require the manufacturer to invest in his own brand thus ensuring the distributor benefits from push and pull marketing efforts.

The evolving need for financial advice will continue to further separate the roles of manufacturers and distributors. Manufacturers have rarely been positioned to source advice to customers, and this will continue. High quality advisor services may extend the lifetime value of retail investors. The successful will embrace the concept of partnership, choosing their partners carefully in the knowledge that success will be achieved jointly.

**In conclusion**

With renewed business confidence, the industry is again investing with the aim of meeting client demands in a cost effective and agile manner. It is encouraging that the investment we are witnessing is being measured against its ability to combat the industry’s more fundamental issues. There’s only one thing more painful than learning from experience, and that is not learning from experience.
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Survey profile
This is the sixteenth annual IBM Investment Management Survey, covering a representative sample of the investment management industry in the UK and Ireland.

This year’s survey is based on returns made by 17 respondents, who together manage approximately £831 billion of assets with combined revenues of £2,055 million, costs of £1,561 million, and employing 10,039 staff. Participation in the survey is restricted to organisations with a value of funds under management greater than £5 billion.

Survey participants
AEGON Asset Management
AIB Investment Managers Limited
Bank of Ireland Asset Management
Baring Asset Management
Britannic Asset Management Limited
Credit Suisse Asset Management
F&C
Henderson Global Investors
Hermes Pensions Management Limited
INVESCO UK Ltd
Irish Life Investment Managers Ltd
ISIS Asset Management plc
J.P. Morgan Fleming Asset Management
Legal & General Investment Management (Holdings) Ltd
M&G Group
Morley Fund Management
Threadneedle Asset Management

We would like to thank all the organisations that participated in the survey for their time and effort in completing the detailed questionnaire.
Profile of survey participants

Funds under management, 2003

Revenue, 2003

Margin on revenue and markets

Cost by activity for each product category

Revenue, cost and margin on funds under management (FUM)

Product net new business
Contact us

This document contains a brief summary of the findings and can also be found on our Web site at:

ibm.com/services/uk/industries/financemarkets.html

Further surveys on themes affecting the investment management industry are planned through the coming year.

For further information on this survey or our wider services for the investment industry, please contact:

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