KPMG

create

Raising the performance bar:
challenges facing global investment management in the 2000s

FINANCIAL SERVICES

by Professor Amin Rajan and
Barbara Martin, CREATE;
and David Ledster and Neil Fatharly,
KPMG LLP (UK)

AUDIT ▪ TAX ▪ ADVISORY

Acknowledgements

This is the third in a series of research reports produced jointly by the think-tank CREATE and KPMG International.

The first two reports focused on how investment managers around the globe were coping with the worst bear market in living memory.

This one aims to identify the means by which they are raising the performance bar in a low nominal return environment.

Our foremost thanks go to some 300 investment managers in 29 countries in all the key regions who have participated in our survey. Collectively, they manage assets worth over 25 trillion euros.

We would also like to offer our special thanks to those 70 CEOs, CIOs, and Board Directors who participated in our post-survey structured interviews. Their insights and foresights have helped us to produce a most comprehensive picture of the global investment industry as it enters a radically different environment.

We would also like to thank our colleagues around the world who have helped us in carrying out this research. In particular, Jenny Latham and Liz Pratt at CREATE; and Tom Brown, Andrew Clinton and Melanie Hutchings from KPMG LLP (UK) and Al Fichera and Dave Seymour from KPMG LLP (US).

Professor Amin Rajan
CEO
CREATE

David Ledster
KPMG LLP (UK)
Global Head
KPMG Investment Management and Funds

The anonymous quotes highlighted in this document were obtained during the face-to-face interview stage of the research project.

Contents

1 Executive summary

“The person who moved a mountain started by taking away the small stones”

Chinese Proverb

What are the aims of this report?

Our 2003 report showed that only a minority of investment managers around the world had expected the recent bear market to prevail beyond 2002. As a result, substantive corrective actions to arrest a headlong decline in profitability were deemed unnecessary by many.

Further market routs in February 2003, however, unleashed a wave of actions: some aimed to cut costs immediately, some to boost the top line in the medium term.

Accordingly, this report aims to identify:

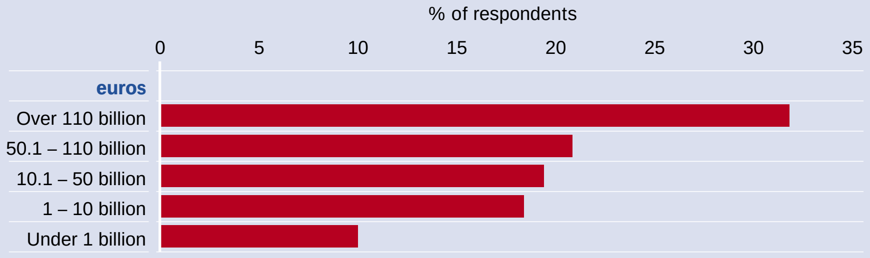
- the nature and scale of these changes
- the extent to which they are reshaping the contours of the industry
- their impact so far on profitability
- specific areas where progress is vital if a vibrant industry is to emerge from the traumas of the last four years.

This report has a highly credible base in terms of breadth and depth. Some 300 investment managers in 29 countries in all the key regions have participated in our survey – including around 90 of the top 100 firms. Together, they manage assets worth over 25 trillion euros as at 31 March 2004 (Figure 1.1).

Some 70 CEOs, CIOs and senior directors have also participated in the follow-up structured interviews, providing fresh insights and foresights.

Figure 1.1 Survey participants by geography and size of assets under management

Australia	Hong Kong	Oman
Austria	Hungary	Poland
Bahrain	India	Portugal
Belgium	Ireland	South Africa
Brazil	Italy	Spain
Canada	Japan	Sweden
Denmark	Latvia	Switzerland
Finland	Luxembourg	UK
France	Netherlands	US
Germany	Norway	



Source: CREATE and KPMG International, 2004

What has happened to profitability?

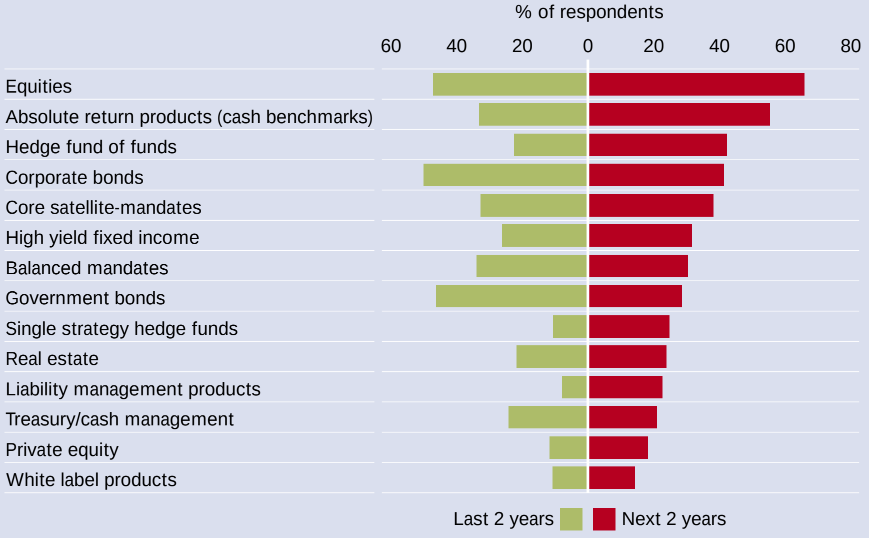
After nosediving between 2000-02, profitability has recovered in the past 12 months, aided and abetted by three factors.

First, there has been significant cost cutting, borne by staff in front and back offices alike: the average cuts have been 20 percent in the US, 18 percent in Europe and 12 percent in Asia Pacific. The lower rate in the latter region reflects major downsizing which occurred earlier due to a prolonged bear market in Japan in the 1990s and the unexpected collapse in the region's emerging markets in 1998.

Second, the strong rally in the global equity markets in the last half of 2003 has also provided a much needed breathing space, without providing any sustainable gains. But, the bulls are nowhere in sight as yet. Even the headlong advances in the emerging markets show signs of fizzling out.

Third, changes in product mix have helped significantly to raise the level of activity: especially the switch to bonds, hedge funds and absolute return products (cash benchmark). They reflect a new form of product blending in order to generate alpha performance, in the wake of huge losses sustained by institutional and retail clients in the bear market. However, according to our survey (Figure 1.2), the appetite for equities is likely to return.

Figure 1.2 Which style and product offering have your clients been attracted to in the last two years, and which will they be in the next two years?



Source: CREATE and KPMG International, 2004

Will these factors be enough to sustain the improvement in profitability?

No.

It is widely accepted that the global investment industry is at an inflection point: the future will be very different from the past.

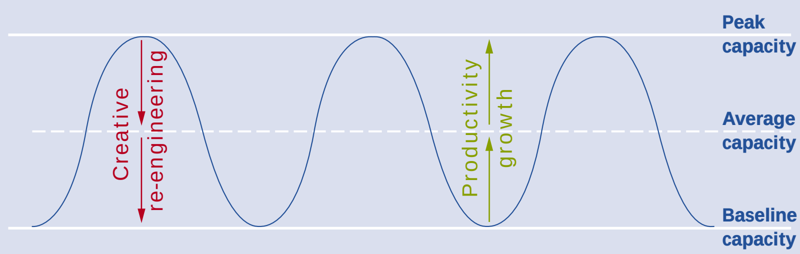
The sheer scale of losses suffered by investors in the last bear market is one reason. The others are mutual fund scandals in the US, pensions mis-selling in the UK and general investor nervousness everywhere. Mounting intrusive legislation is inevitable; as are tight fiduciary disciplines.

The business model that only worked in a bull market is no longer tenable in what now looks like a low nominal return environment for the foreseeable future. At any rate, there is ample recognition that investment management has to be run like a normal business, from peak to trough to peak, as advocated in our last report.

As a result, a number of structural changes have been started by at least one in two investment managers. They aim to grow the top line on the one hand and create a variable cost base on the other. Together, they aim to rationalize the overall people and infrastructure capability of the business to a *base level*, from where any demand growth can be accommodated via productivity improvements, as in the oil industry which is also subject to cyclical extremes.

This 'hard-nosed' approach to productivity aims to take individual businesses, over time, from their peak capacity to base line capacity via some creative re-engineering (Figure 1. 3). However, the tailwind behind it may weaken if the markets recover unexpectedly fast; or get stronger, if markets nosedive again.

Figure 1.3 Aligning business capacity to market cycles: a stylized path



Source: CREATE and KPMG International, 2004

How is this structural change being implemented?

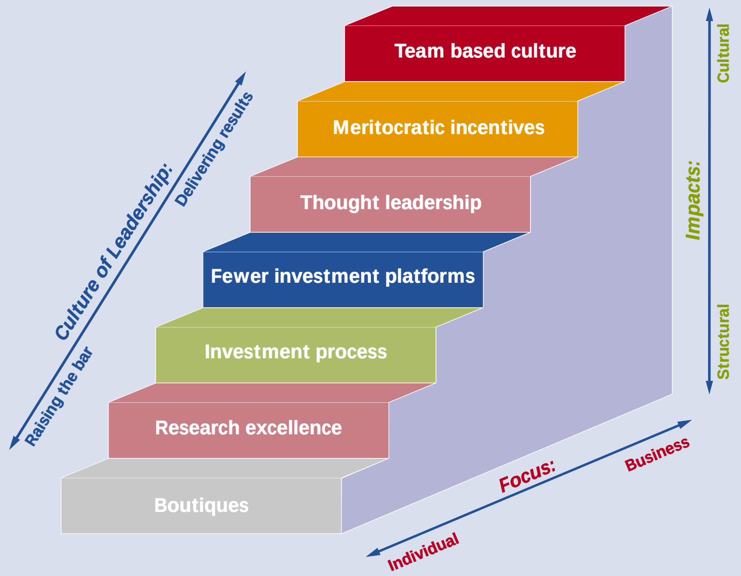
Under the chants of twin mantras: '*product is performance*' and '*customer first*'.

In at least one in three investment houses, the emerging business model – the winning formula – aims to achieve four distinct goals.

First, to regain client trust by proactively identifying and delivering client needs, backed by quality service and business governance that reflect positively against the brand. A new implicit contract is emerging.

Second, to retune the investment engine by initiating improvements in a number of areas that impact on its performance (Figure 1.4). They range from creating new physical structures to changing organizational cultures.

Figure 1.4 Generating consistent performance



Source: CREATE and KPMG International, 2004

Third, to develop a strong investment culture by creating product-based groups organized as a village of boutiques within medium and large houses, in the belief that portfolio managers need to operate in a hassle free environment in which people are pushed to the limits of their thinking; such that ideas breed new ideas, reinforcing their insights and convictions. Such incubators are then integrated into mainstream business through various support activities (Figure 1.5). Boutiques are being created variously through acquisitional, organic and restructuring routes. They aim to emulate the culture now prevailing in some of the most successful partnerships or independent houses in the industry.

Fourth, to reduce overhead costs and turning ever more items into variable costs that are closely linked with the level of activity. Greater clarity in performance metrics for portfolio managers, research analysts and business leaders are an emerging feature of the new arrangement; as is their linkage with bonus awards.

Figure 1.5 A village of boutiques

Source: CREATE and KPMG International, 2004

The central thrust of these changes seeks to re-engineer the business in order to focus on its strong points and do them well. It also reflects the growing recognition that a business model that only works in a bull market is now a recipe for disaster. The emerging model is about growing the top line while containing cost pressures.

So, what are the implications for the value chain?

