

## Revolutionary Shifts, Evolutionary Responses: Global Investment Management in the 2000s

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## Acknowledgements

This study is the result of a collaborative effort between the think-tank CREATE and KPMG International.

This is the most comprehensive study of its kind to canvas the views of so many key individuals and firms in 20 countries around the world, during this substantial period of intense market volatility.

Our foremost thanks go to the 185 investment management firms and their senior executives who participated in the surveys, collectively managing nearly 19 trillion Euros in 2003.

We are also particularly indebted to the CEOs and CIOs from the 60 firms who participated in the follow-up face-to-face structured interviews. They provided rich insights into the industry's recent trends and future prospects. Their unstinting support is yet another indication of how the global investment management industry is keen to learn lessons and thereby send a strong message for a successful future.

We would also like to thank colleagues around the world who have helped us in carrying out this research. In particular, Jenny Latham from CREATE, and Alastair Barbour, Tom Brown, John Capone, Nick Hopwood, Dave Seymour and Scott Wallace, at KPMG.



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The views and opinions expressed herein are those of the authors and do not necessarily represent the views and opinions of KPMG member firms.

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

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## Introduction

This unique global survey doesn't hold back in its views – nor did the participants in giving us their insights.

The long-term future looks bleak for many in the global investment management industry. With 40 percent of firms predicted to report a loss in 2003, the short-term will be challenging, too. Hard choices need to be made: many firms will be sold or be forced to change radically.

However, investment managers will always have a key role to play in the global financial markets going forward. Indeed, as governments look increasingly to encourage individuals to save for their own futures, and as private pension provision is increasingly called upon to cover lengthening retirement years, this role will only become more vital. That is why the industry must deliver.

Our findings suggest that there are fundamental choices to be made: either go global or become an effective niche player. It is clear that some firms are positioned to ride out the storm and succeed in the long-term. The rest need to change their culture and business model or merge or fail.

### The respondents

Representing funds under management of nearly 19 trillion Euros, this research from a balanced cross-section of the industry is the most comprehensive study of its kind (see table opposite). It presents the condensed views of senior executives of 185 investment management firms in 20 countries on the state and future direction of the global industry. This peer group discussion – including most of the top 100 investment management firms – produced fresh insights and frank views on:

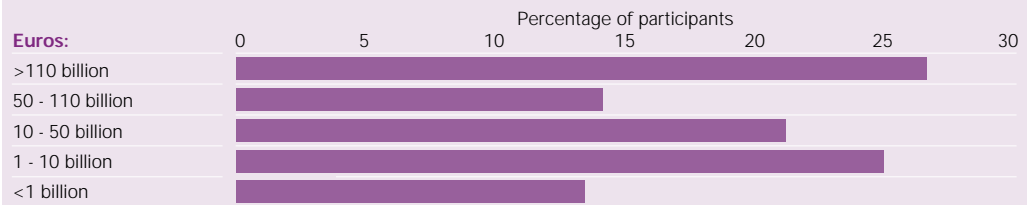
- the nature and scale of changes in the global industry
- their response to massive falls in business volume and profits
- essential actions to get this business back on track.

This is the second in a series of reports produced jointly by CREATE and KPMG International. This report augments our previous work through a postal survey and structured face-to-face interviews with CEOs and CIOs from 60 firms, as mentioned in the Acknowledgements page.

### Participating countries

Australia	Japan
Austria	Luxembourg
Belgium	Netherlands
Denmark	Norway
Finland	Portugal
France	South Africa
Germany	Spain
Iceland	Sweden
Ireland	UK
Italy	United States

### Funds under management of participating firms



Source: CREATE and KPMG International, 2003

## Key forces for change

Our findings clearly show that a step change is needed in the way investment business is run. Market dynamics are reshaping, driven primarily by:

- **demand:** disillusioned customers are demanding better performance, a brand they can trust and effective management of risk
- **supply:** firms are focusing on improving the economics of their product range
- **market structure:** M&A deals feature strongly in the continuing consolidation trend
- **innovation:** the raft of new regulation threatens innovation, while firms are diversifying into other parts of the investment value-chain.

## The winning approach

Who will make it through to the next generation? Our survey suggests that the survivors of the present harsh cycle of change will be those firms which:

- **deliver on their promises**
- **fill the strategic vacuum**
- **run the business like a business**
- **go for disciplined growth**
- **provide effective leadership**

The rest of this report explores these challenges and highlights the responses that are called for.

# 1 Executive summary

*"There is at least one point in the history of any company when you have to change dramatically to rise to the next performance level. Miss the moment and you start to decline."*

**Andrew Grove, Chairman, Intel**

## What are the aims of this report?

Against the background of the longest bear market since the Second World War, this report:

- identifies the nature and scale of changes that have occurred in the global investment management industry
- highlights the responses of individual firms to massive falls in business volume and profits
- underlines further actions that can help their executives to manage the business like any other business: from peak to trough to peak.

As millions lost billions, customer confidence has nose dived. The longest bull market in living memory propelled the industry from growth to maturity in record time. It also concealed the emerging fault lines.

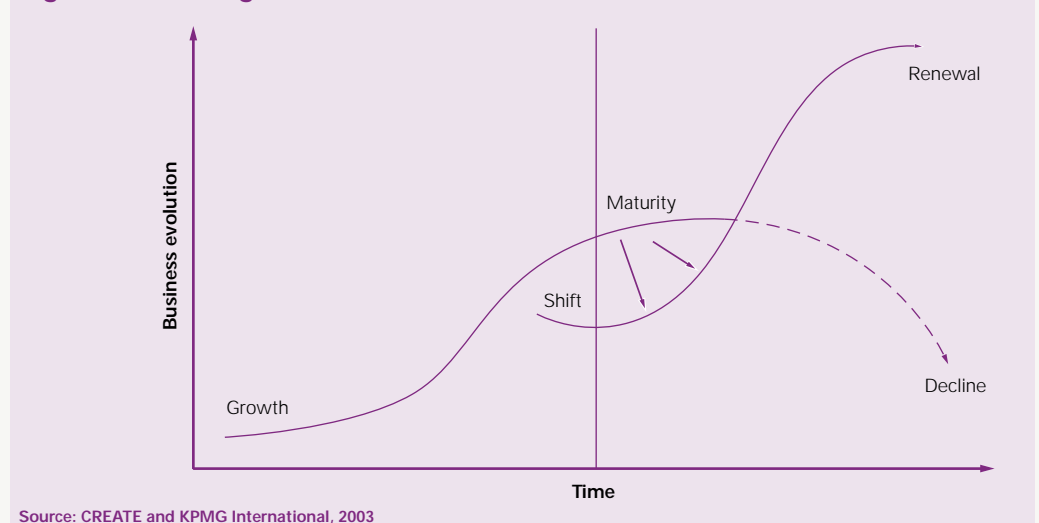
The bear market, in turn, has caused a paradigm shift, requiring painful adjustments. For most firms, the choice is clear (Figure 1.1):

- create a new business model to get on the renewal curve, or
- remain as they are and face terminal decline.

The adjustments dictate that:

- profits matter more than sales
- operational efficiency matters more than bells and whistles products
- business viability matters more than individual egos
- assets under management is not a measure of success.

**Figure 1.1 Strategic choices: renewal or decline?**



## What are the fault lines?

The emerging fault lines in the industry have resulted from:

- **lack of focus:** too many products were launched without regard to customer needs, risk exposures and cost economics
- **unclear value proposition:** the proposition on investment and service was either unclear or not fully honored
- **over emphasis on Funds Under Management (FUM):** profits became an arithmetic certainty on the back of rising markets and relatively fixed charges, to the detriment of efficiency
- **inability to scale:** size begat complexity, complexity begat inefficiencies in many large firms, where diseconomies of scale kicked in early
- **under performance:** a majority of actives were out-performed by the passives over a long stretch; yet they continued to earn higher charges; many were 'closet' trackers
- **inflated egos:** pay escalated; bonuses were either guaranteed or linked to FUM; irrespective of merit, fame and fortune became another certainty
- **concealed tribalism:** rapid growth created bottlenecks, giving rise to a blame culture between front, middle and back offices
- **strategic vacuum:** business strategy had more hype than content; it happened on the hoof, with no reality check
- **leadership vacuum:** as many investment professionals turned into business leaders, the buzz of the investment function was often confused with leadership.

While investment management companies have recognized these failings and are seeking to address them, the marketplace in which they operate has demonstrated many deficiencies as well. Consumers were mesmerized by the relentless rise in equity prices and became undiscerning in evaluating many products. The trustees' approach to managing billions of pension fund assets started to creak as investment returns turned negative, exposing the true risks.

Regulatory and accounting rules came under scrutiny as investment risk became a real issue for the first time for many years. How to present information clearly to quantify these risks is a matter of hot debate, as for example, the new Accounting Standard in the UK has demonstrated. Investor education remains a critical issue for governments and the industry.

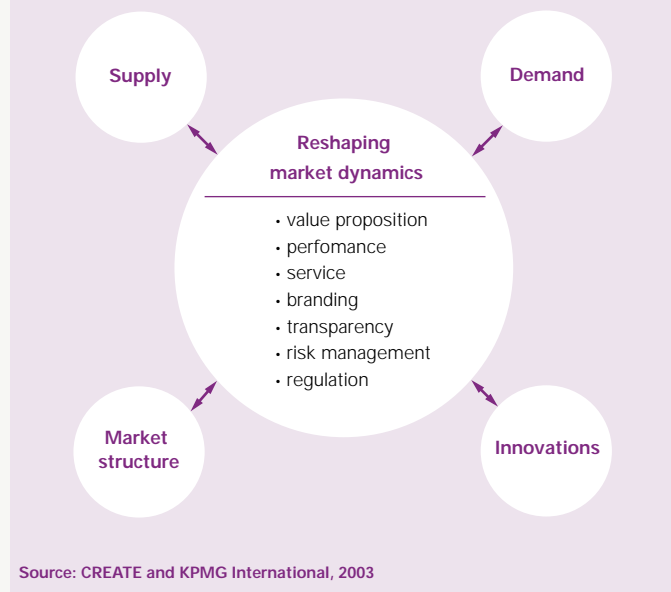
## So, what is happening now?

Against this background, market dynamics are being reshaped markedly.

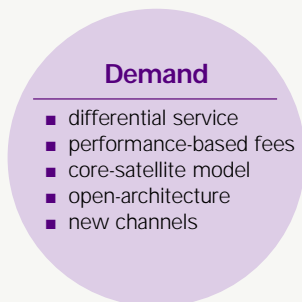
Huge disillusionment has made customers in institutional and retail markets worldwide ever more demanding of their investment managers; they want (Figure 1.2):

- a deliverable value proposition
- higher and consistent performance
- quality service
- a brand they can trust
- a transparent investment process
- effective management of risks
- full compliance with increasing regulation.

**Figure 1.2 Market dynamics: An overview of key changes**



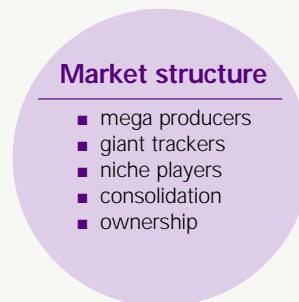
The new dynamic is driven by four sets of forces:



On the demand side, customers are seeking higher or absolute returns, realistic charges, good levels of service and choice of suppliers. In particular, institutional investors are favoring specialist mandates and transparent fees; retail customers are seeking clarity of product, value for money and greater transparency. Both groups have become more discerning.



On the supply side, firms are being forced to focus their capabilities in order to improve the economics of their product range, venturing into white labeling where possible. In pursuit of focus, the long prevailing tension between manufacturing and distribution is highly visible, as is the unsustainable cost base, which is being tackled.



Consolidation remains evident. M&A deals are still a strong feature, reflecting: the need to create critical mass; the problems in migrating to a different business model; and divestments by banks and insurance companies, with brands tarnished by low performance.



In contrast, genuine product innovation is less evident. Instead, there has been significant diversification into hedge funds, real estate, private equity, and guaranteed products. Exchanged Traded Funds (ETFs) are set to grow in Europe, following their popularity in the US and Japan. European expansion remains a goal for most businesses, but substantial progress remains challenging.

## What are the key imperatives now?

They are:

- **hard deliverables:** investors want a new deal before they come back in numbers; so the clear message is: say what you mean, mean what you say, and deliver it
- **business model:** run the business like a normal business; a model that only works in a raging bull market is a recipe for disaster
- **strategic actions:** tackle the diseconomies of scale and create a cost effective business that is resilient to extreme and endemic volatility
- **business leadership:** recognize that the days of the "gifted amateur" as a business leader are over; today's senior executives need to be much more than great investment professionals.

