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Avoiding 'bungee jumps' in the market turmoil

By Amin Rajan

Businesses need sustainable cost models combined with strong leadership if they are to flourish under pressure

The bear market is here. Even before the sub-prime crisis, many businesses already had subtle 'for sale' signs: they were contemplating their strategies. This is usually a euphemism for saying that they were thinking about either buying their competitors or being bought themselves. One thing is certain: cost cutting has already started, as in previous bear markets.

In the 2000-3 equity bear market, some 40% of fund managers worldwide started taking 'baby steps' towards a variable-cost business model which aimed to deliver organic growth through cost cutting. The received wisdom was that you have to prune your business so that it can flourish again. However, as markets recovered in 2003, the momentum was lost.

A research study that I undertook for the Fund Managers Association in the UK in 1999 produced a counter-intuitive finding: at the height of the bull market in the late 1990s, a majority of fund managers had cost structures that were consistent with a bear market where costs rise faster than revenue. As long as margins remained north of 40%, their implied erosion didn't matter.

The contributory factors were:

- **Lack of focus:** too many products were put on the market, without regard to customer needs, risk exposures or cost economics
- **Unclear value proposition:** beyond some hype on past track record and future possibilities, customers had little idea what they were buying
- **Over-emphasis on FUM:** funds under management became a virility symbol to the detriment of profits, which grew benignly on the back of a virtuous cycle of rising markets, net-inflow of funds and higher charges
- **Growing complexity:** a scalable business model remained a mirage. Size begets complexity; and complexity begets inefficiencies.
- **Lack-lustre performance:** the majority of active managers – especially in big houses – were consistently out-performed by indexed funds over the previous decade, tarnishing their brand amid accusations of closet tracking

■ **Inflated egos:** investment professionals developed an inflated sense of self worth, with more loyalty to their craft than their customers or employers. They could only be retained through equally inflated, and in many cases, guaranteed bonuses. Where there was linkage, it was with FUM rather than performance. None of these problems have gone away.

A VARIABLE COST MODEL

Fund management has gone from a craft industry to a mass-market industry in record time and has been unable to foresee and respond to transitional problems. Other industries have experienced similar growing pains.

For example, the motor car industry had the same problem as it went from craft production to mass production in the last century. In order to succeed, small producers like Toyota and BMW had to invest in lean production tools that combined the advantages of both modes of

CASE STUDY: DEPUTY CHAIRMAN OF A UK FUND MANAGER

"With hindsight, our cost problems came from four sources.

We had a strong star culture which was very expensive. Many were on guaranteed bonuses, because it was crucial to retain them in order to raise the comfort level of pension consultants and attract new business.

We had too many products because we needed to parade some outstanding successes in the shop window. We ended up with a lot of segregated funds which raised our back office costs. Our IT systems were

not as scalable as we had been led to believe.

We did a lot of benchmark-hugging to the point where pension trustees began to question the worth of active management. We had undermined our existing revenue streams without realising it.

Worst of all, we did not have strategic leadership. Organic and acquisitional growth powered us into the global league with strong presence in all major regions. But we did not have the management bandwidth to manage it."

Source: CREATE-Research

production, while avoiding the high cost of craft production and rigidities of mass production. They also needed tools that promoted a shift in employee mindset, from efforts to results.

Our latest research study, sponsored by Citi, has found that, as markets have tumbled, a number of investment firms have dusted off their old blueprints for:

- converting as many fixed costs into variable ones as possible
- linking costs to the level of business activity and
- shrinking total costs.

The tools used in the process involve:

- outsourcing back office and, to a lesser extent, mid and front office functions
- re-centralising non client-facing activities in fewer platforms and turning them into centres of excellence
- integrating overhead functions like finance, HR and IT at the parent company level
- linking pay and bonus to performance – corporate as well as investment.

What are the chances of success? Experience shows that corporate changes are as durable as the crises that caused them. Fund houses are renowned for performing bungee jumps: boldly rushing in reforms when a crisis erupts, but quietly reverting to the old ways when markets recover. For reforms to be sustainable, effective leadership is vital.

LEADERS MAKE THE DIFFERENCE

Cost-cutting measures alone do not create a resilient business. Indeed, if mishandled, some can do more harm than good. For example, the benefits of performance-based bonuses are not widely accepted, nor are those of platform integration, despite their inherent appeal.

The success of cost-cutting initiatives depend upon how they are handled. They require leadership that enables top executives to shift employees' mindsets;

- from personal entitlements to business performance
- from short-term personal gains to long term business viability.

Fund managers need a culture that sets challenging goals and motivates staff to achieve them – and holds senior management accountable for the outcomes.

These requirements are making more demand on the business acumen and instincts of top executives than ever before. They are clearly capable people, but the new market dynamics have raised the bar. Business leaders need to be more than great investment professionals; they must also know how to incentivise investment professionals within the new culture.

Two trends are emerging, one more than the other. The most evident trend is to link fund managers' bonuses with the performance of the funds that they are managing, as well as that of the business overall. There is also a tendency to phase out the guaranteed bonuses that prevailed under legacy arrangements.

The other, less notable, trend is to give equity stakes in the business to help shift employees' mindsets towards long-term business viability. This can involve awarding shares of the parent company only; alternatively a cash pot is used to buy shares in other businesses in addition to the parent company. Such shares are then managed by the in-house fund managers.

The first approach links investment professionals to their business. The second one partly does the same, and also enhances employees' overall wealth.

LASTING CHANGES

It is too early to pass judgement on these approaches, but they emphasize that firms are trying a number of approaches to create a high-performance business culture within a cost-cutting environment.

Necessary though it is, cost cutting is not enough. It ensures survival, but not differentiation. How the cost cutting is done is just as important as what is done. Only lasting changes will deliver a business model that can cope with feast and famine. Only leadership will deliver lasting changes. Neither is much in evidence yet. **TFB**

AMIN'S ADVICE

Tips and checklists for CEOs, CIOs and COOs:

- **As investment management has gone from growth to maturity, cost and risk control have become key to survival; however, this alone cannot ensure success.**
- **Success will depend upon performance and service quality delivered on the back of business basics; investors' expectations are adaptive of past losses, so deeds matter more than words**
- **Investment, operational and reputational risks have become ever more dynamic; the challenge is to manage the business in an uncharted environment**
- **Competition is driving consolidation; but M&A should complement, not substitute, the actions towards a variable cost model; strategic positioning in the emerging polarisation is vital**
- **As the business takes off, the law of unintended consequences produces black holes; they dilute the economies of scale and scope alike; they sap scarce dollars and emotional energy**
- **The sacred cow of pay and bonus is long overdue for slaughter. Greed is destroying the economics of the business; customers have wised up, as have the regulators and the media**
- **The old ways of doing things are a recipe for disaster. Equally, the new ways are daunting; so senior people need more mental agility, emotional resilience and personal rapport than before.**

Globalisation of Funds, 2007 is available free from www.create-research.co.uk