To start with, it is being fragmented as investment managers increasingly practice the distinction between (Figure 1.6):

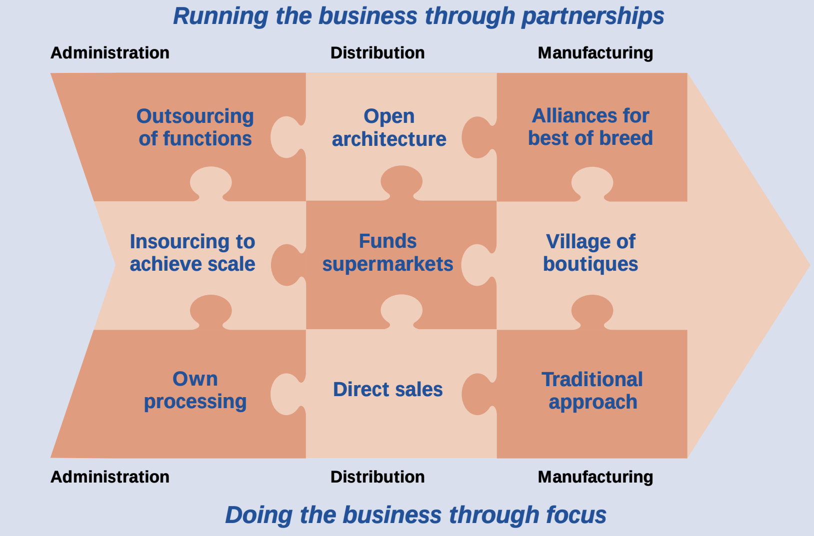
- doing the business by focusing on core competencies
- running the business by forming alliances.

Such alliances are gradually replacing vertical integration within individual firms by horizontal integration between firms through two distinct routes: outsourcing of non-core functions and alliances with best of breed product providers.

The pace of back office outsourcing is still modest in a global context. However, it is likely to take off, if service providers are able to offer the conventional '*prime mover*' upsides and contractual guarantees on operational risks.

Front office outsourcing is in its infancy and currently largely driven by private banks who are focusing on asset allocation and other wealth management services.

Figure 1.6 Horizontal integration: new linkages in the value chain



Source: Create and KPMG International 2004

Open architecture and joint ventures with best of breed producers are being increasingly used in the retail market. Gradually, this is spreading to the institutional market through the sub-advisory route.

Such alliances are one of the routes through which the industry's capacity is being consolidated; but it's not the only one. Four others are being used as well.

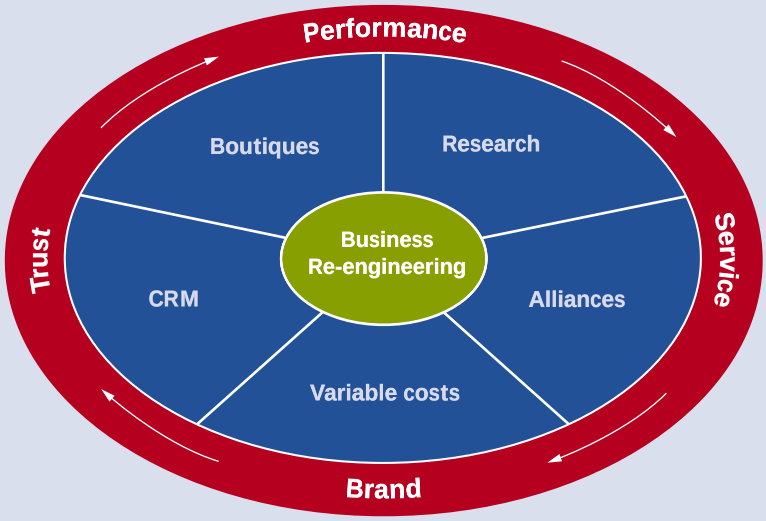
The most important of them is traditional mergers and acquisitions. Notably, their focus has been on the acquisition of skills, rather than scale or market position; thus targeting smaller independent boutiques in preference to medium or large players. The key reason is that the last wave of mergers, originally aimed at building scale, has inadvertently created massive challenges in effective integration because of cultural differences, legacy arrangements and lack of required management bandwidth. Now, economies of scope matter more than scale.

The remaining three routes have involved front office lift-outs, joint ventures and sale of management contracts.

Overall, such horizontal integration seeks to improve profitability by turning the spotlight on four imperatives that are vital to survival in a low return environment (Figure 1.7):
- performance
- service
- brand
- trust

Equally, it is worth emphasizing that the changes described above constitute a 'first stage' rocket; necessary but not sufficient. Their success rests critically on a huge mindset shift.

Figure 1.7 Generating profits through business basics



Source: CREATE and KPMG International, 2004

Why are mindset shifts essential?

The implied shift in the operating model from rigidity to agility requires parallel shifts in business culture from (Figure 1.8):

- paternalism to performance: putting more emphasis on outcomes than inputs; clients rather than self
- entitlement mindset to self employment mindset: putting more emphasis on accountability than position; meritocracy rather than longevity.

Figure 1.8 Changes in the operating model

	1990s	2000s
	Rigidity = flat footed	Agility = fleet of foot
Structure	• Doing everything • Command and control • Vertical integration • Many job grades	• Core competencies • Boutique organization • Horizontal integration • Delayered hierarchy
Dominant requirements	• Weak business management • Weak financial control • Economies of scale	• Strong leadership • Financial accountability • Economies of scope
External relationships	• Limited outsourcing • Local supply chains • Inbred arrogance	• Growing outsourcing • Global supply chains • External alliances
People practices	• Acting like lone rangers • Disconnected business • Blame culture • Input oriented • Job security based on paternalism	• Working in small teams • Joined up business • Individual accountability • Output oriented • Job security based on performance

Source: CREATE and KPMG International, 2004

It amounts to promoting a small company mentality in a large company environment. In this context, progress has been notably slow: such behavioral shifts in people businesses require time, passion and persistence on the part of business leaders. They have yet to be embedded in the cultural fabric of the majority of investment managers. This is because seemingly desirable changes have produced unintended consequences, not least in the area of compensation.

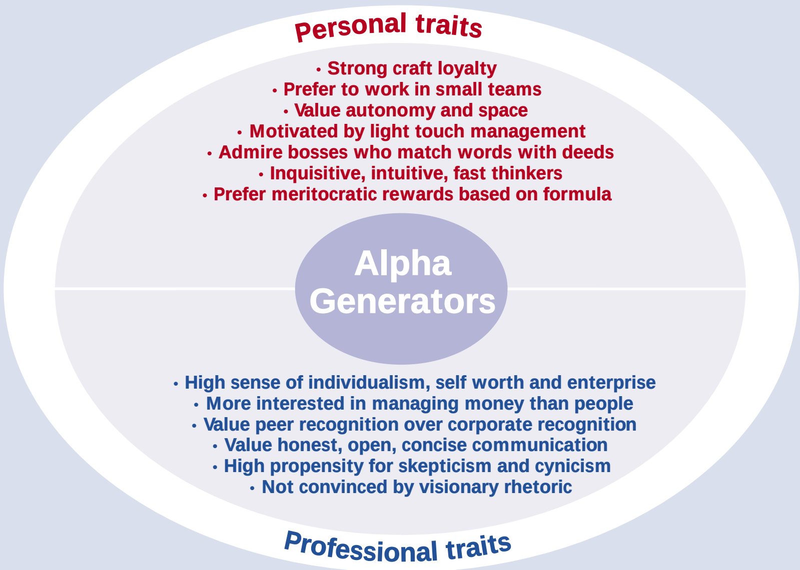
The task is daunting when it is realized that people in the front office – like knowledge workers in other industries – have certain unique characteristics which make them difficult to motivate, retain and deploy (Figure 1.9).

In particular, their success depends upon a 'nuts and bolts' leadership style: one that is stronger on deeds than words; blending a light touch with intensive communication; challenging complacency via restless curiosity.

At any rate, the craft nature of the investment industry requires a strategic performance process that sets clear business goals, de-personalizes the issues in their delivery and allocates clear accountability of the pre-set performance metrics. Such frameworks are evolving, albeit very slowly.

Unless they do, the cultural changes risk being as durable as the crisis that provoked them. After all, experience in other industries shows that business re-engineering takes time and persistence; it's a matter of hard graft. The required mindset shifts have often required more than one crisis.

Figure 1.9 Main traits of Alpha Generators



Source: CREATE and KPMG International, 2004

So, what are the key messages that CEOs need to act on?

- **Sustainability:** the history of change management is littered with failures; unless the re-engineering is well conceived, planned and hard-wired into the business systems and processes, bungee jumps will be inevitable: the more things change, the more they will remain the same.

- **Culture:** mindset shifts are usually as durable as the crisis that provokes them; they need to be systematized through a strategic performance process, with its own set of convincing answers to the most frequently asked questions.

- **Targets:** strategic rhetoric cannot be a substitute for tangible results; a business plan is worthless unless it has short-term measurable or observable targets, accountabilities, reality checks and incentives.

- **Integration:** seemingly desirable changes like in-house boutiques and performance-based rewards also carry the risk of dysfunctional 'us-and-them' mentality as an unintended consequence. Mechanisms need to be in place to minimize this risk.

- **Basics:** re-engineering should not divert attention from those basics of the business which really matter to the clients: performance, service, charges, risk management and compliance.

- **Alliances:** it is important to draw the distinction between '*doing the business*' and '*running the business*'. So, alliances are not just about reducing costs but also about enhancing core competencies as well as business results in the chosen areas of the value chain.

- **Reputational risk:** branding is no longer just about marketing and advertising. It has to incorporate the value proposition and its delivery in products and services. Senior managers need to live, breathe and manage the brand every day.

- **Paradoxes:** change management creates paradoxes in the value chain: e.g. scale vs. scope, focus vs. control, competition vs. collaboration. These require clear communication of the goals and their business-wide buy-in, in order to minimize disconnects between different areas.

- **Incentives:** formula-based bonus is a double-edged sword; in the absence of a culture of leadership, it can promote '*lone ranger*' attitudes. Also, equity participation works effectively if targeted at shares whose prices can be influenced by the success of people in the front office.

- **Transformation:** so deep seated are the problems in global investment management that the current re-engineering has a greater chance of creating a variable cost model, if it is viewed as a journey rather than a series of fixes, no matter how bold.

2 Sorting the wheat from the chaff: what are the key drivers of profitability?

The market rally in the second half of 2003 has given a temporary boost to profitability in 2004 since the current low nominal return environment is expected to persist for the foreseeable future.

As a result, half of all investment managers are now driving positive structural changes in order to sustain the recent improvement in profitability.

Modest in scale and scope, these changes constitute the 'first stage' rocket en route towards a business model that works in bull and bear markets alike. Given the nature of the changes, their positive effects will take a while to come through.

The tailwind behind them may fizzle out if the markets recover unexpectedly. Maintaining the current momentum will require patience and persistence on the part of business leaders.

Although the cost base has been pruned considerably, it has some way to go before coming into line with the lowest level of activity recorded in the last bear market.

Survival: the cyclical drivers

"We owned clients' wallets, not their hearts"

As our 2003 report showed, only a minority of investment managers around the world expected the recent bear market to prevail beyond 2002. As a result, substantive corrective actions to arrest a headlong decline in profitability were deemed unnecessary by many.

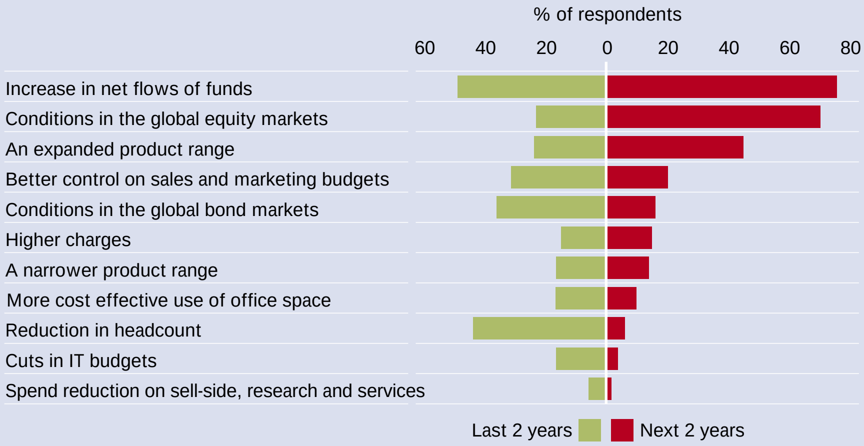
Further routs in February 2003, however, sparked off a series of actions: some were designed to cut costs immediately; others aimed to boost the top line in the medium term.