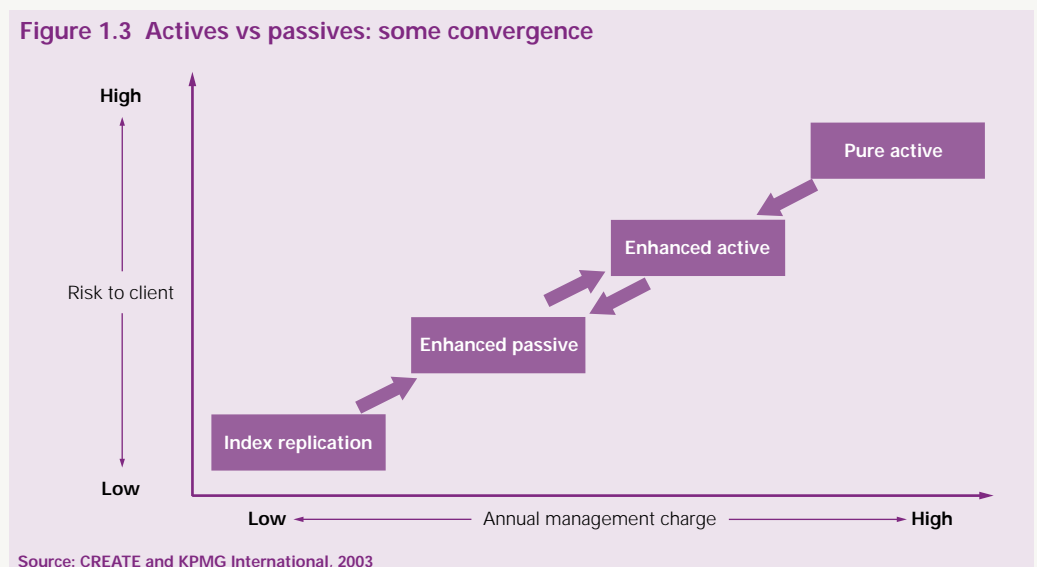
But that is not all. A whole raft of new regulation is moving ever closer which will force notable changes in the conduct of business. In the USA, for example, the SEC is reviewing: how the products were offered, how fees are determined, how directors are chosen, corporate governance and financial reporting and how managers are paid. In the UK, two wide ranging Government-sponsored inquiries also envisage changes in business conduct, and product pricing. The EU, too, is planning to be active with new directives. There is, doubtless, a serious risk of over complexity in both procedures and products that consumers already find confusing.

## So, how is the business being re-engineered?

By tackling some of the deep-seated problems in the corporate boiler room.

The green shoots of change are there. So far, cost cutting and product rationalization have topped the list.

Some 80 percent of firms have focused strongly on costs since the start of the bear market; 60 percent have reduced them by up to 20 percent; the rest by even more.



In descending order of importance, the brunt has been borne by: headcount, bonuses, sell-side services, marketing and advertising, office accommodation, travel and entertainment. Even so, anything up to 40 percent of firms may end up reporting a loss in 2003.

There has also been notable rationalization of products; many funds have been merged in order to reduce marketing and processing costs, as well as eliminate their poor track record. But there is still a long way to go in this process. Medium and large firms are also diversifying in each other's areas, especially in the institutional market (Figure 1.3).

For the majority of firms, however, these actions have been tactical:

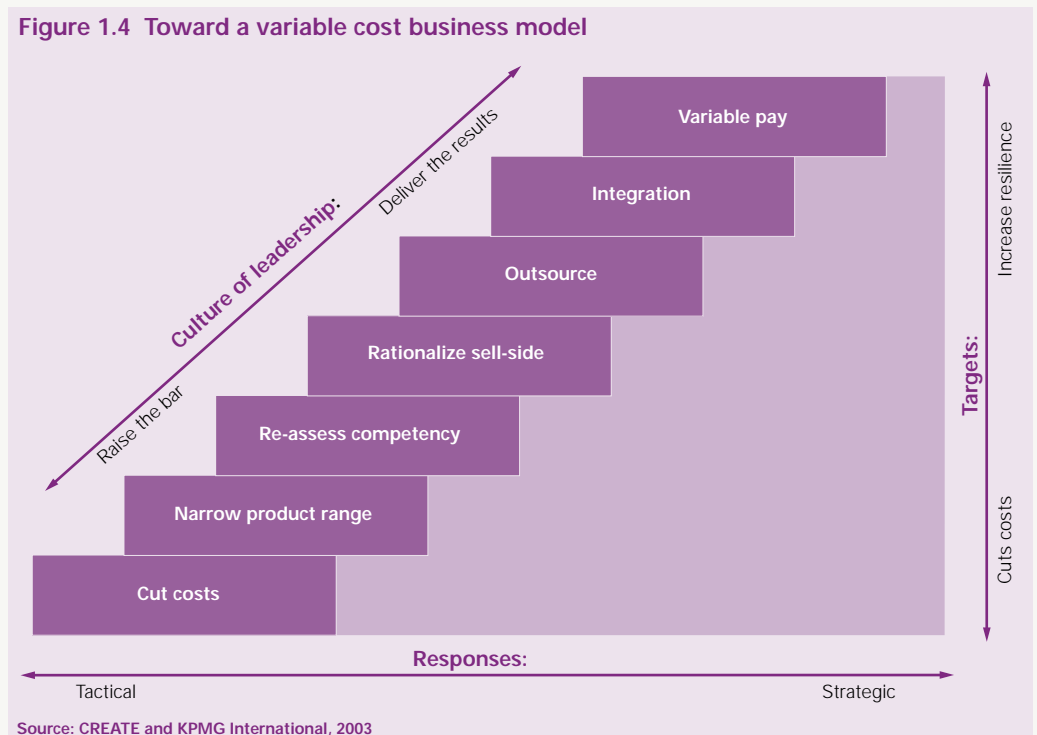
- they aim to score quick wins on the bottom line
- they appear to tackle symptoms more than causes.

Hitherto, their scale and scope had been modest, since only a minority of firms had expected the bear market to last beyond 2001. In any event, parent companies were there to lean on.

But the new market rout at the beginning of 2003 ushered in Darwinism with a vengeance. Serious introspection overtook entrenched complacency.

One in five firms have used early tactical responses as a springboard for strategic actions that seek to convert more and more of fixed costs into variable ones (Figure 1.4).

Firms are forced to live with endemic volatility. That means building a capability that can withstand extremes of fluctuation with no discernible impact on the cost base, as has been the case in other industries, like oil.



## What does a scalable variable cost model involve?

Doing far more than cutting costs, streamlining the product mix and re-assessing core strengths.

Specifically, it requires the adoption of five strategic tools of *lean production* that have long underpinned business resilience in other volatile industries:

- outsourcing of non core activities
- centralizing more and more of the remaining activities in ever fewer platforms
- integrating across geographical and functional areas
- linking pay and bonus to stellar performance – investment and corporate
- creating a culture of leadership that shifts the employee mindset:
  - from entitlement to performance
  - from short term personal gains to long term business viability.

Steps are evident in each of these areas in a small minority of firms. Elsewhere, the mindset shifts are conspicuous by their absence.

## How far has outsourcing gone?

It has been a matter of more haste, less speed.

Back office activities have been the main target: up to 60 percent of firms are outsourcing one or more of them, depending upon the degree of standardization of these activities.

Other areas of the value chain are much less widely targeted. But there are early signs of change: private banks are outsourcing some of the front office activities such as stock selection; pension consultants are undertaking significant asset allocation work as part of the manager-of-managers arrangement; the spread of open architecture is also drawing specialist distributors into the value chain.

However, certain inter-related obstacles still persist. They include:

- lack of credible service providers with irresistible offerings
- negative perceptions of outsourcing on the part of final customers
- different regulatory regimes, especially in Europe, preventing standardization
- lack of experience on the part of the core team in managing external relationships
- the conviction that front office activities are the core of the business.

Many firms recognize the need to tackle the sources of cost pressures head on rather than seek to export them to a third party, which can lead to even more fundamental issues.

Also, there seems to be more enthusiasm for setting up joint ventures with other investment houses than outsourcing to firms lacking long track records in activities outside the back office.

## What has centralization involved?

Two sets of things.

First, putting activities in the whole value chain on ever fewer platforms in order to reduce costs and create distinct centres of capabilities that are in line with the emerging core-satellite model. The majority of firms are centralizing one or more activities in the value chain; especially those that do not involve direct contact with customers.

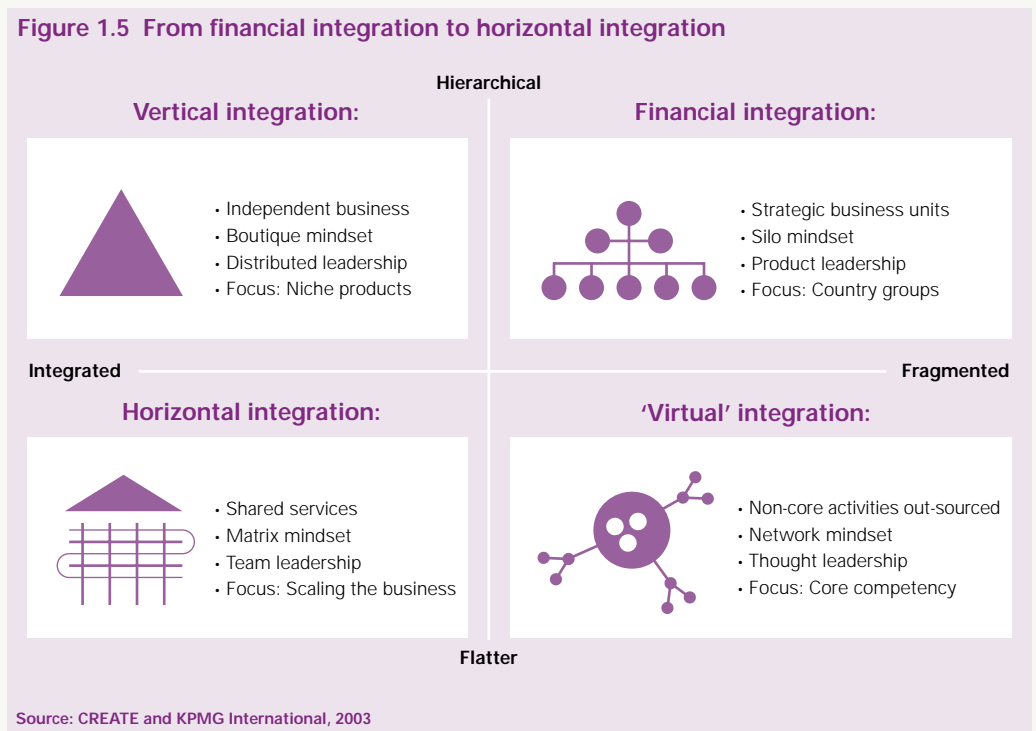
Second, adopting a matrix-based model of horizontal integration in many medium and large firms to achieve (Figure 1.5):

- **corporate integration:** sharing services with the parent company in generic areas like finance, marketing and HR
- **geographical integration:** jettisoning the country structure and running all operations on fewer platforms in fewer regions.

Integration is being largely driven by parent companies who are seeking to assert greater control over their investment subsidiaries. One in three firms in our sample has adopted a matrix structure. Over the next three years, it is likely that three in every five subsidiaries will go down this route, if they remain undivested. The days of unbridled independence are likely to be over before long: firms will no longer be set financial targets and left alone to achieve them. They will be increasingly absorbed by their parent companies through shared services.

Inadvertently or otherwise, both sets of changes thus far have created the perception of unwieldy bureaucracies that stifle initiative and delay decisions.

The core team may not have the mindset agility to cope with the move from financial integration to horizontal integration. Likewise, investment professionals find it hard to defer to the hierarchy and etiquette of multiple reporting: their gut instincts are tuned to the boutique environment. Tensions are evident. New mindsets and new skills are vital.



## How is variable pay being implemented?

Slowly and hesitantly.

In 2003:

- four out of five firms have cut their payroll budgets; with staff cuts bearing the brunt
- two in five have also sought to link bonus payments to either individual or team investment performance, thereby severing the link with FUM.