"The recovery in 2003 has eased a lot of pain"

As a result, a combination of cuts and the market recovery has helped to contain further falls in profits in the last two years (Figure 2.1):

- one in every two investment managers has experienced an increase in net inflows, aided and abetted by improving conditions in the global equity and bond markets
- just under one in two has reduced headcounts
- one in three has reduced sales, marketing or IT budgets.

Figure 2.1 Which cyclical factors have helped your company to contain the fall in profits in the last two years and which are likely to boost your profits in the next two years?



Source: CREATE and KPMG International, 2004

"We're more interested in cost controls than acquisitions; that way if markets improve, we get the operating leverage"

At the time of our last survey, some 40 percent of investment managers were expecting to report an operating loss in 2003. However, a combination of the above factors has probably more than halved that number, according to our post-survey interviews with CEOs, CIOs and senior directors.

On the cost side, the brunt of the decline has been borne by headcount reductions in front and back offices alike. This is not surprising since at least 60 percent of costs are accounted for by staff.

Thinking aloud…

"Clients are wising-up now. The losses in the bear market have totally altered client perceptions. They are no longer driven by prospects of strong returns because the ordinary retail investor didn't benefit from the longest bull market in memory.

Now you have to match your words with deeds. Even with our enviable track records, we encounter skeptics and cynics every day. Our success in the fixed income space rests on a favorable macro economic climate, and a proven track record of long-term consistent performance, based on top down investment strategy backed by superb bottom up bond picking.

Bonds are risky to manage and trade. So, account managers are another pair of eyes and ears for portfolio managers; they have a parity of esteem.

If you don't believe that you can generate alpha more often than not, then don't be an active manager. We've generated it over a long period through a blended approach that combines the tools to extract mis-pricings in the markets with swaps to control risk, both of which rely on strong gut instincts, based on many years of experience. In our non-hierarchical environment, people are pushed to the limits of their thinking as they become more experienced.

Consolidation is inevitable; there are too many producers, especially in the mutual funds space; most of them are pretty mediocre and rely more on customer inertia than good returns."

Source: CREATE and KPMG International, 2004 – Interview quotes

"We've got over 200 funds, but we need fewer than half of these"

"In time, the hedge funds bubble will burst"

Staff reductions varied between the regions: the average reduction was around 20 percent in the US, 18 percent in Europe and 12 percent in Asia Pacific. The lower rate in the latter region reflects the fact that substantive downsizing had already occurred as a combined result of two factors: a prolonged bear market in Japan in the 1990s and the unexpectedly huge correction in the region's emerging markets in 1998.

As we shall see later, changes in the product mix, too, helped to limit falls in profitability; around one in four investment managers increased their product range for institutional investors in order to attract net inflows and around one in six reduced the product range – mainly in mutual fund space – to phase out the less profitable 'bells and whistles' products.

"Our productivity growth comes from selling only pooled funds"

"Product switch has helped productivity"

"We're seeing the industrialization of investment management"

"Balanced mandates are dinosaurs"

"40 percent of profits come from hedge funds and other alternatives"

Over the next two years, these trends will continue except in one important sense: substantive downsizing is over in all the regions, so long as the current sideways drift does not turn into yet another bear market around the world, as happened in 1930-32 and 1973-75. This caveat is worth recording because the current situation appears to resemble disturbing parallels with the past. In any event, there appears to be undue optimism about the future: on the one hand, over two in three firms are bullish about net inflows over the next two years; on the other hand, the same proportion also expect the low nominal return environment to persist over the same period. The bear market has not fully dented the innate optimism of the industry.

In order to facilitate some of the structural changes described below and in Section 3, there is a widespread belief that the cuts have gone some way towards improving investment performance on the one hand and operational efficiency on the other. At the very least, they are seen as an important step towards achieving two goals:

- productivity improvement through greater focus: rationalizing the overall people and infrastructure capability of the business to a level where business growth can be accommodated via productivity improvements
- a variable cost business model: reducing overhead costs and linking as many of the other costs as possible to the level of business activity.

Adaptability: the product drivers

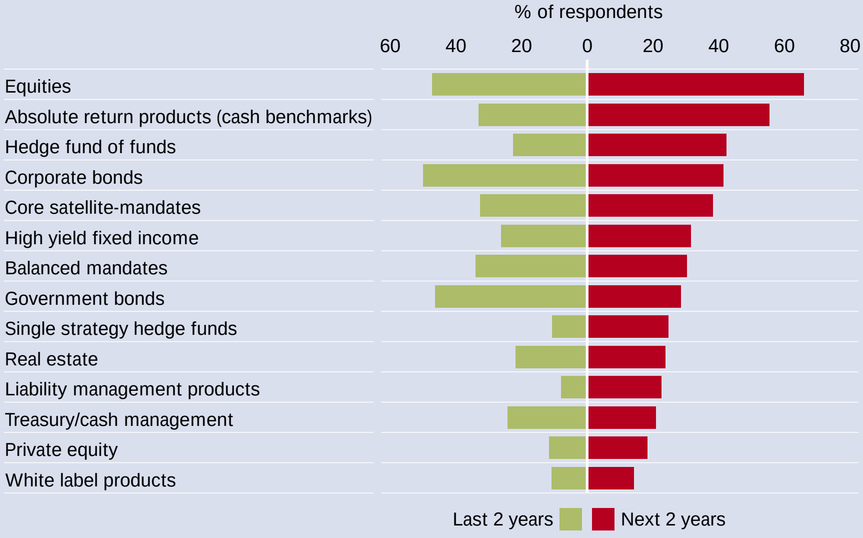
So far, one of the principal avenues used in achieving productivity improvements has involved a switch in investment style and product mix (Figure 2.2).

In the last two years, equities have retained their appeal to less than one in every two investment managers. Alongside, there has been strong interest in corporate and government bonds by one in two managers. More importantly, in response to client demand, more than one in five managers has sought to diversify into:

- absolute return products (cash benchmarks)
- hedge fund of funds
- core satellite arrangements
- high yield fixed income
- real estate

Over the next two years this interest will, if anything, become more widespread and encompass another emerging product group: liabilities management. This diversification into corporate and government bonds, however, is likely to be much less in Asia Pacific than in Europe and the US.

Figure 2.2 Which style and product offering have your clients been attracted to in the last two years, and which will they be in the next two years?



Source: CREATE and KPMG International, 2004

Five noteworthy points emerged in our interviews with respect to changing client needs.

"Hedge funds are a response to dire performance in the past. The price of being in them is only exceeded by the price of being out of them"

First, the implied diversification is gradual; yet noteworthy from a very small base at the time of our 2003 report. It is indicative of the painful lessons learnt in the last bear market. The sheer scale of losses suffered by institutional and retail clients has shifted their interest away from traditional equity-based products to those that target absolute returns in long-only space or alternative classes like hedge funds, private equity and real estate.

"Why lend stocks to someone who is shorting against you?"

Second, some investment houses see hedge funds as a temporary phenomenon whose role has been heightened by a prolonged bear market. Others see them as an emerging phenomenon that will become mainstream in the years to come. On balance, the latter possibility seems the more likely.

"Institutional investors are demanding more for less"

Third, interest in liability management products – combining bonds, equities and swaps – is expected to grow, as institutional investors increasingly use their own long-term liabilities as benchmarks in preference to market-based or peer benchmarks. This is a major departure from the recent past.

"China and India remain distant prospects"

Fourth, over the next two years or so, the lure of the new markets like China and India is expected to be moderate, pending further liberalization that can create a level playing field for non-domiciled investment managers. However, in the medium term, these two markets will attract growing attention.

Fifth, and most important, the diversification is an explicit recognition that high investment performance is now a matter of blending a range of products that can generate alpha, either in the main portfolio or through portable means such as sub-advisory specialist mandates, market inefficiencies in other asset classes, or currency and commodity overlays.

Thinking aloud…

"Our front office is structured as hub and spoke: out of 35 offices around the world, only 10 manage money. Our performance has improved since 2000: the proportion of funds outperforming their benchmarks has quadrupled.

This has been achieved by reducing the dysfunctional tensions between analysts and portfolio managers. Portfolio managers now focus on performance, and let marketing managers do the business development and client service work.

We've had net outflow of funds since 2000 yet our profits are up because the margins have shot up on our high performing products. We recognize that the riskier a portfolio, the greater the latitude for people who manage it. You have to let these guys develop sharp instincts.

We've cut costs in every area of activity by at least 15 percent. We had to downsize significantly; bonus is directly linked to performance; and there is more accountability in every area.

Our challenge is how to create a culture of high performance and retain the fun environment. We are change-fatigued; the old guard has gone, as has the era of paternalism."

Source: CREATE and KPMG International, 2004 – Interview quotes

"Portable alpha is the name of the game"

For individual investment managers, the implication is clear: focus on manufacturing excellence, where that is possible, or access the best of breed products through manager of managers arrangements. The anticipated doubling in the proportion of investment managers expecting to provide hedge fund of funds over the next two years, for example, is indicative of a new form of horizontal linkages now in progress. We return to this point in Section 4.

"People are thinking about absolute returns: so TAA is in vogue"

For now, it is worth emphasizing that the continuing switch away from the old style balanced mandates is being accompanied by an increase in the importance of tactical asset allocation that rewards those managers with the ability to switch in and out of different asset classes in order to meet client needs.

In Europe and the US, this switch to corporate and government bonds features more prominently than in Asia Pacific.

"For consistent alpha, you have to enter different asset classes, through alliances if necessary"

Accordingly, for small scale specialist managers, survival is a matter of achieving out-performance. For mid and large scale players, survival is a matter of delivering out-performance in their chosen capabilities or ability to access the best of breed products through alliances. For all players, generating alpha has become critical in deference to the new mantra: '*product is performance*'.

Growth: the secular drivers

"Costs have been reduced by 15 percent in the last two years. Most of it has come from centralization of front and back offices"

Cost cutting has been the most visible response to the bear market. Alongside this a number of other actions have been taken to improve profitability in the longer term. Although it is widely accepted that the conditions in the global markets will remain a major driver of profits, there is a growing recognition that any business model which works only in a bull market is now a recipe for disaster.

"Once you are number one, it is difficult to know where to go: we need to revamp this business within two years"

Accordingly a number of actions have been implemented in the last two years: at best, they aim to create a resilient business capable of riding out market volatility without taking a major toll on profitability; at worst, they aim to minimize the 'feast and famine' situation as experienced in the last five years by a majority of investment managers participating in this study. Together, they serve to grow the top line while containing cost pressures.

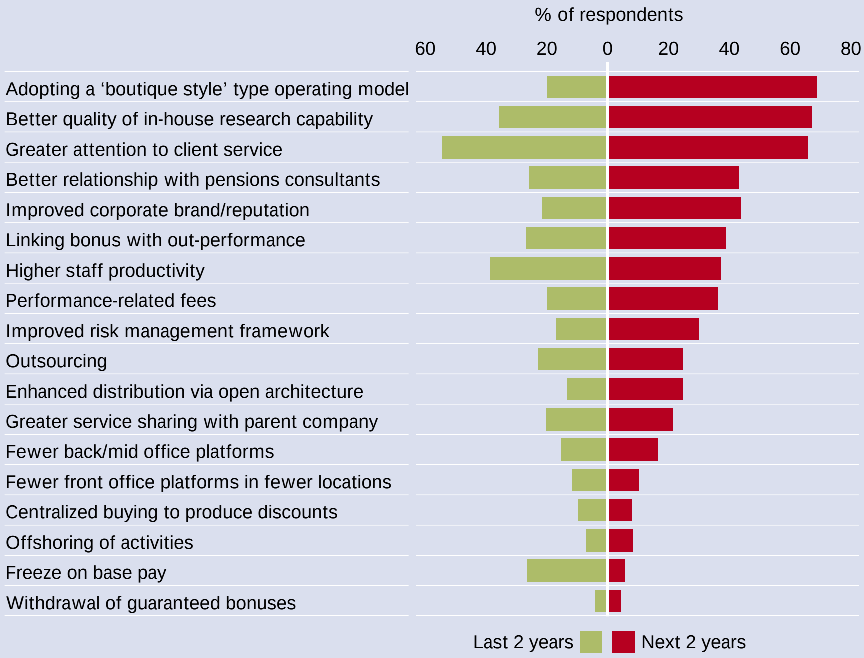
That said, it is important to mention that, in most cases, the actions in question are neither discrete nor stand alone. Instead, they constitute an early phase of larger change programs initiated in the bear market and likely to continue over the next two years or so, given their nature.

Actions taken in the last two years or to be taken in the next two years in order to grow the top line include (Figure 2.3):

- adopting a boutique structure where portfolio managers and research analysts work together in small semi autonomous units (three in five managers)
- enhancing the quality of in-house research (two in three)
- improving the quality of client service (two in three)
- improving relationships with pensions consultants (two in five)
- improving the corporate brand (two in five)
- charging performance-related fees (two in five)
- enhancing distribution via open architecture (one in four).

"Open architecture is more open in the US than Europe"

Figure 2.3 Which structural factors have helped your company to contain the fall in profits in the last two years and which are likely to boost your profits in the next two years?



Source: CREATE and KPMG International, 2004

"Institutional clients have ever shorter time horizons and memories"

"Our indexed funds have doubled in five years; but with no increase in net income"

"Our profit margins are higher than ever because of cost reductions in 2002, increased fees and rising markets. The cost reduction is giving us huge operating leverage"

" We're taking business away from our competitors without jacking up costs"

On the other hand, actions aimed at reducing the cost base and making it more variable in the last two and/or next two years include:

- securing higher staff productivity (two in five managers)
- linking bonus with out-performance (two in five)
- freezing base pay (one in four)
- outsourcing (one in four)
- sharing services with parent company through a matrix structure (one in five)
- fewer front and back office platforms (one in five).

In this context, five points emerged from our interviews.

First, the number of investment managers taking these actions is notably higher than at the time of our 2003 report. Then, around one in five managers had initiated these actions. It is clear, therefore, that a growing proportion of managers are responding to the challenges raised by today's low nominal return environment. By themselves, the numbers do not herald a dramatic turnaround in the foreseeable future; they still constitute a notable advance from what was a low base.

Second, the changes cited here are more evident in the US and Europe than in Asia Pacific where, as mentioned before, investment managers had rationalized in the early and late 1990s. Furthermore, the urgency of these actions has been felt less acutely in the latter region because of the stronger recent market recovery there, compared to Europe and the US.

Third, to the extent that the last bear market has been the key driver of change, it is hard to know how many of the change programs will be sustained in the event of a strong market recovery over the next two years or so. Experience in other industries shows that business transformation takes time, patience and persistence on the part of business leaders. We return to this point in Section 5.

"We're acutely conscious that the twin deficits in the US, before long, will unsettle the markets big time. So we intend to remain lean and mean"

On the other hand, if the current faltering rally turns into another bear market, there is little doubt that a majority of investment managers will resort to further cost cutting. The current cost base has yet to be adjusted to the lowest level of activity experienced in the last bear market.

"History remains relevant: p/e ratios are too high. Policy on both sides of the Atlantic remains misaligned"

Fourth, the boutique concept in medium and large firms is more relevant in the US, UK and Continental Europe, compared to Asia Pacific. This is because many firms in that region are affiliates of larger global investment managers. They have not been subject to the same level of reorganization as their American and European cousins.

Thinking aloud…

"Because of our outstanding track record, our institutional clients want us to go into alternatives. But we said, 'No'. We're a partnership and can't have any semblance of 'star' culture that is required by the alternatives.

However, we have managed to diversify comfortably into absolute returns and liability management products.

Our portfolio managers do all their own research as well, but we don't favor too much interaction with clients. That's the job of CRM professionals who are multi-skilled. Many are ex-portfolio managers.

We have imposed stringent cost control in all areas. Our culture puts client interest first: gives them a decent performance and a high quality service. We also have a debating culture with a low level of politics.

Our client service people listen to clients, anticipate their needs, keep in touch regularly and seek to inspire trust on every occasion. This is becoming a challenge as we get ever more global mandates.

Our bonus system for portfolio managers is based on 40 percent individual performance, 40 percent team performance and 20 percent discretionary."

Source: CREATE and KPMG International, 2004 – Interview quotes

"We risk being a public utility"

"Regulators are causing huge distortions in the behavior of the investing public in general, and fund managers in particular. Currently, I see little balance between fairness and efficiency"

"Regulators are oblivious to the unintended consequences of their actions"

Finally, the shadow of further regulation hangs over the industry. The impending actions in the US post-market timing and late trading scandals, the recent adoption of the Revised Investment Services Directive in the EU, the EU's Financial Services Action Plan (FSAP), the split capital debacle in the UK, and the actions proposed on commissions in the UK by the Financial Services Authority (FSA), are indicative of the fact that the industry will remain under public scrutiny for the rest of this decade.

At the surface level, some investment managers see these changes as a welcome extension of best practices. Others perceive them as unwarranted intrusions that will raise costs and impair efficiency. However, at a deeper level, there are serious concerns about the future in four specific contexts.

The first of these concerns what investment managers can and cannot publicize in their marketing material with respect to returns on their products. The second concerns the nature of 'Chinese walls' between long-short and long only managers, and their *modus operandi*. The third concerns the wide discretion that regulators have armed themselves with in order to interpret behavior after the event. The fourth concerns the slow and rather faltering advance of the FSAP. It puts more emphasis on legislation rather than practical problems in its implementation. It also puts more emphasis on having harmonized rules rather than opening up the markets.

3 The emerging business model: what's new, why is it different?

The new mantra is 'client first'.

So, four areas are receiving priority attention by at least one in three investment managers.

The areas are: client relationship, branding, investment and administration. They aim to raise the performance bar, improve operational excellence and contain costs.

These are regarded as the key ingredients of the new winning formula.

Regaining the trust

"I don't want anyone to confuse the bull market with brains"

The last bear market created many disillusioned clients, as millions lost billions. As if that was not enough, the mutual fund scandals in the US have further dented investor confidence; unsurprisingly, investment managers concerned have experienced massive outflows but the industry-wide impact is hard to judge, although it is no less real. Clients have definitely become risk averse.

"We can regain trust by paying more attention to governance issues in the companies in which we invest, as well as our own company"

Accordingly, regaining investor confidence has been one of the principal concerns of investment managers around the world. After all, institutional investors need to be convinced more than ever that their investments will enable them to meet their long-term contractual liabilities: they're taking their fiduciary responsibility far more seriously. Private investors also need to be convinced that their funds are managed by people who they can trust; they are nursing huge 'paper' losses, inside and outside their Defined Contribution (DC) plans.

"Client service is the cornerstone of our success; through it, we recruit new business, learn a lot about clients and forge relationships that endure. Two thirds of new business comes from existing clients"

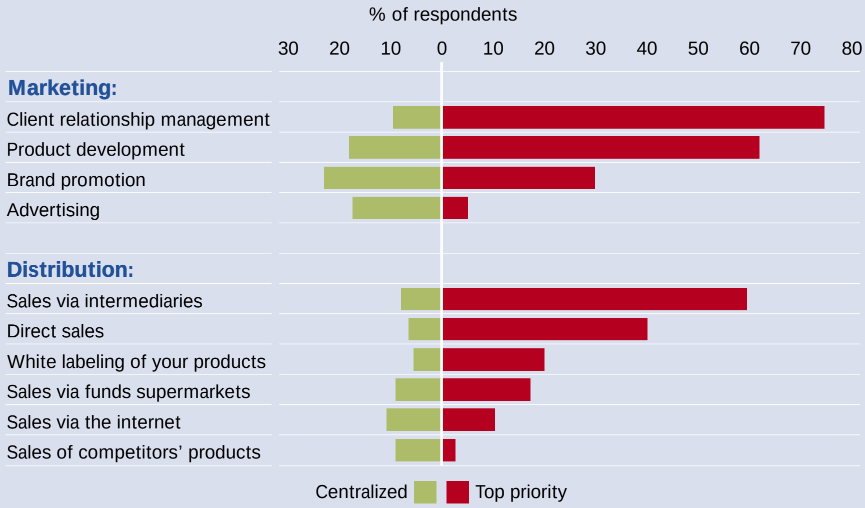
We encountered a strong body of opinion that unless that confidence is regained, the current low nominal return environment will persist, even if the nervousness around the twin deficits in the US has subsided. At any rate, for the industry as a whole, the key challenge is how to bring back into the fold the long-term *'buy and hold'* investors who formed the backbone of bull markets in the past.

In this context, there is a clear recognition that words matter less than deeds. So, the initial actions are focused on areas where investment managers feel that they can achieve some early positive results. As we shall see in Section 5, these are backed up by regular client feedbacks.

Actions are being taken over a wide range of areas, on a scale not evident at the time of our 2003 report. For example, in marketing, three areas are receiving high priority by investment managers around the world (Figure 3.1 upper panel):

- client relationship management (three out of every four managers)
- product development (three in five)
- brand promotion (one in three).

Figure 3.1 Over the next two years, which activities in your company's value chain will either receive priority attention or be centralized in fewer platforms: Marketing and Distribution?



Source: CREATE and KPMG International, 2004

"As Executive Chairman, I spend 20 percent of my time with clients"

Client relationships are now nurtured through more frequent contacts that help to better understand client needs and deliver against them cost effectively. The new trend towards absolute return products – cash and alternatives – as well as liability management products is indicative of the evolution of a new *implicit contract* under which pension trustees, their consultants and investment managers are identifying more robustly the long-term liabilities of trustees, their risk appetite and the flexibility they need. As part of that deal, they are also paying more attention to their own fiduciary role in the companies in which they invest. This kind of 'shareholder activism', however, is still in its infancy stage. This is one major development since our last report. It is especially evident in Europe and the US.

"Our value proposition was that we're an ethical, low cost firm, but we didn't have the culture that went with it"

Another one is the growing recognition that if good performance attracts new business, then a good brand image is necessary to retain it in good times and bad. A growing proportion of investment managers now recognize that brand is more than name recognition: it has to stand for a clear value proposition, to be delivered on the back of good investment performance on the one hand and sound business basics on the other. Such basics have to include effective risk controls, realistic charges, quality service, board accountability and strong compliance – all of which are the key ingredients of sound corporate governance. The importance of brand image has been equally recognized in all the regions.

"Without improved performance, we're on a highway to hell"

This recognition, in turn, is making it possible for investment managers not only to explore alternative channels of distribution (Figure 3.1, lower panel). But it is also enabling them to sell – through symbiotic branding – the best of breed products manufactured by others.

Thinking aloud…

"Fund managers have to accept a greater role in the corporate governance of the companies in which they invest. But they are far from ready. It's not just about beating the hell out of the remuneration issue: public companies are like self sustaining oligarchies. We have yet to learn how to exercise our power with responsibility.

As for investment, we are now very constrained; new opportunities soon get arbitraged away. Alpha guarantees a zero-sum game. Alpha will become a smaller proportion of funds. Yet consultants don't see this issue. It's a dereliction of duty. All they want to see is a consistent process. Yes, you can have massive volume in derivatives only because their opaqueness serves to hide the problem. We now talk about liabilities management rather than alpha generation and use swaps contracts as a matching instrument.

Hedge funds are over-hyped: they won't look so sexy when equities revive. Top flight capacity is limited and people's track record of picking a manager of hedge fund managers is not so good. But we have gone in to them in order to diversify into growth areas.

Until there is some buoyancy in the markets, all we can do is to clean up our act so as to regain clients' trust. Too many things went wrong in the recent past. Before then, I don't know how much trust there was between clients and us: arguably, the relationship was based on greed. But I know for sure that the trust level is at its lowest in living memory. Rebuilding those bridges is taking longer than I thought. So, we have to pay attention to all the basics of this business – like service, risk controls, compliance, charges and cost controls."