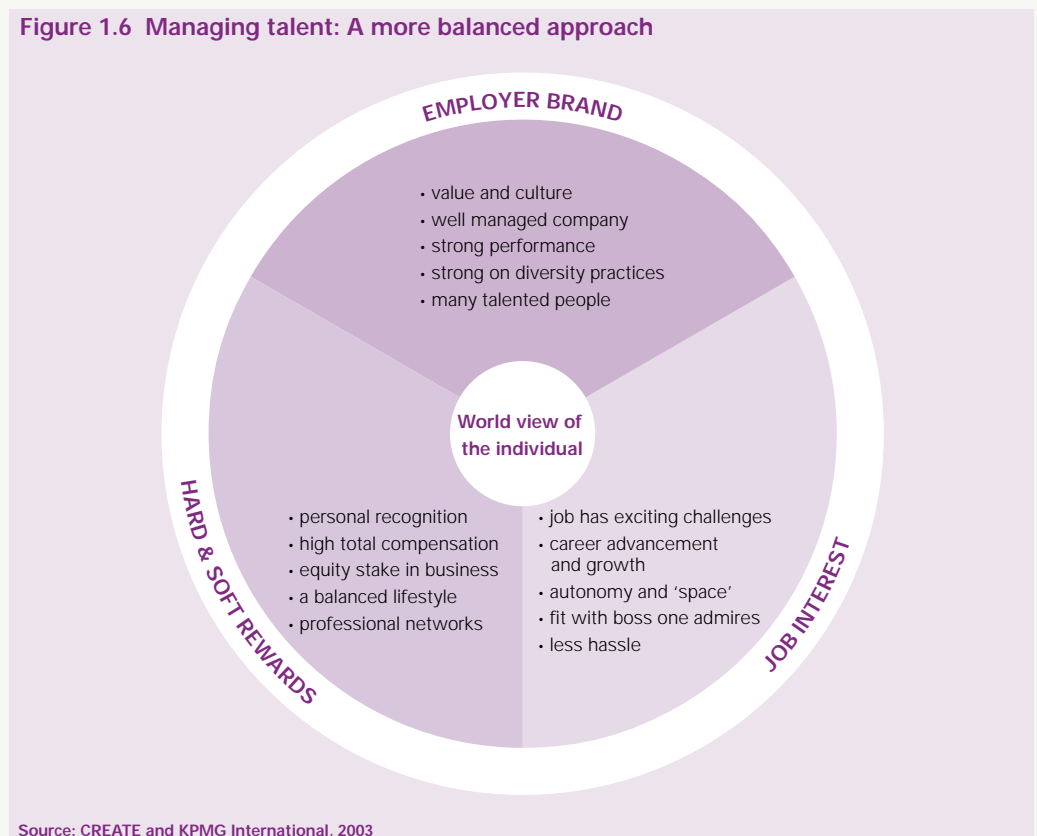
Furthermore, a small minority are in the process of ending guaranteed bonuses: the true number proved hard to quantify.

Yet there was agreement on one point: the reward system is the 'sacred cow' of investment management: compensation accounts for between 50 and 65 percent of costs. Yet, even in the fourth year of the bear market, fear of high attrition is cited as a major inhibitor of change! In the majority of firms, pay and bonus remain resistant to radical change.

But in one in every three firms, there is some 'work in progress' on one or more of four options:

- having low fixed base pay and higher variable bonus
- linking bonus with out-performance over more than a year
- offering equity stake in the business as a part of the bonus system
- emphasizing non financial elements in the reward system (Figure 1.6).

**Figure 1.6 Managing talent: A more balanced approach**



The emphasis on non monetary elements is a deliberate one. It serves to drive home two messages. First, extravagant cash payments were a feature of a *'feast and famine'* culture, which is unsustainable in a world of low nominal returns that is here at least until 2005. Second, the intangible benefits are an essential feature of a resilient business that also puts emphasis on job satisfaction and career progression.

However, the high and consistent performance demanded by institutional and retail investors will continue to sustain some element of the 'star culture'. The single biggest challenge for individual firms is how to change the perceptions of investment professionals as a group about their self worth. It requires a culture of leadership to determine who to reward, by how much and in what manner.

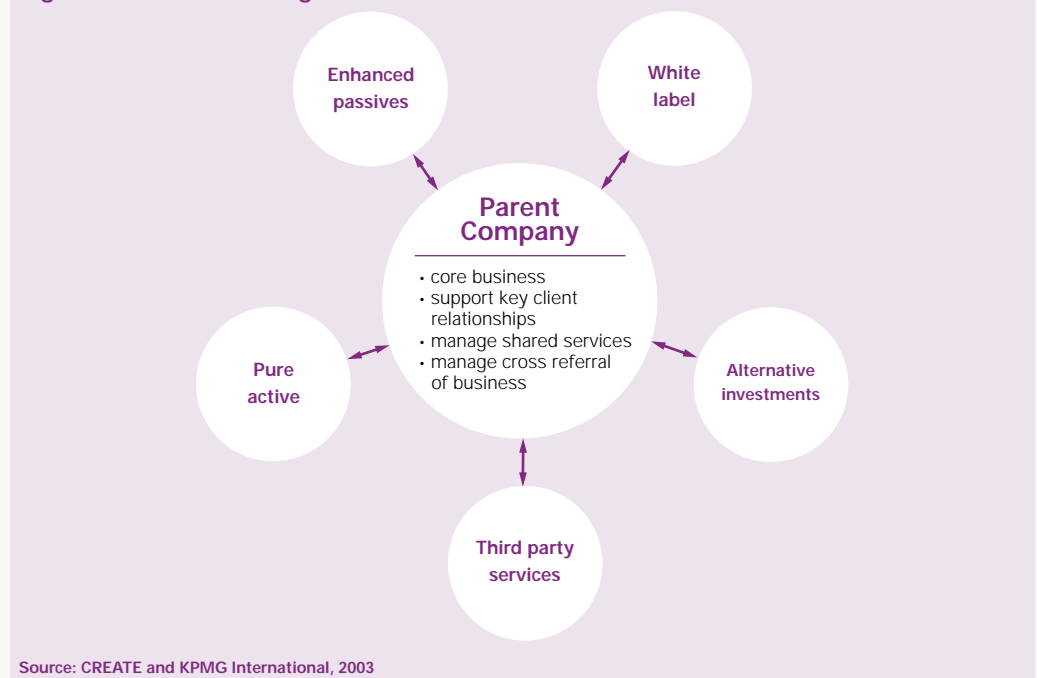
### Has anyone achieved a variable cost model?

Yes, near enough.

We summarize the experiences of two of them in Section 5. Each has developed strong internal cultures, too; duly recognizing that a quick fix on compensation and benefits alone is not enough.

Another feature is that individual businesses are treated as independent entities with their own brand; these entities are jointly owned by their managers and the parent company (Figure 1.7). Management and ownership clearly overlap; as do independence and integration.

**Figure 1.7 Model of integration and differentiation**



## Finally, what about the culture of leadership?

It is about providing a strategic orientation to the progression charted in Figure 1.4.

The fault lines exposed by the bear market are systemic. They require the top team in individual firms to undertake one or more of five overlapping activities, each requiring a number of leadership attributes (Figure 1.8).

Everyone finds change painful; investment managers are no exception. To manage it effectively, the top team needs to be proactive so that they can provide convincing answers to the four most frequently asked questions in any business transformation:

- **direction:** where are we going, what are our goals?
- **deliverables:** do we have business leaders and senior crew to deliver them?
- **local impacts:** how will the goals affect individual staff and their immediate colleagues?
- **motivation:** what's in it for me?



The required level of proactivity is far from evident. Even industry leaders themselves reckon that there is a notable leadership gap at present (Figure 1.9). In too many firms, it remains everybody's concern but nobody's clear cut responsibility.

Elsewhere signs of change are evident: two in five firms are doing something to help their top teams to enhance their skills; and one in three is recruiting these skills from outside. The aversion to having non investment professionals as business leaders is still widespread, but it is weakening.



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

- **qualifiers:** as industry has gone from growth to maturity, basics such as efficiency, cost, risk management and regulatory compliance have become the key to survival; by themselves, though, they cannot produce success
- **differentiators:** success will depend upon performance and service quality delivered on the back of excellence in business basics; investors' expectations have changed in the light of past losses, so deeds matter more than words
- **paradigm shift:** the shifts in demand, supply, market environment and product mix are changing the face of the industry, against the background of huge volatility; firms need to have increased flexibility in the way they do things
- **regulation:** necessary though it is, regulation will raise costs, create more hassle and restrict initiative; through their industry bodies, firms need to use their collective clout to ensure that the impending measures are sensible and practical
- **risk:** investment, operational and reputational risks have become even more dynamic; the challenge is to manage the business with ever changing risk exposure
- **structure:** competition is driving consolidation; but M&A should complement, not be a substitute for taking actions towards a variable cost model; strategic positioning in the emerging polarization is vital
- **scale:** the law of unintended consequences produces black holes, such as uncontrolled compensation, as the business takes off; they dilute the economies of scale and scope alike; they also sap scarce dollars and emotional energy
- **panaceas:** outsourcing and centralization are not the solution to everything; they can reduce costs only so long as they are packaged as a part of a strategic approach that implements actions on other fronts
- **compensation:** the 'sacred cow' of pay and bonus is long overdue for a radical rethink; greed can destroy the economics of any business; customers have wised up, it is now a focus for the regulators and the media
- **leadership:** the old ways of doing things are untenable; equally, new ways are daunting; senior executives and investment professionals need far more innovative thinking, emotional resilience and personal rapport than ever before.

## 2 A paradigm shift: what are the imperatives for survival?

*Investment management went from growth to maturity in record time.*

*The worst bear market in living memory exposed the fault lines and shattered customer confidence.*

*Regulators are now casting a worrying shadow of further complexity.*

*Running the business like a business has become the pre-condition for survival, even when markets recover.*

## Millions lost billions

### **Interview quotes:**

The euphoria of the 1990s attracted a huge inflow of funds from institutions and individuals alike. The dot.com mania was one factor. The other was more deep-seated: the growth of defined contribution schemes.

*“In the 1990s even a monkey couldn’t fail”*

The pension reforms that started in the US with 401K plans spread to Europe: countries like the UK, the Netherlands, Sweden and Denmark began to liberalize their pension markets on a scale that created a new breed of investors. Their ranks were further swollen by new tax-efficient instruments.

*“Clients fall into two categories: frustrated and horrified”*

Together, they brought into being a new generation of buy-and-hold investors, who helped to fuel the longest bull market in 70 years. All that ended abruptly with the bursting of the dot.com bubble in March 2000.

*“We sold dreams and delivered nightmares”*

Initially, this was viewed as no more than a long-expected market correction, according to many CEOs and CIOs of the major investment management firms who have participated in our research.

*“Tolerance for error and under-performance diminishes by the day”*

Before long, however, the correction turned into a rout, as other developments began to take their toll: economic recession in the OECD countries, the 9/11 terrorism in New York, the high profile accounting scandals at former titans such as Enron and WorldCom, and evidence of serious mis-management at numerous corporate icons on both sides of the Atlantic.

*“People’s expectations are adaptive; losses of the past three years have made them more pessimistic”*

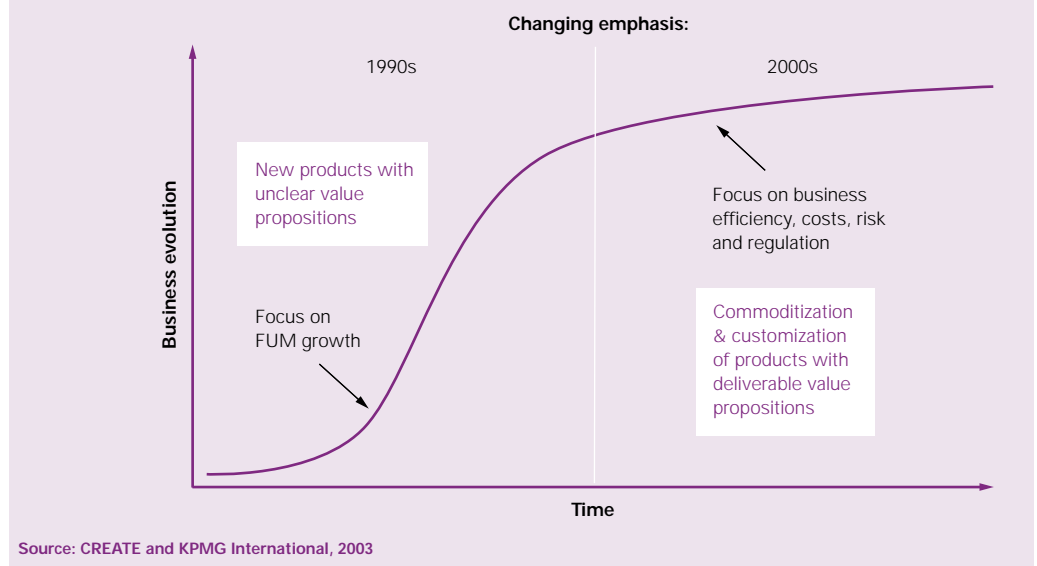
For investors, the results have been catastrophic. According to estimates compiled by one of the investment managers participating in this research, Europe’s leading companies now have a shortfall of at least 500 billion Euros in their DB pension fund assets; and individuals are nursing losses of over 250 billion Euros. The numbers are even more staggering in the US.

*“On both sides of the Atlantic, the affluent got badly burnt”*

Never have so many lost so much in so short a time. The breadth and depth of the resulting disillusionment amongst investors have no precedents in the post-War period.