Source: CREATE and KPMG International, 2004 – Interview quotes

Retuning the investment engine

"You need only a handful of people for alpha and the right environment for them: the rest are time wasters"

In order to improve investment performance, a number of areas are receiving attention (Figure 3.2 upper panel). They include:

- stock selection (one in two managers)
- asset allocation (one in two)
- research and analysis (two in five)
- liability management capability (one in four)
- risk and quant analysis (two in five).

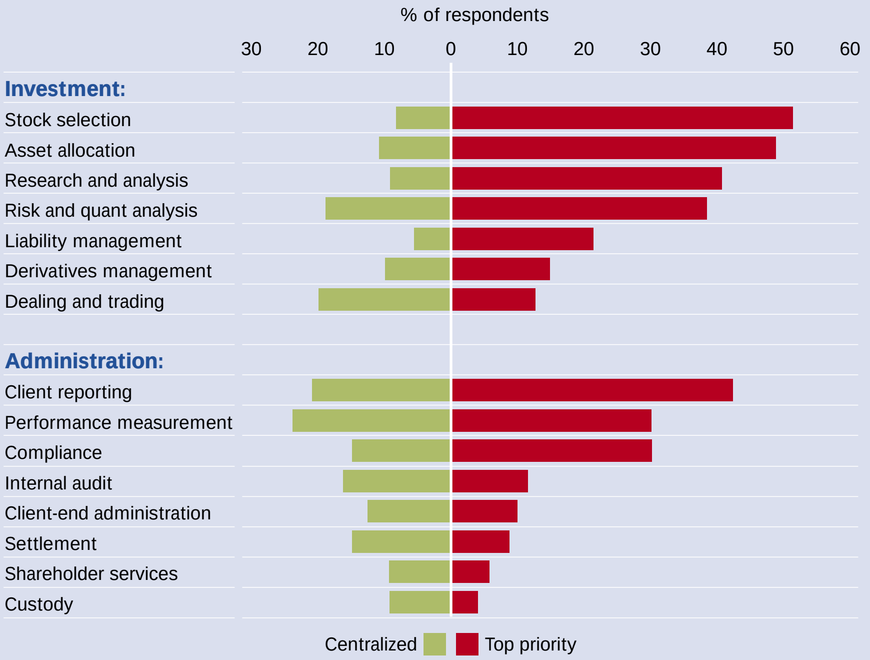
"Stripped of jargon, alpha means 'do well'"

In large houses, these activities – along with dealing and trading – are being centralized by putting them on fewer platforms in fewer locations. The aim is to reduce costs and create synergy. As we shall see below, a new structure of boutiques is also being created inside medium and large houses, in order to allow portfolio managers and analysts to focus on their craft in an incubator type environment.

"Our investment processes now reflect no more than the talent of the people who run them"

As a part of better client service, client reporting, performance measurement and compliance, too, are receiving priority attention (Figure 3.2 lower panel).

Figure 3.2 Over the next two years, which activities in your company's value chain will either receive priority attention or be centralized in fewer platforms: Investment and Administration?



Source: Create and KPMG International 2004

Creating a village of boutiques

"Scale is the enemy of alpha"

"We're more interested in having incubators than acquisitions"

"There is no reliable process for generating alpha. The best we can do is to ask some pertinent questions, like why markets are inefficient and why inefficiencies would not be arbitraged? Will we make money after allowing for the transactions cost?"

As we saw in Section 2, by far the most widespread change – undertaken by two in three investment managers – has involved creating a series of product-based boutiques within medium and large houses.

Referred to as 'alpha shops' in many cases, these are semi autonomous groups of around seven people, typically comprising portfolio managers, research analysts and product specialists. The latter tend to be more senior portfolio managers experienced in product development and client relationship management. Their logic rests on three arguments.

First, such an arrangement is the best way to emulate the strong investment culture that prevails in some of the most successful partnership houses or small independent boutiques in the industry.

"We've kicked out a lot of portfolio managers who ignored research and acted like lone rangers"

Second, such an arrangement is also most conducive to sparking creativity through intensive interactions between people in small groups operating in a hassle free environment. In this context, alpha is seen first and foremost as a product of creativity that is not a serial process of knowledge creation but a random explosion of energy often borne of frustration with the *status quo*. Successful examples of such boutiques prevail in large firms in pharmaceuticals and aerospace, where R&D is a major component of value added.

"Alpha is our oxygen. There's nothing magical about the process: we recruit people who relish challenges; they frequently communicate ideas in chat rooms; we have a common business culture across the globe; our investment committee focuses on critical alpha themes in a spirit of free thinking and business excellence"

On this argument, robust investment process and philosophy are not enough. They need to be backed by strong gut instincts that thrive in an incubator type environment.

Third, such small self managed teams are perceived as running with the craft nature of the investment function; promoting a small company mindset in a large company environment; encouraging knowledge sharing on the one hand and entrepreneurial behaviors on the other. All this is viewed as critical in diluting the long prevailing star culture.

Thinking aloud…

"Our research engine lacked coherence because it was inherited from several mergers in the past five years.

In one case, portfolio managers acted like lone rangers, did their own thing and never consulted analysts; in the second case, analysts produced volumes of material but there was no monitoring of how it was used, by whom and to what effect; in the third case, research was centralized and portfolio managers relied on it a lot. So, we did a number of things.

To start with, we centralized research in two locations – in order to create a strong capability for cross border coverage. These analysts also exchange ideas on key developments in their sectors.

Furthermore, each analyst in each location now covers two distinct universes through fundamental research: primary and secondary. The primary universe covers and rates around 25 stocks that underpin our existing regional and global stocks. The secondary one covers an additional 15 stocks that have the potential to join the primary universe over time.

In each case, the aim is to identify stocks that will out perform their sector. Analysts are expected to visit companies and develop a strong gut feel about their future prospects, over and above building robust financial models. By combining hard and soft information, they are expected to make clear recommendations on 'buy', 'sell' or 'hold'.

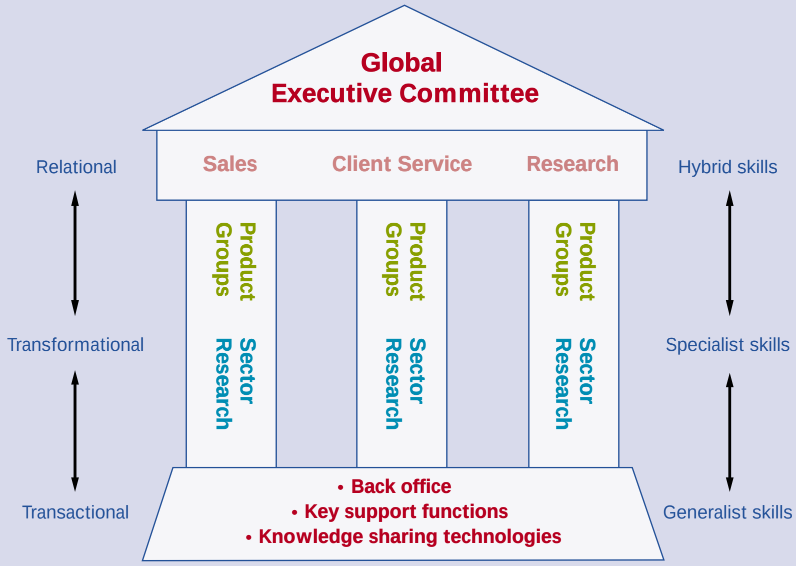
Finally, analysts are expected to nurture a good collaborative relationship with portfolio managers through daily meetings, voice mail and e-Mail. In order to build their credibility in the eyes of portfolio managers, each analyst is also given a small pot of money to manage. Their compensation is then based on a weighted scorecard, comprising the success rate of their recommendations, the performance of their own funds and 360 degree feedback from their colleagues in the front office."

Source: CREATE and KPMG International, 2004 – Interview quotes

"Boutiques are inevitable because this is a craft business"

A typical structure is presented in Figure 3.3, where the boutiques constitute the independent pillars which give differentiation. In turn, they are integrated into mainstream business by two sets of generic functions on which they rely: sales, marketing and global research at the front end; and administration, compliance and technology at the back end.

Figure 3.3 Creating a community of boutiques



Source: Create and KPMG International 2004

"To generate alpha, we've dumped the process solutions that suppress talent and given portfolio managers more authority"

It is also worth emphasizing that boutiques are being created through three avenues:

- acquisitions: around one in fifteen investment managers are acquiring strategic stakes in former independently owned boutiques and then running them at arm's length. This is most common in the hedge funds space, where the parent firm is also given a preferential allocation in the boutique's much coveted investment capacity.
- organic: around one in twenty investment managers who are expanding in the DC and mutual funds markets are accommodating their growth by creating new capacity by introducing new semi autonomous units. They are also leveraging their main brand as an additional integrating mechanism.
- restructuring: around one in two medium and large firms are reorganizing their existing structures by adopting the model presented in Figure 3.3. Their rapid growth in the 1990s had inevitably created bureaucratic unwieldy structures that were unconducive to creativity.

The trend towards in-house boutiques is more notable in the UK, US, the Netherlands, Sweden and Switzerland – namely countries where pension reforms have been taken furthest.

That said, it is worth emphasizing that in-house boutiques are not seen as a one-sided deal for two reasons.

"This industry will change; within consolidation, boutiques will remain vibrant. Even very large houses will need their own boutiques to generate decent performance"

First, on the one hand, they are seen as a source of generating alpha and retaining talent. On the other hand, they carry downside risks: promoting a silo behavior and personal franchises, neither of which are conducive to creating a 'one company' mindset. The chances are that they are more likely to succeed as a part of a well thought out business strategy, as defined in Section 5.

Second, giving alpha managers autonomy and space is one thing, but controlling investment, operational and reputational risk is quite another.

"Fund managers need to be brutally honest: alpha is 98 percent hard work and two percent inspiration based on accumulated experience"

Their latitude is confined to the limited – albeit important – area of tactical asset allocation and stock selection. They are otherwise fully integrated with their firm in other front and back office activities, as shown in Figure 3.3. At a time when regulators are putting so much attention on fiduciary issues, providing autonomy within an overall culture of control is a high wire act: achieving balance is more an art than a science. It requires a distinct brand of leadership, as we shall see in Section 5. It is too early to say how many of these boutiques will succeed.

Thinking aloud…

"Our clients remain disillusioned. Even with a global brand and reach, we have not scaled this business profitably. Our clients no longer want relative returns; their expectations are based on what they can get from small, nimble asset managers. Quite simply, they want consistent performance with alpha.

We've spent a lot on creating a decentralized structure of highly skilled boutiques. They are product-based semi-independent businesses located in key cities in the US. They are investment-only outfits, using a common back office.

An important feature of this model has been the rather expensive recruitment of experienced portfolio managers from outside. Our long serving employees found the switch rather difficult. Some of them have left and others now work in central functions.

In any event, we want to create a new capacity that can help us to deliver a compelling proposition to a potentially large retail market. In the US, over 80 million will reach retirement age over the next 20 years, many of them are not in Defined Benefit (DB) plans. Currently, they highly value our brand. We want to sell products that combine insurance and investment capability.

The model is based on the belief that portfolio managers need to operate in a low hassle environment in which ideas breed new ideas. They have the autonomy to back their high conviction ideas and work closely with other professionals; spending 80 percent of their time on managing portfolios.

On the institutional side, however, portfolio managers work closely with client relationship managers at the center. On the retail side, they largely rely on brokers for new business.

The product groups work independently. At present, there's not a great deal of knowledge sharing between them other than what happens at the quarterly capital market meetings, involving heads of individual businesses.

Any changes to this model will be incremental because we have experienced a significant improvement in our performance relative to peer groups and brand market benchmarks. Over time, we will develop a competitive absolute return strategy based on our own in-house hedge fund capability, depending upon the prevailing regulation. The boutique model gives us the nimbleness to do things that we couldn't do before."

Source: CREATE and KPMG International, 2004 – Interview quotes

4 The growing horizontal integration: how is the value chain changing?

Putting performance and clients above all else means concentrating on core activities in the value chain and forming alliances with third party suppliers for the rest.

Such alliances involve two things: access to best of breed products and outsourcing non-core activities.

Together they are gradually reshaping the contours of the investment industry through consolidation.

They will be just as important as traditional routes that have promoted polarization in the past. There will be a lot of diversity in polarization.

Consolidation: more haste less speed

"Much heralded consolidation has yet to happen; large firms are too difficult to manage in people terms"

It is universally accepted that the global investment industry has excess capacity: there are far too many players especially in the European theatre. One of the paradoxes of the bear market, then, is that it has not sparked off a wave of mergers and acquisitions on the scale that was anticipated at the end of the 1990s. Less than 20 percent of the houses participating in this research had been involved in any merger and acquisition activity in the past two years.

"Paradoxically mergers and acquisitions didn't take off in the bear market"

The single most important reason was over-valuation. With nine in ten houses in Europe and two in three in the US being owned by banks and insurance companies, the parent companies have been holding out for higher prices in order to recoup the high acquisition costs of the heady days of the 1990s. In many cases, at the time, these costs were based on the assumption that assets under management would grow at an annual compound rate of 20 percent well into this decade.

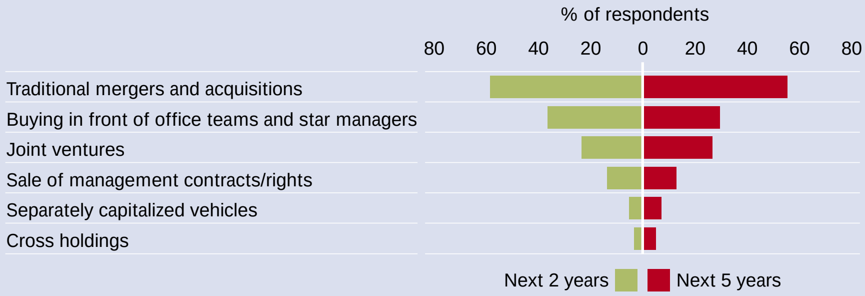
"Scale is the enemy of alpha; it crushes entrepreneurial spirit"

Hence, unlike the 1990s, there is more emphasis now on buying expertise rather than scale or market position. As our 2003 report showed, attempts to grow the business through organic or acquisition routes invariably generated diseconomies of scale where cost increases outpaced revenue growth. The emphasis on skills has meant that large houses are either interested in buying a stake in small independent boutiques or creating their own.

"The required management band width is just not there"

In any event, large scale mergers and acquisitions towards the tail end of the bull market have, in fact, created major integration problems in the face of cultural differences and organizational complexity. These problems have delayed integration in some cases and caused a skills hemorrhage in others. In some instances the necessary management capabilities have not been there to create joined up businesses.

Figure 4.1 Which avenues are most likely to be used in consolidation in the global investment management industry?



Source: CREATE and KPMG International, 2004

Thinking aloud…

"We have done two large acquisitions since 1997. Our aim was to create a scalable business with a global reach. But their integration has proved a nightmare because of cultural differences.

A strong reliance on institutional business in all the regions has meant that we have not been able to replace portfolio managers who could not fit into our vision, for fear of offending pension consultants. That apart, many of them have golden handcuffs; buying them out has proved hugely expensive.

In order to retain some of them at the time of the acquisition, we even agreed to ring fence the businesses to which they were heading, without realizing that they will, over time and unwittingly, turn into bullet proof baronies. Turning them into joined up businesses has been like climbing a wall which is leaning towards you!

We have neither the scale nor the scope that goes with size. We are a confederation of businesses that finds it hard to leverage our combined strength. Before long, we will have to divest. In the meantime, through demotivation, many of our alpha managers have left to start their own hedge funds or join competitors. Our shareholders are none too pleased."

Source: CREATE and KPMG International, 2004 – Interview quotes

"Consolidation is long overdue but it won't happen: prices are too high"

Over the next two or five years, the traditional mergers and acquisitions are likely to take place (Figure 4.1). However, they are likely to focus on the acquisition of skills: that means the target will be smaller independent boutiques rather than mid or large size players. Other avenues of consolidation – like buying in front office teams and star managers, or joint ventures – are also likely to be used to promote consolidation. The pace of this form of mergers is likely to be faster in the US than Europe, as the current round of acquisitions shows.

The polarization between global scale players at one end and independent boutiques at the other – a prominent feature since the middle of the 1990s – will progress, albeit slowly.

There will be a lot of diversity within overt polarization. Between the two extremes, there will be a number of subsidiaries of large global players, operating at arm's length. Either through design or default, they will not be integrated with their respective parent companies. In fact, some of them already operate as independent boutiques.

Alliances: in search of best of breed products and channels

"Our business model is hugely diverse because the investment platform is global, research is localized by markets, dealing is done regionally, distribution is localized and the operations platform is global. A complex matrix joins them up"

"Avoid the 'curse of success'. Close the fund when it has maxed out"

"Best alpha players will team up with the best distributors before long; that's inevitable"

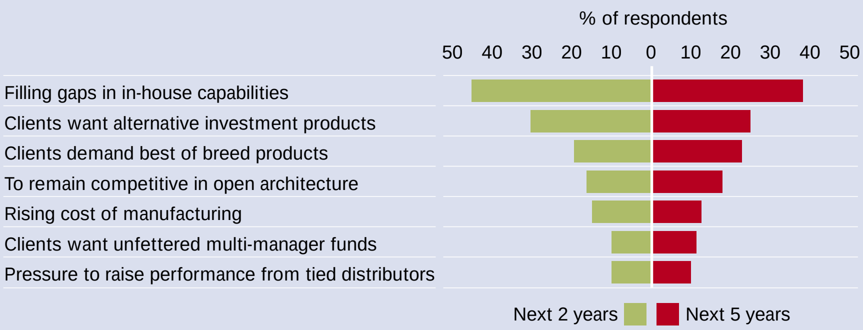
One of the contributing factors behind the somewhat subdued interest in large scale mergers is that investment managers are more willing and able to form alliances with others, in order to fill the gaps in their own in-house capability or access the best of breed products. This trend is likely to grow over the next two to five years (Figure 4.2).

This is yet another major development since our 2003 report. It is indicative of the growing maturity of the industry on one hand and the growing urgency to meet client needs on the other. Investment managers are becoming smart at forming distribution alliances with major retailers and banks in order to access retail clients.

At the manufacturing end, they are not averse to parceling out these funds to other manufacturers if they can produce better returns than the in-house portfolio managers – especially in retail markets (Figure 4.3). In this process, they are aided and abetted by their own brand reputation and the proliferation of channels. The trend has spread to the institutional space as well, subject to approval from pension funds, whose attitudes are reportedly beginning to change for the better on this issue.

This process is gradual, however. But it marks yet another new trend. This trend is more evident in the US first, Europe second and Asia Pacific third. That said, it is not without a paradox: most investment managers believe that they need to have a strong brand in order to become a manager of managers. In particular, they also need to be respected players with whom

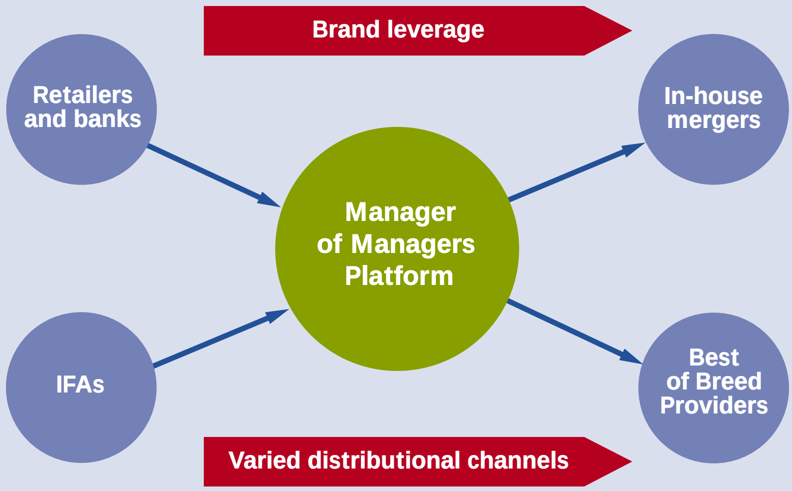
Figure 4.2 Which factors would influence your company's decision to form joint ventures and alliances?



Source: CREATE and KPMG International, 2004

others want to associate. Yet many don't have the scale and are seeking to build it through alliances. Some don't have it because it kills alpha. So, there is an impasse to overcome. Unsurprisingly, there remains a strong interest in producing a top or second quartile performance consistently, rather than promising something which is well nigh impossible to deliver year on year.

Figure 4.3 Manager of Managers: the emerging model



Source: CREATE and KPMG International, 2004

Thinking aloud…

"As a small house, a growing proportion of our new business comes to us through the sub-advisory route. Our principal clients are large US and UK houses who find it hard to generate alpha internally. So they parcel out the funds in small chunks to managers with a proven track record.

These large houses are also forming alliances with prominent retailers and banks that can leverage their brands to attract retail clients. They then parcel out the funds to those who can produce decent returns. If that means by-passing their own in-house managers, so be it. We are witnessing the birth of new alliances in pursuit of decent performance. Manager of managers is a concept not just confined to pensions consultants. It's a strong reality in the retail space and will spread to the institutional market before long."

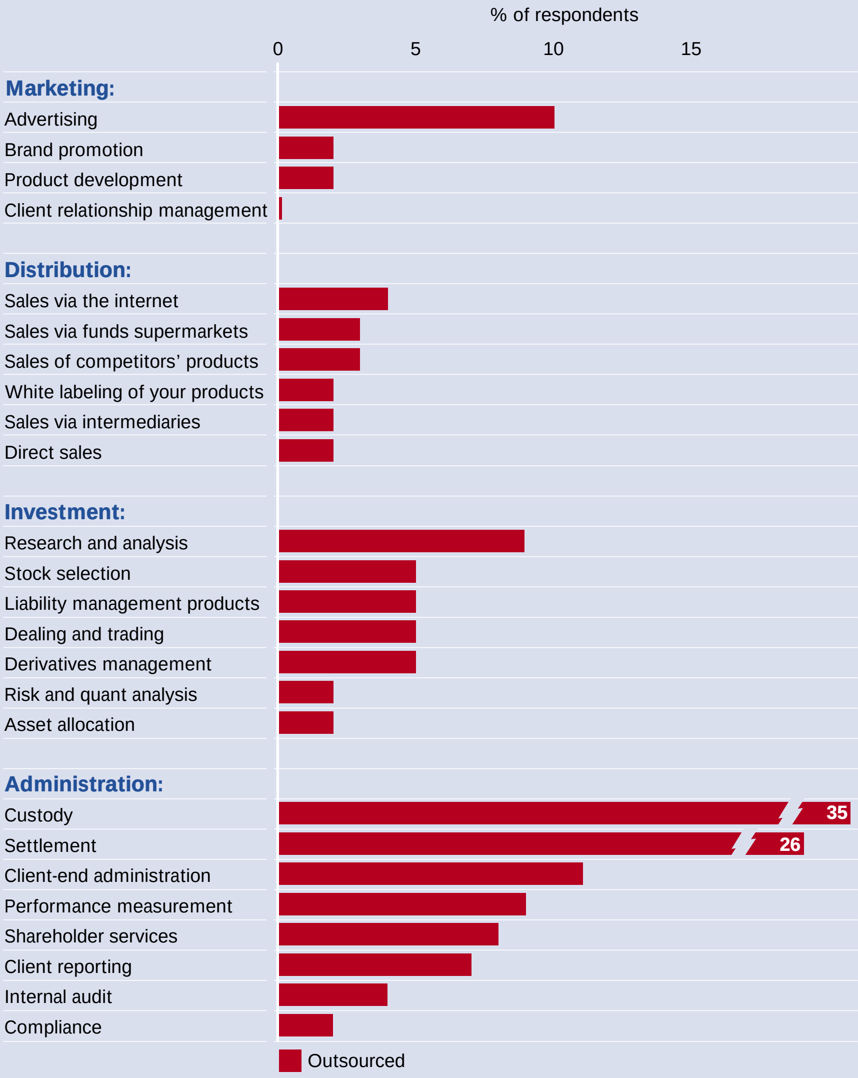
Source: CREATE and KPMG International, 2004 – Interview quotes

Outsourcing: cutting the umbilical cord

"Outsourcing and open architecture are having a major impact on our cost base"

Another factor that is promoting horizontal integration in the industry is, of course, outsourcing. Over the next two years, it is likely to occur over the entire value chain in varying degrees (Figure 4.4). Given the huge media attention paid to the outsourcing deals, the projected scale of increase appears decidedly low, even in highly commoditized areas like custody and settlements.