It was a crushing end of a dream for a generation who had been enticed to believe that stock markets had the magical power to do what governments could not: deliver decent retirement pensions. Few saw it as a zero sum game: where winners win only because losers lose, as in the game of poker.

**Figure 2.1 Going from growth to maturity: A stylized path**



*“The industry will be in a nominal return environment for the next five years; so efficiency is the key”*

*“We all know what should be done, but don’t have the will to do it. There are usually 1000 reasons why we shouldn’t do the right thing”*

*“At least 40 percent of fund managers are losing money in Europe and Japan; it’s less so in the US because costs are more variable”*

*“The bull market served to delay difficult choices and decisions; the consequences have been painful”*

*“Nothing fundamentally different is happening; everyone is praying for the markets to recover. I have no faith in business leaders to do anything else”*

Now it has all changed. There is little doubt that the investment management industry has entered a new phase (Figure 2.1) where:

- profits matter more than volume
- actions more than words
- business efficiency more than bells and whistles products
- business viability more than professional egos.

## Premature maturity: the death of common sense

These shifts need to be put into context.

It took industries like auto, oil, and pharmaceuticals over 50 years to acquire a global orientation in terms of clients, markets, ownership and production facilities. Investment management achieved something similar in a third of that time, thanks to a raging bull market.

Although it still remains a cottage industry in many respects, over-rapid growth concealed many structural weaknesses. It also projected the seductive image that the industry had the deliverables envisaged by the nascent pensions revolution. The market collapse of the last three years has not only exposed these weaknesses. It has also revealed the role of other players in fueling the euphoria.

Let us start with principal weaknesses, as identified in the post mortems carried out by CEOs and CIOs participating in our research:

- **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 were not presented with clear value propositions on performance or service.

### Thinking aloud...

*"Today's average DC plan holders think no differently from our grandparents, who saved a pot of money, sought to protect it by putting it in a savings account, and watched it grow, and then used it to meet their family needs.*

*But what they get is very different. They're encouraged to track S&P or FTSE because benchmark hugging is in fashion. Or they're sold a product which provides better relative returns.*

*In the process, the plan holders move away from their original aim of protecting and growing their wealth for rainy days. Worse still, nobody tells them that relative returns in a bear market do not buy grocery!"*

Source: CREATE and KPMG International, 2003 – Interview quotes

*"Our mainstream business is ex-growth"*

*"It was the greed of the investors that drove the market."*

*"The collapse of confidence is far greater now compared to 1973-74"*

*"People's wealth has nose-dived and with it their confidence in their fund managers. In the meantime, fund managers, consultants, IFAs and pension fund trustees are all blaming one another"*

*"What pension trustees pay consultants is protection money, nothing else"*

- **over-emphasis on FUM:** funds under management became a virility symbol to the detriment of profits. The latter grew benignly on the back of a virtuous cycle of rising markets, net-inflow of funds and higher charges
- **inability to scale:** costs grew faster or in line with revenue; a scalable business model remained a mirage. In large houses, quite perversely, diseconomies of scale kicked in fairly early. Size brought complexity; complexity produced inefficiencies
- **lack-lustre performance:** the large majority of active managers – especially in big houses – were consistently out-performed by indexed funds over the last decade, tarnishing their brand amid accusations of closet tracking
- **inflated egos:** investment professionals developed a hugely inflated sense of self worth as indices rocketed, with more loyalty to their craft than their customers or employers. Being intrepid job hoppers, they could only be retained through equally inflated and, in many cases, guaranteed bonuses. Where there was linkage, it was with FUM rather than out-performance.

Quite simply, the business was not run like a business; it was only sustainable because the markets were powering ahead with seemingly unstoppable momentum.

Equally, in retrospect, it is unwise to ignore the role of other key players who help to create this illusion of a cash cow.

To start with, it is clear that many pension fund trustees did not realize how debatable it was to cater for their future contractual liabilities by targeting the bulk of their assets on a potentially volatile class of assets: equities. The same can be said of pensions consultants, who had mandated the equity funds year after year to large recognized brands with limited reappraisal of asset allocation strategies.

In their eagerness to wean tax payers off the state schemes and into DC plans, governments did not highlight the risks involved in aligning the future livelihoods of citizens to the volatility of stock markets.

## The new mantra

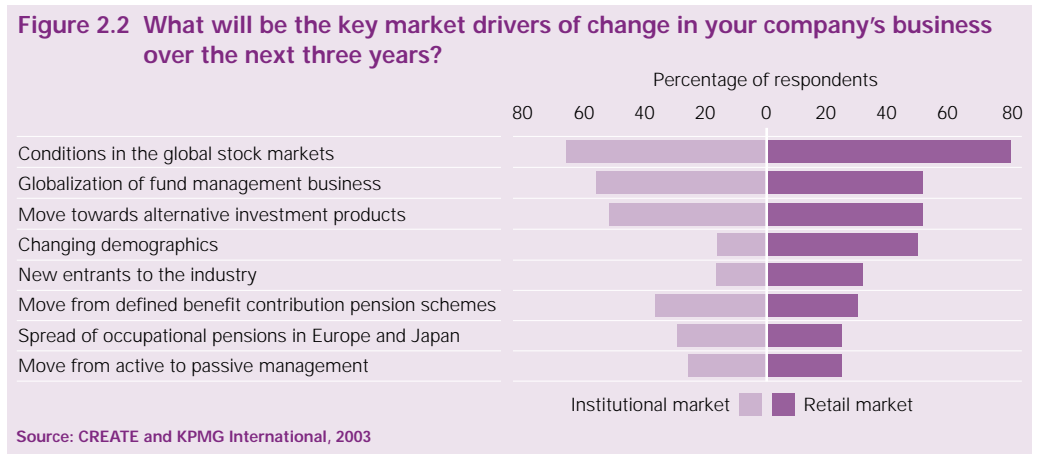
*“As markets rise, punters will come back. But they will be wiser”*

As we saw in Figure 2.1, business dynamics have changed. Investment managers recognize it all too well.

According to our survey that ran in parallel to the interviews, a number of drivers will re-shape institutional and retail markets over the next three years (Figure 2.2):

*“Unless we focus on our strengths, investors will punish us”*

- conditions in the global stock markets, which will be a major determinant of the amount of funds that will be managed
- continuing globalization of investment management business, which will further intensify competition and erode profit margins
- focus on alternative investment products, which will continue to reflect ever changing risk appetites of clients in different sectors.



*“If the FTSE goes below 3,300, we shall hear howls of anguish: consolidation will accelerate”*

A further sustained equity rally is not likely in the foreseeable future. Hence, competition amongst existing investment managers will only intensify, as existing suppliers chase the more investment aware and price conscious customers, further undermining their profitability.

*“It is no longer enough to be on the right train; you have to be in the right seat in the right car”*

Factors that had a huge influence in the last decade – e.g. move towards the DC schemes, popularity of passive funds in the institutional market – are likely to have a limited impact, at least in the first half of this decade. Changing demographics will, however, continue to exert a significant influence on the retail market, as an increasing number of the post-war ‘baby boomers’ are obliged to replenish their eroded portfolios.

*“Many firms have no genuine comparative advantage other than a market presence; they do not have that reservoir of skills that their clients are led to believe”*

Accordingly, client focus is likely to be the top priority. This will not be easy. After all, many among the existing generation of investment managers have never had the experience of managing market collapse and investor disillusionment on the scale that has happened in the past three years.

Not surprisingly, therefore, responses within individual firms (Figure 2.3) are based on the recognition that:

*“The industry will need another downturn to sort out the men from the boys”*

- customers demand higher and consistent performance because of the sheer scale of capital losses suffered since the current downturn began
- customers require a clear value proposition because more than ever they want to know the basis on which their money is invested
- customers favor well recognized brands because they want to be sure that their money is managed by firms that are well run and trusted.

*“Across Europe, there is massive over-capacity and massive underperformance”*

Pension fund trustees, hitherto focused on investment performance, will be more influenced by branding. They will want to be sure that the firms who manage their investments are run competently and the brand and associated values will be seen as part of the performance promise.

*“In a rising market, it’s OK to be in everything. The tide has gone out; so we have to focus”*

With growing transparency, investment managers who are perceived to take advantage of their customers, or pay huge bonuses to their top people even when their performance is mediocre, or ignore corporate governance issues in their own backyard, will tarnish their own brand. Any significant adverse publicity in the media, which sees itself as the guardian of customers, is now believed to be highly detrimental.

*“We need a steady state for three years to sort out the mess”*

Like trust, brand is an ever fragile commodity. Hence, managing reputation risk will be paramount; as such, investment management business will be no different from other businesses. Consumerism will become a major factor in the institutional and retail markets alike.



*“There are very few sustainable businesses. Even today’s success stories face oblivion. They lack foresight and resilience. We’re ripe for a cultural revolution”*

*“We’ve been shell shocked for the last three years”*

*“Volatility is here to stay”*

*“For two years, CEOs were deluding themselves that this was just a blip. They have had a rude awakening”*

*“The license to operate is not just an FSA issue”*

*“This is not a well managed industry. It has no future, unless it is”*

When the survey results are combined with those that emerged from our interviews, four imperatives stand out:

- **value proposition:** say what you mean, mean what you say, and deliver
- **business model:** run the business like a normal business, from peak to trough to peak; a model that works only in an upturn is a recipe for disaster
- **scale:** grow a cost effective resilient business by tackling the causes of diseconomies of scale
- **leadership:** the days of the ‘gifted amateur’ are over; business leaders need to be more than good investment professionals.

## License to operate

These four imperatives are about having the license to operate in the eyes of institutional and retail customers. As if they are not challenging enough, two other developments are making life increasingly hard for investment managers: volatility and regulation.

Taking them in turn, market volatility has accelerated in the past two years due to a number of unforeseen factors:

- buy-and-hold investors, once a powerful stabilizer, are fleeing; they are replaced by ‘trigger happy’ traders
- shorting is rife in all markets, thanks to the growth of hedge funds
- insurance companies and pension funds are re-basing their equity portfolios owing to regulatory capital and risk pressures
- last, but not least, terrorism, war and continuing instability in the Middle East have seriously impacted the markets.

Meanwhile, regulators in the US, UK and Continental Europe are casting a worrying shadow on the industry. In the UK, for example, the industry has been the subject of two critical scrutinies, as embodied in the Myners and Sandler Reports.

### Thinking aloud...

*“I do not doubt that there’s a lot that the industry needs to sort out. We need to put our house in order before the regulators do. And if we rely on them to do it, then heaven help us! Are we inexorably becoming a regulated utility?”*

*Over-regulation will result in excessive bureaucracy in everything that we do; and bureaucracy is a kiss of death for innovation and enterprise. It is a blunt instrument that treats good and bad alike. Governments need to provide a framework that provides adequate protection to investors.*

*On our part, we need to do far more for our customers than in the past. For example, in the retail market, what we do is akin to selling a bottle of milk, expect the customer to drink it, and then leave him alone. It is as though investment is a consumable product.”*

Source: CREATE and KPMG International – Interview quotes

***“There’s a need for vibrant, honest and open asset managers. Unless we provide them, further legislation is inevitable. That will restrain growth”***

***“Our biggest challenge is the transfer of the substitution portion of employee pension fund liabilities to the Japanese Government. It will reinvest its tracker funds on the employees’ behalf. This will erode our margins even further”***

***“There’s a massive overshoot in regulation. We may have to re-consider where we’re domiciled. Consolidated supervision can mean hoarding cash in our balance sheet. This can make us an easy target for a take-over. It’s all insane”***

It will have to contend with nearly 200 consultative exercises mounted by the UK’s Financial Services Authority (FSA) and some 40 legislative actions under the EU Financial Services Action Plan. On top of that, there are numerous measures to contend with in the area of social legislation, emanating from Westminster as well as Brussels.

In this context, several key points emerged from our interviews with CEOs and CIOs.

There needs to be a balance between fairness and efficiency. Nobody questions the role of regulation as an instrument for safeguarding the interest of investors; nor in creating transparent markets; nor in curbing potential abuses.

But we encountered serious concerns that emerging proposals may tilt the balance towards over-regulation. At a time when many investment managers are nursing heavy losses, this imbalance will add to their compliance cost.

Investment managers across Europe need to work together to ensure that regulatory changes are necessary, sensible and practical. Unless they unite together in influencing the law makers at the formative stage, new regulation will have a perverse effect: harming the very people that it seeks to protect. The role of trade associations was emphasized in this context.

What has been lacking are serious initiatives aimed at customer education. In an age when individuals are expected to take on more and more responsibility for their own retirement plans, the role of education cannot be over-stated. This is not a role for the industry alone.

Finally, there is a growing recognition that unless the industry gets its own house in order, the regulators will try. Regulation is a blunt instrument. Hence whilst individual investment managers are re-jigging their business models, they may be forced to widen the scope of what ‘license to operate’ means.

### 3 The market dynamics: how is it being reshaped?

*Performance, fees and service are coming under scrutiny like never before.*

*Emergence of new forces on demand and supply side are changing the market structure and business environment.*

*The green shoots of change are visible, but are only slowly emerging.*

*Responses are partial in design, patchy in scope, slow in timing. Cost cutting seems to be the norm.*

*Only a minority expected the bear market to last beyond 2001.*

*Threats to their own brand have obliged the parent companies to use their deep pockets to bale out their struggling investment subsidiaries.*

*But not for long. Darwinism is here with a vengeance.*

## Understanding customer needs

### Interview quotes:

*“It is becoming increasingly hard to make money on new business”*

*“The Morning Star rating is critical”*

*“We’ve upped the ante through a platinum strategy, with a variety of propositions for different clients”*

*“In the retail market, alpha gets offset by high fees”*

The old dictum that funds are sold, not bought has far less relevance today. Customers are no longer indulgent of their investment managers according to our survey results (Figure 3.1). So, the fundamentals of the business are being assessed.

Well over half the industry recognizes now that delivering value to institutional and retail clients alike is about:

- possessing a clear investment philosophy backed by thought leadership
- delivering either top quartile or above average performance consistently
- improving customer service, backed by effective relationship management.

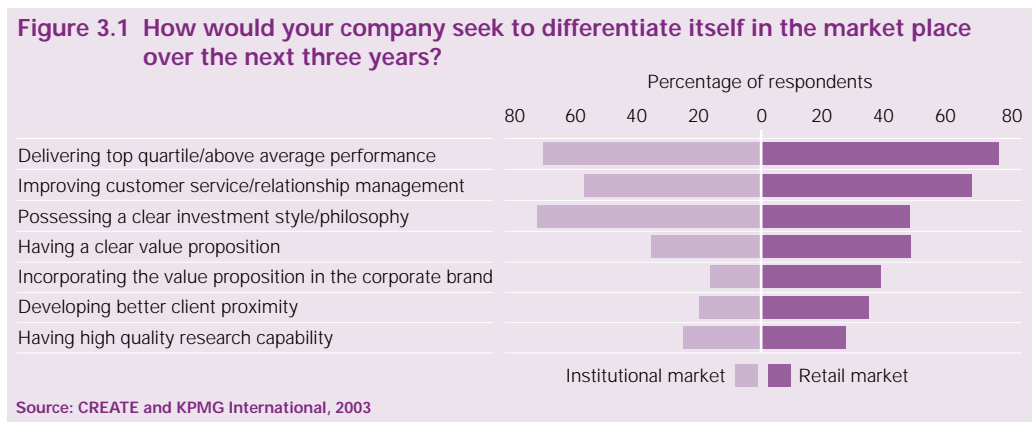
In our interviews with CEOs and CIOs, one point emerged above all else: the old ways of doing things – inadequate customer focus, few guiding principles, ineffective teamwork, mediocre business leadership, under-performance – are now a recipe for disaster in an ever more unforgiving market place.

Accordingly, investment firms are now increasingly forced to do what manufacturing did in the 1980s and retailing in the 1990s: adopt the mantra of ‘customer first’. In other words, what has long been second nature to other industries is now being painfully internalized by investment managers in America, Europe and Japan.

This focus on the customer is aided and abetted by other actions that aim to articulate and deliver the value proposition: such as creating a recognizable brand and improving client proximity.

This new customer focus has been reported by three out of every four firms in our survey, suggesting that the rest either don’t see the problem or can’t do much about it. It is clear that a combination of depressed markets and regulatory pressures are forcing serious contemplation and reassessment among half the firms in our sample.

However, introspection is one thing; action quite another.



**Figure 3.2 How does your company seek to grow its business over the next three years?**



**“Around 60 percent of firms in London are loss making on a run-rate basis”**

Individual investment managers are implementing a number of actions that impact on the demand and supply side of institutional and retail markets (Figure 3.2). When the survey data is combined with our interviews, it appears that the responses are somewhat patchy.

On the *demand* side, firms are:

**“The culture of performance-based fees is coming: no added value, no benefit”**

- providing different service levels to different client groups and adjusting their charges accordingly (*one in every two firms*)
- seeking alliances with other prominent players in order to get value for money for clients in all the activities in the value chain (*two in five*)
- selling competitors' products through open architecture (*one in four*)
- developing new distribution channels or other supermarket type arrangements in order to access a wider customer base (*two in five*)
- adopting a performance-based charging policy in order to attract new mandates by linking fees more closely with performance (*one in four*).

**“There's a lot of cleansing going on through open architecture, break up of the value chain, manufacturing-distribution decoupling; and white labeling”**

## Structural responses

The above results are generalized across the patch. A more detailed examination shows that there are discernible differences in the approaches adopted in the institutional and retail markets.

In the institutional market, more emphasis is being put on:

- specializing in fewer products to achieve the necessary scale and win specialist mandates within the core-satellite arrangement
- adopting a performance-based charging policy to attract mandates.

In contrast, in the retail market, more emphasis is put on:

- developing new distribution channels
- adopting an open architecture to sell competitors' products.

**“Retail and institutional markets are converging”**

### Thinking aloud...

*"We used to do a poor job for our clients and made claims that were unsupported.*

*We need a new implicit social contract between the sponsoring organization, the trustees and beneficiaries. Under it, we need to appraise the risks that can be tolerated, returns that can be reasonably expected, the flexibility that employers and employees have in their contributions, and expectations of likely benefits over time.*

*We must recognize that clients want five things when they appoint a manager: the performance promise met; good communication, not just periodic reports; satisfaction that their money is being handled in proper fiduciary and compliant manner; lowest possible charges; and service provided in the vehicle of their choice.*

*We ignore these at our peril."*

Source: CREATE and KPMG International – Interview quotes

***"You don't have to own a cow to sell the milk"***

***"In the Nordic area, we have no choice other than merge: there's no glory in draining shareholder value"***

***"We need to go back to more than basics and shed the herd mentality that has suffocated this industry"***

***"We agonise about any new idea, in case it's a bad idea"***

***"In a falling market, you have to re-invest and re-structure; which few appear to be doing"***

***"The key challenge is our global clients want to deal with ever fewer fund managers and pay the fees that prevail in the lowest cost location"***

Equally, on the *supply* side, our interview results show that firms are:

- recognizing that the days of large balanced mandates are over and only specialist capability will ensure success in the emerging core-satellite model (*two in three*)
- providing 'white label' products as a part of exploiting the specialist capability to its maximum (*one in eight*)
- rationalizing their product range in order to achieve scale economies in production and brand recognition in distribution (*one in four*)
- decoupling manufacturing from distribution so as to focus on distinct core competencies within the value chain (*one in six*).

Whereas these trends are clearly discernible, it is as well to point out that the momentum behind them is incremental, at best.

Less than three in five are doing anything structural and less than two in five, anything significant. The principal action taken so far has been cost cutting: some 80 percent of firms in our study have focused strongly on their costs: 60 percent have reduced them by up to 20 percent, and the rest by more than 20 percent. They have encountered obstacles in a number of other areas that require actions. We focus on two of them to illustrate the point.

First, performance-based charges are making investment managers more responsive to client needs and, to that extent, they are a welcome development. However, pension fund trustees are not exactly whole-hearted about them for fear that managers may ramp up the risk, with no downside loss to their own income.

Second, the decoupling of manufacturing and distribution is an acutely live issue in banks and insurance companies alike. The scale of losses suffered by their customers in the funds managed by in-house investment managers is believed to have tarnished the brand of the parent groups.

*“We need to de-mystify the craft of the investment function”*

*“The solvency pressures and brand risks at insurance companies will turn them into distressed sellers of their fund business before long. There’s a limit to how long they can continue bailing us out”*

*“Our aim is to make this outfit eminently saleable”*

*“Many banks have failed in their proposition for the mass affluent”*

*“Core-satellite strategy is a lot cheaper”*

*“Every asset manager in Europe is contemplating its strategy right now. This is a euphemism for saying they are all thinking about buying their competitors or being bought themselves”*

*“You and I can start an investment business this afternoon. There are no barriers to entry”*

*“Many businesses will be up for sale in the next 24 months”*

Furthermore, those who had done expensive acquisitions of investment managers have yet to reap the expected financial rewards in the bull market because of spiraling costs at their subsidiaries. On their part, the in-house investment managers have failed to leverage the distribution channel of their parent firms on the expected scale: the record of cross referral of business in the bancassurance model remains dismal in the large majority of integrated financial houses around the world.

If anything, the tensions between manufacturing and distribution have only become more acute in the bear market, to breaking point in many notable cases, according to CEOs and CIOs participating in our interview program.

Yet the possibilities for decoupling in the immediate future remain limited because:

- there are few buyers around for these in-house units
- there remains reluctance on the part of some insurance companies in particular to entrust the management of their funds to third parties
- the in-house entities operate on a threadbare basis points regime to the extent that they find it hard to develop third party business
- over 90 percent of investment managers in Europe and over 65 percent in the US are owned by banks and insurance companies; this limits the scope for divestment.

Many parent companies in the industry with current equity ties to a single investment manager would prefer to replace this with an open architecture arrangement of a handful of high performing manufacturers. Accordingly, whether the decoupling will occur is not in doubt; only its pace is.

## Changing industrial landscape

In turn, the structural responses are changing the market structure. The evolving shift from balanced to specialist mandates is promoting five seemingly durable trends.

The first one involves a clear focus on core competences. This means becoming one of three legs of the stool that will increasingly characterize the investment management industry in this decade:

- **mega producers:** with distinctive capabilities in active and passive management and a well recognized brand
- **giant trackers:** with huge scale in passives that is also leveraged into enhanced passives and actives
- **niche players:** with distinctive capabilities in a narrow range of active products, including hedge funds.

The second trend concerns further consolidation. Given that the number of quoted investment managers is very small – less than 5 percent in Europe, 35 percent in the US – the scope for buying firms through equity swap is limited, as is the purchase of large managers.

### Thinking aloud...

*"I have no doubt that a lot of businesses will soon have 'for sale' signs.*

*First, this is because the distribution landscape is changing in favor of banks. Only the very largest can play in their space; even then, I'm not sure, because these powerhouses are going into a lot of non-peripheral activities like payroll administration. More than 40 percent of their earnings come from non-core activities.*

*I suspect that today's powerhouses will be tomorrow's fading stars. With their current scale and reach, they will get their eye off the ball before long. No one can go on defying gravity for ever.*

*Second, there are too many tensions in large houses. They stop us doing a good job.*

*We may well go down the same route as private banks: namely outsource. It's not a question of "if" but "when". It's impossible for us to deliver value otherwise.*

*The room for manoeuvre is very limited when you have one internal captive client who pegs the basis points below 10 and has no interest in investing in this business. We do not feature in their future strategy.*

*Our ability to change to a new model is very limited. We have neither the resources nor the people."*

Source: CREATE and KPMG International – Interview quotes

***"We will not exist in the current form in 3 years because banks are merging and they no longer want their own asset managers"***

***"We've always relied on M&A for growth and scale"***

***"There's a lot of denial in the industry: there are no fundamental changes in the boiler room"***

However, that is unlikely to prevent the take-over of medium-sized and small players. Indeed, recent statistics from Cambridge International Partners show that the value of the deals world-wide has dropped from \$31.7 billion to \$7.9 billion between 2000-02. Yet, at the same time, the number of deals increased marginally from 116 to 117 per year. This will continue for one simple reason: the current market structure is oriented towards a world which no longer exists. Focus is the name of the game. In fact, well over 50 percent of the firms who participated in this research were interested in mergers and acquisitions.

The third trend concerns the elimination of the weakest. The interest in M&A is symptomatic of two problems.

To begin with, at the medium and lower end, it reflects the need to have a critical mass to survive: it's viewed as a less painful way to build the necessary scale. More notably, the interest is in acquiring assets rather than expertise. As a result, the prices offered are low and the pace slower than that dictated by current market conditions. However, if the bear market continues into another year, there are bound to be many distressed sales.

*“Egos and conflicts are big negatives in M&A”*

*“A lot of US banks are pulling out of fund management. They paid a lot and get so little”*

*“The probability is that either for operational risk or regulatory reasons, we will need to employ more capital”*

*“Growth in regulation is squeezing the margins and stifling innovation”*

*“Our parent was desperate to raise capital. We were hived off”*

More worryingly, though, according to our interviews, the interest in M&A also reflects the seeming inability to migrate to a business model that focuses on one of the following as a *winning formula*:

- asset gathering
- wealth management
- pure manufacturing
- service provider under outsourcing.