Figure 4.4 Which activities in your company's value chain will be outsourced over the next two years?



Source: CREATE and KPMG International, 2004

"Alliances mean that if you fail, then you fail with the best"

"The choice for us is leading edge or bleeding edge"

Be that as it may, there are four sets of observations to report on these figures.

First, in order of importance, the key areas are likely to be the back office activities, especially custody and settlement. Other activities will also be outsourced although their incidence is likely to be low. Many prominent deals have been reported in the past 12 months; although there are significant time lags in their implementation, it is clear that a critical mass of capacity is emerging amongst the service providers. Indeed, there is a school of thought which believes that, given the large size of these deals, the service providers concerned may be reaching their own capacity limits.

"Growth in the DC market will bring further convergence between institutional and retail markets"

Be that as it may, the process is likely to accelerate under two conditions. First, as and when the service providers build a critical mass, their unit costs are likely to fall. So, if they are prepared to offer an upside to their early clients from the profits made from subsequent clients, then more and more investment managers will resort to outsourcing in order to enjoy the prime mover advantage. So far, few service providers are willing to offer such incentives mainly because they have not yet reaped enough returns on their initial investment. The second factor that will accelerate the process is when the service providers can contractually fully underwrite the compliance risks associated with back office operations. Some regulatory issues are discouraging outsourcing at present.

"Rising costs of manufacturing is an issue, as is the speed at which commoditization is occurring. But it is clear that predatory pricing is a real threat, especially at a time when businesses are obsessed with costs"

Currently, in almost all countries, investment managers can only delegate regulatory responsibilities to service providers; not abdicate it. Furthermore, investment managers are also responsible for instituting new procedures on issues like money laundering and market timing. Not surprisingly, therefore, there is a growing call for outsourcers to be directly authorized and regulated. But there is as yet little sign that regulators are willing to relieve principals of their responsibility.

The second observation relates to small scale outsourcing expected in the front office. This is being driven mainly by two factors. First, more and more firms are expecting to reduce the spend on sell side research and meet their needs either through in-house sources or specialist external sources. Second, some private banks are gradually withdrawing from the mainstream investment function and entering into a manager of managers arrangement.

"We've also outsourced cash money market funds and index funds"

The third observation relates to two strategic factors behind the reported interest in outsourcing. One is cost. For example, the highest estimate of savings from back office outsourcing that we were given amounted to around seven percent of the overall costs. This does not allow for saving in capital costs when systems need to be upgraded. The second source is focus. There is a growing recognition that having a focused business means making a judicious choice between 'doing the business' and 'running the business'. By letting someone else run the non-core side of the business, management is able to concentrate on the doing side.

Thinking aloud…

"Fund managers have a remarkable propensity to learn nothing from history: any product has to go beyond spin and create value for clients.

Alpha generation is a myth; the issue is how you generate value. In retail space, people want performance but from the right brands. They also want multi-manager products so as to spread the risk. We've got alliances with major retailers and banks with trusted brands. We supply our own products or best of breed funds to their clients. Our aim is to build a brand by delivering value to these retail customers. Our in-house investment managers are none too happy that we use competitors' products. They are slow to recognize that investment is no longer our core competency; it's being good at forming alliances and doing symbiotic branding.

Open architecture is product led: so retail customers are showing less interest. Performance attracts funds, brand retains them. Your brand has to be authoritative, innovative and responsible.

The secret is to pick the best fund managers, create the right environment, back their judgment and reward them on results. Like Napoleon, also hope that your generals are lucky!

Our value proposition puts client interests above all else. But how can we deliver when our performance is mediocre? The key is not to be a fund manager; but to be a manager of managers, and develop a distinct brand as the gatekeeper of best funds.

We now also have third party business – we can't otherwise attract talent."

Source: CREATE and KPMG International, 2004 – Interview quotes

"Offshoring to India is bound to grow; the business case for it is irresistible"

"Our core strength is in knowing what clients want and meeting those needs. If that means outsourcing, so be it"

The final observation relates to offshoring. Currently, there is no more than a small scale interest in it. But a handful of prominent players have already set up back and middle office operations in India. Over time, the numbers are bound to grow.

When the expectations of consolidation, alliances and outsourcing are considered together, there is little doubt that the investment management industry will become diverse through fragmentation of activities in the value chain within individual firms; yet it will become increasingly more integrated horizontally between firms. In this respect, it will merely follow the trajectory taken by more mature industries.

5 Revitalizing the corporate DNA: why are mindset shifts proving so difficult?

Significant attempts are being made to reorient staff towards performance, clients and operational excellence.

These efforts, however, are hampered by legacy thinking and legacy arrangements.

Significant emotional disconnect still prevails between different parts of the business.

The mindset shifts that are necessary to overcome it require a robust strategic framework.

Without them, the new culture risks being as durable as the crisis that provoked it.

Corporate culture: speeding up the metabolism

"We can't emulate the culture of independent houses but we can create specific traits that can evolve into the kind of culture we want. In the meantime, you've got to do all the right things"

"Our value proposition was that we're an ethical, low cost firm, but we didn't have the culture that went with it."

"Culture is the invisible glue that holds together how you run money, deal with one another and deal with clients"

In day-to-day parlance, the term culture is defined as 'the way we do things around here': a collection of norms of behavior – the unwritten rules that condition the way in which staff do things and the way in which they relate to people inside and outside the organization.

A majority of the investment managers who participated in our interviews are seeking to effect a major shift in their culture from:

- paternalism to performance: putting more emphasis on performance than effort; on clients rather than self
- entitlement mindset to self employment mindset: putting more emphasis on accountability than rank; on meritocracy rather than longevity.

These shifts are but the logical counterpart of the dominant shift in the operating models of medium and large players: from rigidity to agility, as outlined in the last three sections and summarized in Figure 1.8 in the Executive summary.

In order to facilitate these shifts, investment managers are either developing the necessary cultural traits now or are seeking to do so in the future (Figure 5.1).

Figure 5.1 Which statements describe your company's business culture currently, and which describe the culture it aspires to achieve?

Source: CREATE and KPMG International, 2004

"Alpha means minimal bureaucracy and hassle"

"Many managers are emotionally ill-equipped for alpha"

"Alpha flows more from individual discretion and less from the investment process. But it carries the risk that managers end up owning the franchise unless you have a culture of fun, reward and longevity"

"Ours is a culture of longevity; a large majority of analysts and managers are home grown. We allow analysts to manage money; sometimes it is proprietary money. All recommendations from analysts are put on a web page as are the outcomes. They get rewarded for the right recommendations, even when these are not implemented. Their scorecard is also publicized widely amongst clients"

The traits being developed by at least two in five investment managers include:

- building trust with clients (three in four managers)
- balancing the culture with prudential risk controls (three in five)
- linking bonus with profitability (two in five)
- encouraging ethical behaviors above profit motive (one in two)
- promoting ownership of mistakes (two in five)
- encouraging front office people to share their ideas freely (two in five).

Likewise a varying proportion of managers also aspire to achieve some or more of these traits. Within that list, two traits that at least two in five managers still aspire to achieve are:

- encouraging staff to act as if the firm were their own business (three in five managers)
- building trust with the client (three in five).

A number of points emerged from our interviews on these results.

First of all, clients, ethics, risk control and compliance have all crept up the business agenda as important instruments of regaining trust. This need to run the business like a normal business with accountability and transparency is yet another change from our 2003 report.

Second, in every area, however, the current situation is best described as 'work in progress'. The bear market was instrumental in forcing these changes. But there is widespread acceptance that it will take a lot longer for them to be firmly embedded in the fabric of the business. Time, passion and persistence on the part of top executives are critical in this context.

Third, changing the employee mindset to think and act as if they were self employed has taken a long time in other industries. It is about changing the world view of the individual. It takes more than one crisis to alter it. In particular, it requires a pragmatic leadership from the top, as argued later on.

Thinking aloud…

"Our front office people are red in tooth and claw. They sport red braces and short hair cuts. But they remain deeply set in their ways. Their primary loyalty is to their craft, then to their peers and then to their firm.

They are trained to distrust CEOs and CFOs of the companies in which they invest. They take this too seriously and turn it on their colleagues as well, with the result that teamwork is only there in name.

They can be over cynical. Yet they manifest a number of positive traits which we're just learning to capitalize on: like, for example, they value practical leadership over visionary rhetoric; they are intuitive fast thinkers who value autonomy and space.

But, it doesn't help when you've 60 job titles and legacy systems. For example, currently we have two large global clients with seven different mandates. We use seven systems to service these mandates. We should really have one dealing system, one back office system and one client service system.

These legacy systems promote legacy thinking. There's too much 'us-and-them' between the front and back office. We are trying to create a structure in which people can think outside the box. We've got to reinvent ourselves constantly: relationships don't stand still. We can no longer assume that things that worked well in past will necessarily work in future.

Yet, changing things here means first having to overcome every conceivable objection. For example, there still remains a huge resistance to outsourcing because of the prevailing philosophy of 'built here, sold here'. Guaranteed bonuses, inherited from the previous mergers, also act as a big drag on what we're trying to do. Unwittingly, they have created personal franchises.

Yes, we are now making a determined attempt to break the mould. But I am realistic enough to know that converting our aspirations into reality will be a long hard slog. Even implementing a sensible concept, like boutiques – that run with the grain of human nature – will take numerous iterations. It is one thing talking about a self employment mindset, quite another delivering it. When people have been entitled to so many things that were unrelated to merit, anything that disturbs it is viewed with suspicion."

Source: CREATE and KPMG International, 2004 – Interview quotes

Actions: going after low hanging fruits

"Our compensation for alpha managers is based on 360 degree assessment because we want to promote a culture of leadership"

In order to embed the desired cultural traits into everyday business practices, a number of actions are being taken (Figure 5.2).

Figure 5.2 What specific actions are taken to achieve the aspired culture?

Source: CREATE and KPMG International, 2004

"A large part of our bonus pot is deliberately 'gray'; it enables us to reward team behavior as well as performance. We don't use formulae"

Those that are being implemented by at least one in three investment managers include:

- developing a strong client focus through service quality (three in five managers)
- having clear performance criteria for all senior staff (one in two)
- enhancing the skills of existing business leaders (two in five)
- inviting regular client feedback (two in five)
- linking bonus to investment out-performance (two in five).

"There are no dual citizens here. Yes, we've got a different reward system for hedge fund managers: their bonus can account for ten times their base salary. However, 75 percent of their profit goes into the bonus pot reserved for long-only managers"

There are a number of noteworthy points in this context.

First, the above actions have taken precedence over others partly because of their urgency and partly because early results in these areas are deemed essential to embarking on further actions. They are considered necessary but not sufficient. They reflect the priority order.

Second, inviting client feedback is a new development. Although it is on a limited scale so far, it does not detract from two points: it is carried out by investment managers of all sizes; and its results receive far more than lip service. The industry is still a long way away from a situation where its funds are 'bought' not 'sold'. The bear market has decidedly forced deep introspection on this point.