The inability to migrate, in turn, is due to three factors:

- the need to guard the existing revenue stream in today’s difficult climate
- lack of financial resources needed to create a new infrastructure of skills and systems
- lack of mindset flexibility on the part of senior executive teams.

As a result, there is a gap between the rhetoric of new models and reality. That means that investment management will continue to remain a cottage industry. But not for long: the structural changes are ushering in a more vicious form of business Darwinism.

The fourth trend refers to risk. The scope for risk management is continually expanding. CEOs are increasingly expected to pay attention to operational and reputational risk, in addition to the traditional investment risks, as regulators and media become ever more vigilant in countries such as Japan, Germany, Denmark, France, UK and the US.

### Thinking aloud...

*“The new world is about managing risk on a total return basis relative to liability. It also requires tactics for managing risk budgets that were difficult to handle in the balanced mandates.*

*The core-satellite arrangement is much more sensible. For the foreseeable future, I see it as the main way of delivering value.*

*In my experience, fund management is far less scalable than is commonly believed. Risk control mitigates against it.*

*There is also growing evidence that, outside the indexed funds, clients prefer niche players over global leviathans.*

*This is because in large active houses, fund managers get involved in everything except investment! They are now realizing that boutiques are eating away their lunch.*

*That’s why we have chosen to become a manager of managers. For us, it’s the only way we can deliver value.*

*Now focus is the name of the game: I definitely see a three-way polarization between large active houses, giant trackers and boutiques.”*

Source: CREATE and KPMG International – Interview quotes

*“The boundary between fund managers and pensions consultant is blurring. The latter increasingly offer an asset allocation overlay”*

Investment managers, on their part, are addressing the issues by introducing new risk and compliance methods that are, as a side effect, making the business more structured and bureaucratic. Not only does this development sit uncomfortably with senior staff, it also makes it difficult to attract, retain and deploy talent in large organizations. The birth pangs of a new approach to business conduct are all too evident. They arise from the need to reconcile seemingly different priorities of investment managers and pension trustees in an ever litigious society.

The final trend relates to pensions consultants. The shift away from the balanced mandates is rapidly enhancing their role, especially in the UK and Continental Europe. Trustees are becoming more mindful of their fiduciary responsibilities and rely on consultants as the main source of expertise, especially in asset allocation and managing the managers. There is a definite blurring of boundaries between investment managers and consultants. Tensions between them have been inevitable; the only way in which investment managers can have the upper hand is through a solid track record, which many do not as yet have.

## 4 Business re-engineering: how is the corporate boiler room changing?

*So far, the responses have been tactical in order to score quick wins.*

*Cost cutting and product diversification have been at the top of the list.*

*But strategic responses are also being planned: they aim to make costs more variable and staff more productive within a new operating model.*

*The responses rely on lean production tools that have revolutionized other industries which suffered over-capacity, inadequate focus and falling profitability.*

*If and when implemented, they will change the face of investment management.*

## Arrival of lean production

### Interview quotes:

*"We don't believe in scale without tough controls."*

*"Having a global business means different regulatory regimes and a lot of sign offs. Bureaucracy is stifling"*

*"Every business needs brakes to go fast"*

*"We need a model that spends less and earns more"*

*"The diseconomies come from leaders not having management skills. Growth brings new fund managers and dilutes the culture"*

*"Here, there are empires within empires: checkers are checking the checkers"*

The available numbers neither support nor refute the claim that size inherently generates cost advantages in investment management. In our interviews with CEOs and CIOs three points emerged clearly:

- **nothing unconditional:** economies of scale are there but they only accrue when certain obstacles are overcome as the business grows
- **growth creates black holes:** the obstacles arise from the law of unintended consequences; that's why it is uncomfortable to address them
- **tackle them head on:** if left alone, they create an illusion of relentless expansion and limitless opportunities.

More detailed analysis went on to identify six principal 'black holes' that have sucked in scarce dollars and precious energy in many houses as they scaled the business in the 1990s:

- **lack of product focus:** proliferation of products raised back office costs because the systems were more oriented towards handling pooled funds; also little attention was paid to the economics of individual products partly because of the problem of 'indivisibilities' and partly because of the lack of robust financial modeling.
- **volume more important than profits:** in a rising market, FUM came to be a virility symbol because growth begot growth, like a self-sustaining cycle: more funds meant more revenue which was used to attract more funds; whilst the markets were zooming upwards, profitability was an arithmetic certainty; not enough attention was paid to the growth in costs.
- **uncontrolled compensation:** costs escalated because the over-heated labor markets everywhere hiked the pay rates, whilst lavish bonuses inflated total compensation. In the majority of houses, bonuses were either guaranteed or linked to FUM; not to the out-performance of the individual or the profitability of the business.
- **concealed tribalism:** front office staff had more interest in building personal franchise; they had greater loyalty to their craft than to their business; there was little knowledge-sharing between them; worse still, rapid growth created administration problems that, in turn, gave rise to a strong blame culture between front, middle and back office.
- **strategic vacuum:** few large houses had a clear process on design and implementation of business strategy; in the rest it happened on the hoof with no reality check; it had more hype than substance; it created a momentary glow, but not much else.
- **leadership vacuum:** the overwhelming majority of houses had investment managers as business leaders, in the belief that only a gifted professional can run an investment business, no matter what its size, reach and complexity. The buzz of the investment function was often confused with leadership.

The above list is by no means exhaustive. But it is long enough to make a general point: as investment management went from a craft industry to a mass market industry in record time, it was unable to foresee and respond to transitional problems.

***“You can’t mothball ‘plants’ in a people business. This is a fixed cost business that can’t be leveraged in a cyclical market”***

The motor industry had the same problem, as it went from craft to mass production. In order to survive, it had to invent *lean production*, which combines the advantages of both modes of production, whilst avoiding the high cost of the former and the rigidity of the latter. It uses less of everything compared to mass production: half the human effort in factory, half the space, half the investment in tools, no inventories and so on.

Most of all, it requires a shift in employee mindset:

***“There will be huge downsizing once continental banks merge”***

- from entitlement to performance
- from efforts to results.

From our interviews, it is clear that investment management is beginning to move in that direction, too; albeit gradually.

***“The City location is a status symbol; nothing else”***

As we mentioned in Section 3, some 80 percent of the houses have focused on their costs since the start of the bear market: 60 percent have reduced them by up to 20 percent; and the rest by more than 20 percent. The items which have borne the brunt of the cuts in descending order of importance are: staff numbers, bonuses, sell-side management, marketing and advertising, office accommodation, travel and entertainment.

***“What really matters now is flexibility, replicability and scalability”***

These have been *tactical* in two respects.

***“We segregate funds at the customer end, not the producer end”***

First, the cuts have produced quick results in stemming the scale of losses. Even so, some 40 percent of the sampled companies were still expecting to report a loss by end-2003, unless the market bounced back dramatically, which nobody was expecting.

### Thinking aloud...

*“With hindsight, our cost problems came from four sources.*

*We had a strong star culture which was mega 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. A strong blame culture was the inevitable outcome.*

*We did a lot of benchmark-hugging and, before long, pension trustees began to question the worth of active management. We had undermined our existing revenue streams without realizing 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. It also vastly increased the complexity of the business; yet we had not got the right people at the top who could manage it.*

*They could manage portfolios, not people. This is the first thing we have changed in our current re-engineering.”*

Source: CREATE and KPMG International – Interview quotes

### Thinking aloud...

*“Balanced mandates were Jack of all trades and master of none. This is the age of specialists. If pension fund trustees want indexed funds, they go to a specialist. They don’t want a closet indexer, whilst paying active rates.*

*Despite a falling market, we’re growing our FUM. Why? Because we have a trusted brand, low charges, a tight rein on cost, extensive automation of manual activities, and superb customer service.*

*We try and pool everything whenever we can. If we can’t, we work out the true cost of segregated funds and reflect it in the fees. Investment consultants like this transparency. We have scaled the business exponentially without ramping up costs. And we continue to do it.*

*We have a house philosophy on knowledge sharing because we are here to promote asset classes, not stars. We don’t believe in the theory of efficient markets. Inefficiencies are there to be exploited. So, we have a range of active and enhanced passive products.*

*We also have a hard-nosed senior management that understands the market dynamics. Yes, luck plays a part in this business. But good managers create their own luck.*

*In fact, managers come in three categories: those who make things happen, those who let things happen, and those who wonder what has happened.”*

Source: CREATE and KPMG International – Interview quotes

***“Good investment performance is hard to repeat, so product diversification is vital”***

***“We sell generic products with private labels, and take a lower fee. We don’t advertise.”***

***“Brokers sell comments, not research: sell side is a mess but there are no alternative sources yet”***

Second, and arguably, the cuts so far have tackled the symptoms, not the causes. It was only in 2003 that a significant minority started to re-engineer the operating model in order to create a more robust business. Their strategic responses have focused on six areas:

- product mix
- outsourcing
- re-centralization
- matrix structure
- pay and bonus
- culture and leadership.

In the rest of this section, we focus on the first two, leaving the rest for Section 5.

## Improving the economics of product mix

*“Multi assets are difficult to manage; best to sell more of the same products”*

*“Focus on one thing, and do it well”*

*“Alternatives are the new mantra. They’re over-blown”*

*“Hedge funds are hugely risky. They’ll come a cropper, for sure, as will bonds”*

*“Passives will grow”*

*“Many functions have been salami sliced, but costs have not decreased”*

*“Absolute return products are the name of the game, at least over the next three years”*

*“Bonds will retain a strong space in asset allocation”*

Four dominant trends have been evident in the aftermath of the crash in 2000.

First, there has been a distinct switch in the product mix (Figure 4.1), away from equities towards :

- **hedge funds:** they appeal to investors with a strong appetite for flexibility with greater risk
- **bonds:** they appeal to investors who need to manage liabilities and have an income stream
- **guaranteed products:** they seek to attract disenchanted investors back into the market
- **passive products:** they appeal to those who are willing to track the market at minimum cost.

The emphasis on bonds and guaranteed investments is yet another indication that investment managers do not expect investor optimism to revive significantly in favor of equities over the next three years or so.

That said, it is equally important to emphasize that the majority of investment managers regard the popularity of hedge funds and bonds as no more than cyclical.

On the other hand, they see the trend towards guaranteed products and passive funds as durable. They mark a decisive change for those retail and institutional investors whose expectations of the future have been conditioned by the losses in the recent past. The secular trend reflects the growing pre-occupation with wealth protection and management fees. It also carries a downside, though. In the prolonged bear market, the base has become smaller and shifted the client mindset towards liability or absolute return products, resulting in a diminishing set of opportunities for investment managers.

The problem is compounded by the fact that, on their part, managers have been reluctant to engage in product innovation on a notable scale; partly because competitors usually follow suit immediately and partly because product rationalization has been their main pre-occupation.



*“Guaranteed products are not guaranteed; nobody offers a ‘stop loss’ box”*

*“We need to reinvent this industry; we can’t guarantee absolute returns day in day out”*

*“Consultants encourage star culture; they only notice people who are successful”*

*“Pension consultants always want to deal with big names to cover their own backs”*

*“Pension consultants do not have the expertise to manage too many managers”*

*“We can’t manage everything; only focus is everything”*

*“There will be polarization between boutiques and large scale; middle ground will disappear”*

The second trend relates to product range. The numerous ‘bells and whistles’ products that so conspicuously undermined profitability in the past are either being discarded outright or merged into fewer products, which can permit a pooled approach to:

- marketing in the middle office and
- processing in the back office.

The third major trend relates to geographical orientation. In order to gain new business, investment managers are concentrating on their domestic market, as a part of the policy of ‘sticking to the knitting’. Beyond that, the European market is seen as a better option for growth in the short term (Figure 4.2).

The fourth trend relates to convergence in the product mix, albeit a gradual one. At one end, large index houses are leveraging their huge client base to sell enhanced actives, quants, white label products and pure actives. On the other hand, large active houses are creating islands of capabilities which, amongst others, are mobilizing their skills to ‘tilt the index’ (Figure 1.3). Before long, therefore, three outcomes are likely:

- **bi-polarization:** over time, this would make mega producers and giant trackers less distinguishable; the industry structure will be dominated by them at one end and niche players of different sizes at the other.
- **a distinctive supply chain:** in order to tackle diseconomies of scale, these new icons may well develop strong alliances with niche players, exactly in the way that auto firms have done with a selected number of component suppliers, accentuating the current trend. The supply chain will not only see decoupling of manufacturing and distribution; more importantly, it will also see large players outsourcing manufacturing of specialist products in order to increase their variable cost base on the one hand and access expertise on the other.
- **status quo ante:** the pendulum may well swing towards balanced mandates, especially as pension consultants themselves come under fire, if and when the core-satellite model fails to deliver the expected results. After all, it cannot overcome the ultimate randomness of markets without undue risks. Like investment managers before them, consultants may be the next victim of their own success. After all, managing managers is a rare skill, which many have yet to develop. Whether the anticipated swing will go the whole way is arguable.