"Bonus is based on performance and discretionary elements: 60-40. The latter takes into account business development and team contribution"

"There are no pyramids here so all the learning points get quickly internalized"

"Our employees think this is their own firm because they have phantom shares under a long-term incentive plan"

"Our boutiques are jointly owned by their managers and the parent company. They invest excess profit into the business because of the ownership structure"

"Our compensation model has an equity participation plan based on phantom shares: 20 percent of staff are in it already. It has upped the ante"

Third, linking bonus with performance is more widespread now than at the time of our 2003 report when only around 20 percent of houses had any link with performance. In so far as investment managers and research analysts prefer formula-based bonus to discretionary awards, this is an important step. However, its implementation has been far from straightforward.

To start with, it has been difficult to get agreement on metrics to be used for legacy funds: even for new funds, it has not been easy to decide whether to use market, peer or some other benchmarks. The formula approach is also seen as limiting senior management's ability to promote qualitative improvements like teamwork, knowledge sharing and better people leadership. The majority of investment managers with a formula-based approach have also tried to include qualitative indicators, without having the necessary tools to measure them. As a result, perceptions of unfairness have not been uncommon.

In any event, many investment managers have deliberately shied away from formula-based bonus for fear of promoting a 'contract mentality' that runs counter to the ethos which they are seeking to promote.

Fourth, either way, most investment managers recognize that an effective incentive system requires an equity-based upside, since most investment professionals are far more interested in their net wealth position than annual income flows. But, for them, having equity participation in the parent company – as is the norm in medium and large houses – is not good enough, since they are too far removed to influence the company's share prices. Even hefty discounts on share allocations have not proved a sufficient inducement.

Instead, they would prefer one of two arrangements: phantom shares in their immediate firm or special units in the funds which they manage, subject to local regulation.

This is unsurprising: if creating a boutique structure is about giving people autonomy and space to generate alpha, then the equity stake also needs to be modeled on what happens in independent boutiques, so the argument runs. Investment managers owned by publicly quoted parents have found this a seemingly intractable problem. How can they explain to the outside world why their own portfolio managers don't want to own shares in them as a special incentive?

Thinking aloud…

"Alpha managers thrive in the craft environment, with all the attendant trappings. One of the principal reasons behind our success is that we run two distinct corporate entities in our business. The first is the 'mother ship' which has its own product portfolio and also the capability to provide shared services to the second entity, which are mini product-centric boutiques with their own P&L responsibilities.

An important feature of these boutiques is that they are jointly-owned by their own managers and the mother ship; the mother ship has a majority stake only when a boutique is a fully developed business whose fortunes are not closely tied to a handful of key personnel. The parent is represented on the boards of individual boutiques but mainly works on the principle of 'management by exception': only intervene when they're doing something stupid! By the same token, it minimizes the hassle of overhead functions by providing them on a shared services basis.

Another feature is that the parent also has the first bite of the cherry when it comes to juicy capacity. So far, it's been a win-win situation: the relationship is characterized by equity stake and supply chain.

Pundits talk about polarization in this industry. If that happens, it won't be so black and white: we shall also see a lot of cross-ownership within it. As in the car industry, our supply chain is becoming very diverse. Our biggest challenge is whether we have the people to manage this level of diversity."

Source: CREATE and KPMG International, 2004 – Interview quotes

Be that as it may, it is clear that this is a major issue, according to our interviews. This is all the more so since there is evidence that a rightly-targeted equity stake has a positive incentive effect. For example, anecdotal evidence shows that boutiques which are jointly-owned by their immediate managers and quoted investment managers are reported in our interviews to have a superior performance over a longer period. They truly epitomize the kind of self employment mindset that mainstream investment houses are now trying to cultivate.

Next steps: toward a strategic framework

“Fix the culture and numbers will follow”

“This is a human capital business; you can’t fudge decisions and strategy”

“Clarity of thinking means clarity of actions”

“Our biggest problem is lack of change management skills; migrating from one model to another is easier said than done”

The global investment industry has begun to move in the right direction; it’s come some way since our 2003 report; but it has a long way to go. Experience of other industries teaches us that culture change is a matter of hard graft, not quick fixes.

In order to sustain the improvement, we present here a simple strategic performance process which has worked well in some of the most successful investment houses around the world (Figure 5.3). Currently, in the majority of houses, such a process is conspicuous by its absence. It is presented here in the spirit that a mature business requires a mature approach.

Its main thrust is dictated by it being a people business; the disciplines needed to run it in good times and bad; and, above all, by the personal and professional traits of alpha generators (as explained in Figure 1.9 in the Executive summary).

Figure 5.3 Strategic performance process

Source: CREATE and KPMG International, 2004

"Corporate politics is corrosive: we need a robust process that depersonalizes the issues and provides a clear road map for actions"

The process enjoins the top executive team of the business to have a regular forum where new business ideas – on clients, products, processes, markets – are generated and subjected to a reality check, in order to decide which ones are worth pursuing. The aim is to make the business more outward looking, while tapping into the collective 'memory' of the business.

This analysis, in turn, is used to generate business goals which form the backbone of the strategy for the near term, along with a clear list of specific actions. The strategy is *emergent*: its implementation allows for opportunism, in order to take into account the changing circumstances and bottom up feedback on the unfolding reality on the ground.

"We've had three CEOs in four years; only one board member has survived the bear market. We're doing a lot but achieving very little"

The strategy also allocates resources for the implementation activities, has clear metrics of outcomes, a monitoring mechanism and, above all, clear individual accountabilities, these are duly backed by a realistic structure of incentives.

Leaders are expected to 'walk the talk' and develop honest convincing answers to the six most frequently asked questions by people in the front and the back office alike:

- direction: what are our business goals and why have they been adopted?
- deliverables: do we have the right caliber people to deliver our goals?
- credibility: do these leaders have the resilience to cope with the unexpected?
- impacts: how will these goals affect me and my immediate colleagues?
- expectations: what is my and their role in delivering these goals?
- motivation: what is in it for me?

"It's hard to leverage our strengths because consensus style leadership has created a stifling bureaucracy"

Answering these questions is an integral part of creating a joined up business and mobilizing all its resources.

"If you put any of our CEOs in front of a team of portfolio managers, they will be torn to shreds"

The process favors a consensus approach at the early ideas generation stage and a hard nosed approach at the later implementation stage. It means having a high wire leadership style: one that avoids trying to please everyone, without micro-management.

In the investment houses where such a framework has worked well, top executives have eschewed the visionary rhetoric that investment professionals so distrust and adopted a strong 'nuts and bolts' type leadership involving:

- business awareness
- organization savvy
- walking the talk
- encouraging creative teamwork
- anticipating problems
- displaying restless curiosity
- asking catalytic questions
- listening and reflecting
- providing honest feedback
- challenging complacency

"Corporate culture is like a giant jelly: unless you shake it hard, it wobbles back to its original position"

This type of engaging leadership style is seen as promoting behaviors that are self regulating on the one hand, and entrepreneurial on the other – as in partnerships or an independent boutique structure.

6 Doing a reality check: what should today's business leaders do?

"I don't give a fig for simplicity this side of complexity. But I would give my life for simplicity the other side of complexity"

Justice Oliver Wendell Holmes (1841-1935)

Ten golden tips

This report has identified the nature of business re-engineering now being undertaken by investment management firms, as they enter the new era of low nominal investment returns. This final section draws together the critical success factors as ten *headline messages*. It also raises three specific questions.

As such, the section is both an *aide memoire* and a check-list of things that need addressing by today's Chief Executives and others who now have the substantive responsibility for designing and implementing the business strategy of their firms.

The check-list, in turn, has been so presented to provide a *'first level'* diagnostic by assessing three inter-related aspects of each message:

- criticality: is the message pertinent to your firm's circumstances?
- implementation: are actions being taken to implement the critical message?
- effectiveness: how effective are the actions that are being implemented?

The main messages are presented individually, each with its own three point self-assessment as follows:

Message 1 Sustainability: the history of change management is littered with failures; unless the re-engineering is hard-wired into business systems and processes, bungee jumps will be inevitable.

	Is this message critical?	Are you doing anything about it?	Is it effective?
Not at all			
Moderate			
Priority			

Message 2 Culture: mindset shifts are usually as durable as the crisis that provokes them; they need to be systemized through a strategic performance process, with its own set of convincing answers to the most frequently asked questions.

	Is this message critical?	Are you doing anything about it?	Is it effective?
Not at all			
Moderate			
Priority			

Message 3 Targets: strategic rhetoric cannot be a substitute for tangible results; a business plan is worthless unless it has short-term measurable or observable targets, accountabilities, reality checks and incentives.

	Is this message critical?	Are you doing anything about it?	Is it effective?
Not at all			
Moderate			
Priority			

Message 4 Integration: seemingly desirable changes like in-house boutiques and performance-based rewards also carry the risk of encouraging a dysfunctional 'us-and-them' mentality as an unintended consequence. Mechanisms need to be in place to minimize this risk.

	Is this message critical?	Are you doing anything about it?	Is it effective?
Not at all			
Moderate			
Priority			

Message 5 Basics: re-engineering should not divert attention from those factors of business which really matter to clients: performance, service, charges, risk and compliance.

	Is this message critical?	Are you doing anything about it?	Is it effective?
Not at all			
Moderate			
Priority			

Message 6 Alliances: It is important to draw the distinction between ‘doing the business’ and ‘running the business’. So, alliances are not just about reducing costs but also about enhancing core competencies as well as business results in the chosen areas of the value chain.

	Is this message critical?		Are you doing anything about it?		Is it effective?
Not at all		→		→	
Moderate		→		→	
Priority		→		→	

Message 7 Reputational risk: branding is no longer just about marketing and advertising. It has to incorporate the value proposition and its delivery in products and services. Senior managers need to live, breathe and manage the brand everyday.

	Is this message critical?		Are you doing anything about it?		Is it effective?
Not at all		→		→	
Moderate		→		→	
Priority		→		→	

Message 8 Paradoxes: change management creates paradoxes in the value chain: e.g. scale vs. scope; focus vs. control; competition vs. collaboration. These require clear communication of the goals and their rationale, in order to minimize the disconnect between different areas.

	Is this message critical?		Are you doing anything about it?		Is it effective?
Not at all		→		→	
Moderate		→		→	
Priority		→		→	

Message 9 Incentives: formula-based bonus is a double-edged sword: in the absence of a culture of leadership, it can promote lone ranger attitudes. Also, equity participation works effectively if targeted at shares whose prices can be influenced by the actions of people in the front office.

	Is this message critical?		Are you doing anything about it?		Is it effective?
Not at all		→		→	
Moderate		→		→	
Priority		→		→	

Message 10 Transformation: so deep seated are the problems that the current re-engineering has a greater chance of creating a variable cost model if it is viewed as a journey rather than a series of fixes, no matter how bold.

.

	Is this message critical?		Are you doing anything about it?		Is it effective?
Not at all		→		→	
Moderate		→		→	
Priority		→		→	

Appendix: list of figures

kpmg.com

For further information on issues raised in this report, please contact:

David Ledster
KPMG LLP (UK)
Global Head
KPMG Investment Management and Funds

Tel: +44 (0) 20 7311 5195
e-Mail: david.ledster@kpmg.co.uk

Professor Amin Rajan
CEO, CREATE

Tel: +44 (0)1892 526 757
e-Mail: amin.rajan@create-research.co.uk

Neil Fatharly
KPMG LLP (UK)
KPMG Investment Management and Funds

Tel: +44 (0) 20 7694 2265
e-Mail: neil.fatharly@kpmg.co.uk

Barbara Martin
Research Manager, CREATE

Tel: +44 (0)1892 526 757
e-Mail: barbara@create-research.co.uk

Please visit www.kpmg.com/financial_services to learn more about KPMG's Global Financial Services practice

CREATE is an independent think-tank, specializing in the emerging business models in financial services. It undertakes major research assignments from prominent financial institutions and global corporates. CREATE's advisors work closely with key decision makers on both sides of the Atlantic. Their work is disseminated through high profile reports and events which attract wide attention in the media.

Produced by KPMG's Global Financial Services practice in the UK. July 2004.

Designed by Mytton Williams.

Printed by Jevons Brown, UK.

208951