## Outsourcing: more haste, less speed

*“Of 150 insurance companies in Germany, 40 will outsource AM entirely”*

*“Outsourcing is not a credible option. Our customers do not have positive perceptions of it. How can anyone care more about my customers than me?”*

*“Outsourcing is often an admission that we can't run the business ourselves and therefore have to export our problems”*

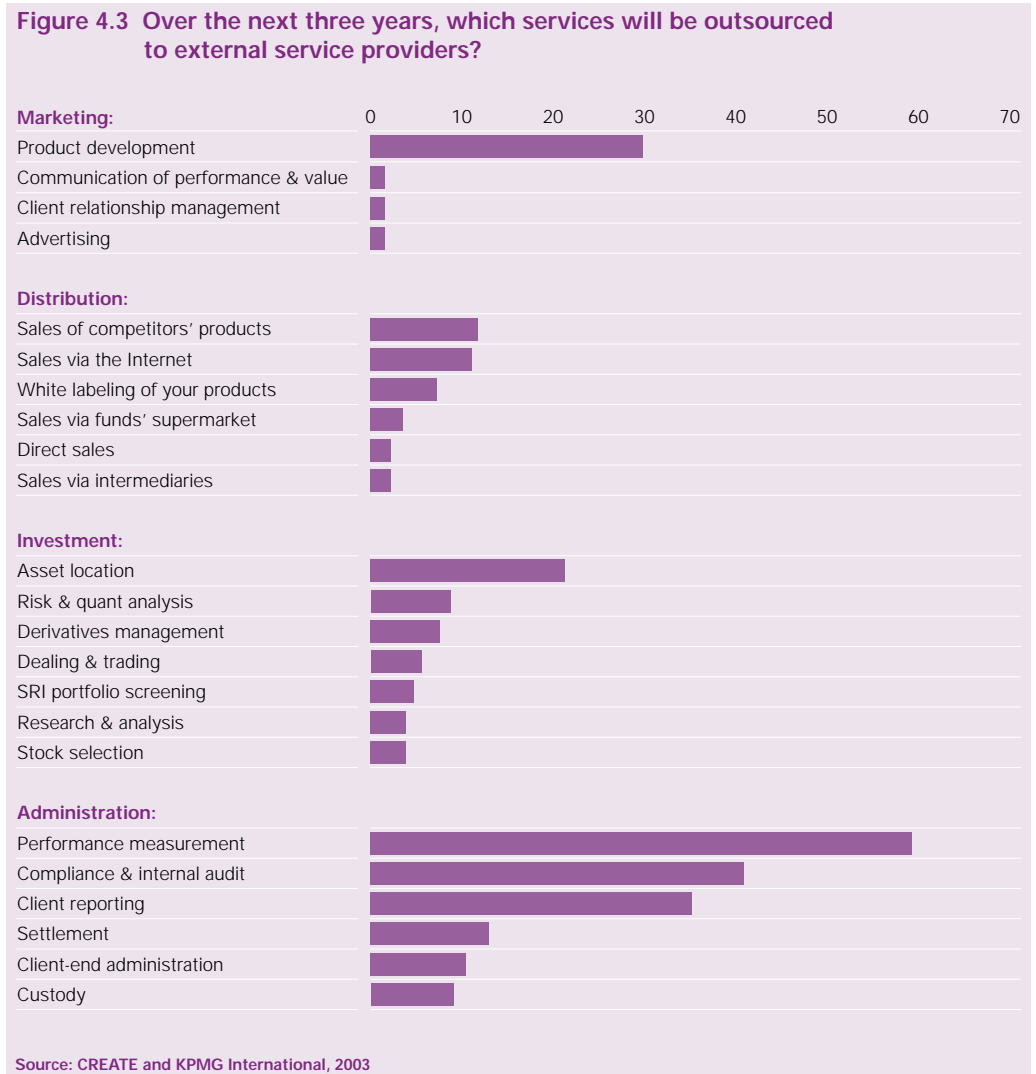
The early shoots of change are evident. It is likely that the next wave of outsourcing will continue to be dominated by back office activities, such as performance measurement, compliance and internal audit, client reporting and settlement (Figure 4.3).

Their aim has been three-fold:

- convert as many fixed costs into variable costs as possible
- link costs to the level of activity
- shrink total costs.

In other areas of the value chain – marketing, distribution and investment – outsourcing is also likely to increase over time. But its pace is likely to be gradual due to four reasons.

First, many investment houses believe that there are no credible service providers in the market place who can make a genuine impact on costs without sacrificing quality. The perceived risk to brand remains huge. However, as cost pressures have intensified, the mood is decidedly changing.



***“We risk losing huge mandates every year; so we have an exceptionally retention-driven culture”***

Second, in Europe, it has not been easy for service providers to develop a critical mass that can generate scale economies because of different market and product structures as well as regulatory and compliance regimes. So far, the preferred option has been for a small number of investment managers to come together under common regimes and share a dedicated capability. This trend is likely to continue.

***“If there were reliable back office service providers in India or China, they would be inundated”***

Third, the executive teams in individual houses have not had the confidence to manage business through alliances with external suppliers. Few had worked out the economics of the product mix; or that of the value chain. Now the reluctance to look at alternative scenarios is weakening.

***“We outsource heavily and leverage our partnerships”***

Fourth, the cost savings associated with outsourcing are biggest in the front office and smallest in the back office, reflecting the huge imbalance in their respective staff costs. However, few managers could contemplate significant outsourcing in the front office for fear of undermining their whole *raison d'être*.

Many have taken the view that it is more prudent to attack the causes of cost escalation than merely to export them to a third party; especially, since staff account for between 50 to 65 percent of overall costs. We return to this point in Section 5.

## 5 Culture change: how to deploy talent in a variable cost model?

*Attracting, retaining and deploying talent without spending a fortune is the single most important strategic imperative for firms of all sizes.*

*Lean production tools don't make it easy; they eschew the excessive individualism that has hitherto characterized the craft of investment.*

*The answer is a new approach to compensation within a culture of leadership.*

*That will not be easy because many among today's generation of business leaders have not been trained to deliver such a culture.*

*Until they are, the ride towards a variable cost model will remain bumpy.*

## Avoiding duplication

### Interview quotes:

*“We’re a Cinderella industry, with no obvious cost pressures other than the ones that weak management can’t resist”*

*“Under our federal system, expenses rocketed”*

*“The partnership model is not a magic bullet. It helps, though, because banks and insurance companies can’t cope with a business driven by retention and reward”*

A streamlined product mix and outsourcing are two of the six strategic tools of lean production that are being implemented in the global investment management industry, as we saw in Section 4.

The other four are: re-centralization of platforms, matrix structures, a sensible reward system and culture of leadership. Each is considered separately in this section.

To start with, one thing is clear: if the business model is about client focus, then the operating model is about minimizing duplication in all parts of the value chain.

Over the next three years, centralization of various activities will dominate the evaluation of how various internal operations are conducted (Figure 5.1).

All along the value chain – marketing, distribution, investment and administration – activities will be concentrated in fewer platforms in order to reduce costs by reducing duplication.

That apart, two other factors are driving the trend towards centralization.

First, investment managers everywhere are striving to develop centers of excellence – islands of specialist capabilities – which can deliver the value proposition on the one hand and cost synergies on the other. These centers also reflect the trend towards specialist mandates. For example, in large firms operating in multiple geographies, these centers of excellence draw together the collective expertise within fewer platforms. Even within firms operating in a single country, centralization will reduce the number of physical locations over time.

Second, the trend towards centralization merely reflects the adoption of a matrix organization which is being implemented in a number of firms of medium and large size. Their central thrust is to cut costs and leverage expertise across the firm.

The emerging matrix is involving one of two forms:

- **corporate integration:** sharing services with parent companies in generic areas like finance, marketing and HR
- **geographical integration:** jettisoning the country structure and running all investment management operations through ever fewer platforms centralized in one of four regions: US, UK, Continental Europe and Asia-Pacific.

**Figure 5.1 Over the next three years, which of the activities in your company's value chain will be de-centralized or centralized?**



*“Everyone wants to work for a boutique; but few understand what is involved. You have to have a strong belief that you will succeed. The only barrier to entry is the brutality of the process”*

*“66 percent of costs are staff; bonuses are on a downward path; and we will cut the base pay”*

*“When I changed our bonus system, there were loud screams. A lot of managers were over-paid, even by market rates”*

In either case, the drive for integration is coming from the parent companies who are aiming to assert greater control on their investment subsidiaries. In contrast, activities that require closer client proximity are being de-centralized – such as relationship management, sales and client reporting.

At any rate, either form of integration has – albeit inadvertently – created the perception of unwieldy bureaucracies that stifle innovation and delay decisions. According to CEOs and CIOs involved in our interviews, the early experience has not been so promising due to three problems.

First, the job losses resulting from these new structures have undermined staff morale to the point where many have become semi-detached and would leave their firms as and when the markets recover.

Second, front office staff find it hard to defer to the hierarchy and etiquette of these new structures. Their gut instincts are tuned to a boutique environment.

### Thinking aloud...

*"We were soft and podgy but all that had to change in 2002 when markets tumbled big time. Now, our operating model is a complex matrix that combines financial and geographical integration. We are drastically streamlining our manufacturing platforms and back office functions. A 50 percent cull in our global headcount has already lifted the bottom line by 300 percent.*

*But life is far from easy. Clever people continue to analyze and paralyze about the company's problems, rather than tackle them.*

*People create empires as they climb the greasy pole in the world of integration. There is a tendency to put off decisions because we've suddenly become consensus-driven. When decisions are made, it is usually outside the meetings. We have yet to create transparency and inclusiveness.*

*The matrix is complex; it drives me nuts! It is too political. It's testing my ingenuity. What I need is a blend of strong business skills and a bit of Machiavellian diplomacy. I can't believe that this is the future."*

Source: CREATE and KPMG International – Interview quotes

*"Our model is very efficient; it does not run the risk of being hollowed out"*

*"On the institutional side, there's an illusion that if I leave, consultants will scream, even if I am an idiot"*

*"People do not leave for money. They want an equity stake; they value wealth over income"*

*"In a volatile market, you need product flexibility or cost flexibility; preferably both"*

*"In this egocentric, silo-minded business, it is hard to give up star worshipping"*

*"The paradox of scale is that talented people want to work in boutiques"*

Third, the complexity of the matrix requires leaders with different skill sets, as we shall see later.

That the matrix is here to stay in many firms is not in doubt. The reported difficulties are in the nature of teething problems. Like everyone else, investment managers find change painful. Currently, nearly one in three houses in our sample is adopting a matrix model. Furthermore, three in five houses who are subsidiaries of banks and insurance companies expect to implement the model over the next three years.

Clearly, the days of unbridled independence are over for the majority of investment managers. Even boutiques, with a parent, will not escape a leash around their necks.

### Reward: attacking the sacred cow

There is little doubt that payroll budgets have been slashed (Figure 5.2), with the biggest cuts in the US and UK. Three key drivers have been:

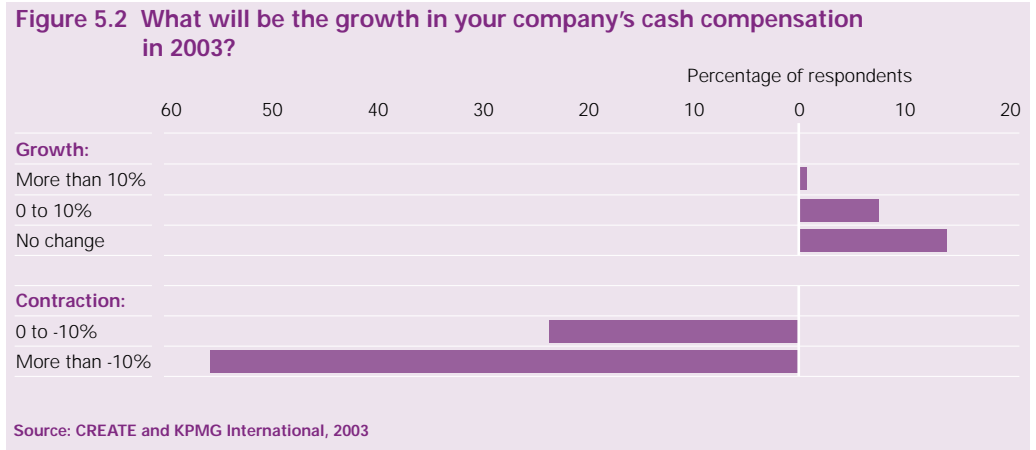
- **cyclical losses:** with 40 percent of firms in our sample reporting a trading loss, the attack on bonuses became irresistible
- **systems changes:** two in five houses have revamped the reward criteria to reflect individual and team performances; the linkage with FUM has been severed
- **ending of golden handcuffs:** houses of all sizes have started to end the legacy bonuses that were agreed in the days of the booming market. These were guaranteed, irrespective of market conditions or individual performances. Some are coming to the end of the contractual period; others are being 'bought out'. Their scale proved hard to quantify: few firms wanted to discuss the issue.

*“Recently, we had an independent evaluation to assess how many of our fund managers were worldclass. Results: none. That came as a rude shock to them”*

*“It’s hard to change the compensation and benefit system here: the dead weight of history still weighs us down, big time”*

*“If we don’t dump our pay system, we’ll be dead in the water”*

*“Bright talented individuals do not want to work for large firms; so we shall remain a cottage industry in which people want an equity stake, with no sex and violence on route”*



But they were more than willing to identify one or more of the four areas where there was ‘work in progress’:

- **change the balance:** this would involve low base pay and a higher bonus
- **link bonus with out-performance:** this would jettison the entitlement mindset and offer bonus for exceptional performance for one year or more
- **offer equity stake:** this would recognize that many managers are interested in their total wealth, not annual income; equity has already proved an effective tool for retaining key staff
- **emphasize non money elements:** this would ensure that individuals recognize the importance of benefits that enhance job interest, or market worth, as identified in Figure 1.6.

Unless one or more of these ideas are implemented, it will be difficult to return to profitability in a nominal growth environment. Smart firms who have tackled this issue are infinitely better placed.

***“Wall Street’s discretionary pay model is no longer optimal in asset management: best practice is a blend of structured and discretionary elements”***

***“We operate like a listed company, meeting best practice standards of the industry”***

***“Rocket scientists burn out, too”***

***“The boutique model is hard to emulate because managers have to invest their own capital; you require an ongoing greed for money that is more psychological than physical”***

***“We’re commercializing the culture in terms of how managers operate; how they drive the bottom-line, how they segment the market”***

***“Boutiques are more attractive because they offer an equity stake and partnership opportunities. Also, large diversified firms have short-term focus and mediocre leaders who irritate fund managers”***

## Thinking aloud...

*“If the client does not want to pay our level of fees, we walk away. Investors trust us. We avoid bells & whistles business. We just don’t take on anything; we do a few products and do them well. We are one of the few firms which have not been hit hard by the bear market. In fact, our FUM have grown since it started.*

*Most of the top guys have been here for more than 20 years. We’ve not changed the investment process and philosophy since our birth. This is helped by the fact that we grow our own talent and retain it. The average stay of an analyst is around 14 years; that of a fund manager even higher. We don’t shoot them when profits fall. We protect people in the downturn and earn their lasting respect.*

*Out of every 1000 applicants, we hire three. Nobody has ever been fired, so rigorous is our selection process. People work in autonomous units and are encouraged to resist becoming mini bureaucracies.*

*Employees own 35 percent of the firm’s stock; the rest is widely diffused among shareholders. We attract people who want to work for an independent house with less control, less hassle, less bureaucracy, faster decision making and a clean reward model. Fund managers are assessed on what kind of role model of corporate principles they offer, how well they communicate with analysts, and what their performance is over a longer period, not just one year. We aim to protect people and their bonuses in the downturn.*

*Yes, we do have a star culture; we’ve got a lot of single funds with single managers. But we don’t tolerate egotistical behaviors that show scant regard for others. That’s why we’ve kept out of hedge funds.*

*Our fixed costs are very low. Variable costs are tightly controlled. Salaries have been frozen in real terms for more than five years. Bonus is linked to ideas sharing and longer term performance, not buys and sells.*

*Analysts are rewarded on the basis of the quality of their recommendations and their adoption by fund managers. Recommendations that are not adopted are still rewarded if, in retrospect, they turn out to be correct. Knowledge sharing is our core competency. We once let go a very capable guy: he couldn’t work in a matrix.*

*Our uniqueness comes from the long term nature of our approach. Our competitors do not seem to make an investment for long enough to build a viable business. Theirs is a feast and famine approach. It doesn’t work outside the bull market.”*

Source: CREATE and KPMG International – Interview quotes

## Creating a culture of leadership

*“Good leaders who can run asset management firms are lacking in Japan”*

*“Making a mistake is not a cause of dismissal, its cover-up is. Be unforgiving if things go wrong, but don’t kill”*

*“Either off-load costs or off-load businesses. That’s the policy in these difficult times”*

*“Independent fund managers have a better chance of success because there are no ownership pressures”*

*“Cost flexibility comes through close attention to numbers”*

*“If we lose five people to competitors, we will be in trouble”*

*“We are successful because we are internally segmented, have developed fixed income capability, provide excellent service, charge a simple annual charge with no front end; put huge emphasis on internal knowledge sharing; and have a small company mindset.”*

If lean production is about having fewer people but getting them to work smarter, there are early signs of positive change.

Changes in the operating model, as described above, are tantamount to changing the hardware of the firm.

There are signs that its ‘software’ is being changed, too, through the reshaping of business culture (Figure 5.3).

Prominent changes include:

- **ensuring that the top team does in fact work like a team:** this is to ensure that centralization does not replace old silos with new ones
- **enhancing the skills of existing business leaders:** this is to help them manage the complexity and diversity of outsourcing, operating models and variable pay
- **promoting more teamwork in the front office:** this is to minimize the negative aspects of the star culture as well as ensuring that individual knowledge is leveraged across the front office
- **paying people on the basis of individual/team performance:** this is to encourage more teamwork and link pay with performance
- **adopting a matrix structure:** this is to encourage geographical and corporate integration, as discussed earlier.

In the changing environment of the 2000s, the culture of leadership, however, amounts to two things.

First, senior executives of the business should have a strategic orientation that allows them to address the questions that are most frequently asked by their colleagues at the workplace. Our research identified four questions:

- **goals:** where is this business going?
- **deliverables:** do we have the leaders and cultures to deliver the goals?
- **local impacts:** how is the move towards lean production affecting people and their immediate colleagues?
- **motivation:** what’s in it for me?



### Thinking aloud...

*"Our products and processes can be copied; but not our culture.*

*We're populating ourselves around satellites by creating small units of capabilities, each with its own distinct brand identity. The parent company acts like a mother ship, providing a security blanket for individual businesses.*

*It provides support in overhead functions except marketing, where our multi-asset class, multi-style, multi-country clients require different approaches. We rely on a system of transfer pricing for the supply of overhead functions. It is done with a light touch; each party makes realistic demands on the other. But tensions do occur sometimes.*

*Each business is jointly owned by its managers and the mother company. It has its own compensation and benefit systems to suit its own circumstances, while linking reward with outstanding performance.*

*It is expected to come up with new ideas and put its capital where its mouth is. It is encouraged to take entrepreneurial risks. Otherwise, it is left to its own devices.*

*They all work on the formula that revenue has to grow faster than costs each year. We have a small group of CRMs, who network internally and externally and facilitate cross referral of business.*

*This model has worked well for us because it gives managers latitude in the way they run their own ship, whilst leveraging the group resources."*

Source: CREATE and KPMG International – Interview quotes

***"There's been a lot of cost cutting which has sapped staff morale; the high flyers are likely to leave at the first opportunity"***

***"Is it legitimate for fund managers to parade their past performance?"***

***"Product innovation is not on, since others can copy quickly. Skills are the only thing that can't be readily replicated"***

***"We hire when others de-hire"***

From our research, it is clear that in a large majority of houses this strategic orientation had been conspicuous by its absence until 2001. Understandably, the emphasis has been on tactical responses, as described in Section 4.

Second, senior executives of the business need to rethink their own style. When asked whether firms in investment management world-wide have business leaders who can manage the business from peak to trough to peak, the answer was revealing:

- 3 percent said 'most firms have these leaders'
- 47 percent said 'some do and some don't'
- 50 percent said 'very few do'.

These leaders also went on to identify the skills they need in order to have a more strategic orientation. These have already been listed in Figure 1.8. Acquiring them is the pre-condition for developing a workable variable cost model.

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

*"Nothing will ever be attempted  
if all possible objections must first be overcome"*

**Samuel Johnson (1709-84)**

*"Chance favors only the prepared mind"*

**Louis Pasteur (1822-1895)**

## Ten golden tips

This report has identified key threats and opportunities faced by individual investment management firms, as they enter the new era. This final section draws them out 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 attention by today's Chief Executives and others who have the substantive responsibility for designing and implementing the business strategy of their firms in this decade.

The check-list, in turn, has been so presented to provide a first level audit 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 audit as follows:

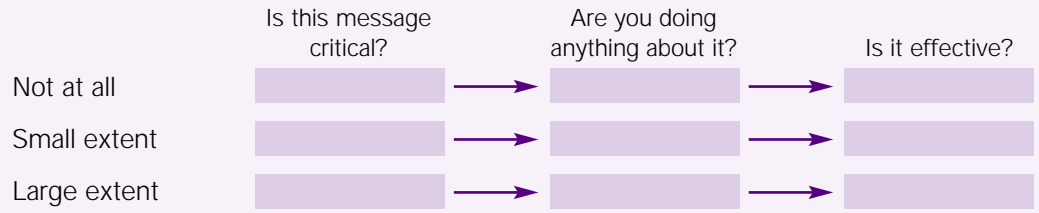
**Message 1** As investment management has gone from growth to maturity, cost and risk control has become key to survival: however, this alone cannot ensure success.

	Is this message critical?	→	Are you doing anything about it?	→	Is it effective?
Not at all	<input type="text"/>	→	<input type="text"/>	→	<input type="text"/>
Small extent	<input type="text"/>	→	<input type="text"/>	→	<input type="text"/>
Large extent	<input type="text"/>	→	<input type="text"/>	→	<input type="text"/>

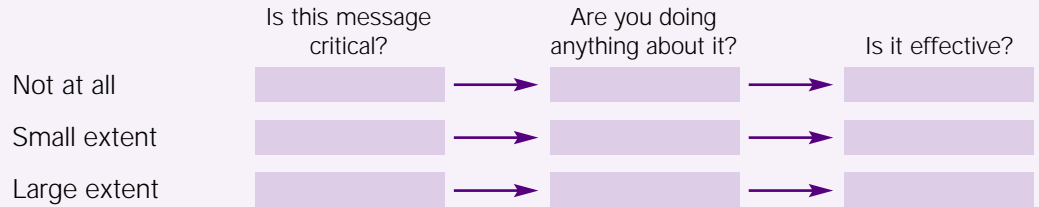
**Message 2** Success will depend upon performance and service quality delivered on the back of business basics; investors' expectations are adaptive of past losses, so deeds matter more than words.

	Is this message critical?	→	Are you doing anything about it?	→	Is it effective?
Not at all	<input type="text"/>	→	<input type="text"/>	→	<input type="text"/>
Small extent	<input type="text"/>	→	<input type="text"/>	→	<input type="text"/>
Large extent	<input type="text"/>	→	<input type="text"/>	→	<input type="text"/>

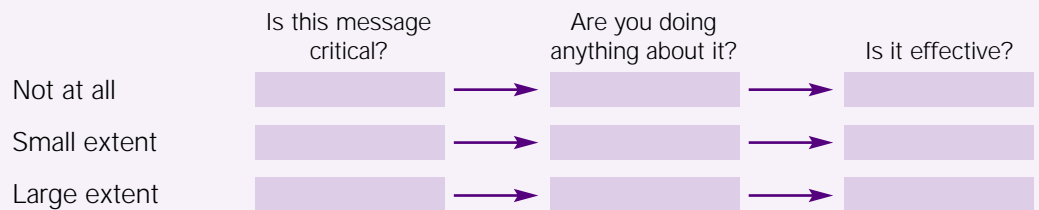
**Message 3** The shifts in demand, supply, market environment and product mix are changing the face of investment management, against the background of huge volatility; firms need to have flexibility in the way they do things.



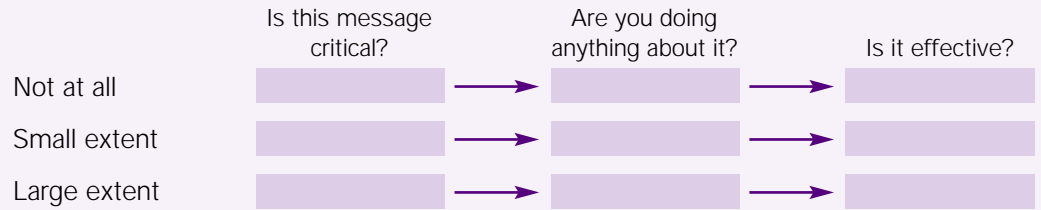
**Message 4** Necessary though it is, regulation will raise costs, create more hassle and restrict initiative; firms need to use their collective clout to ensure that the impending measures are sensible and practical.



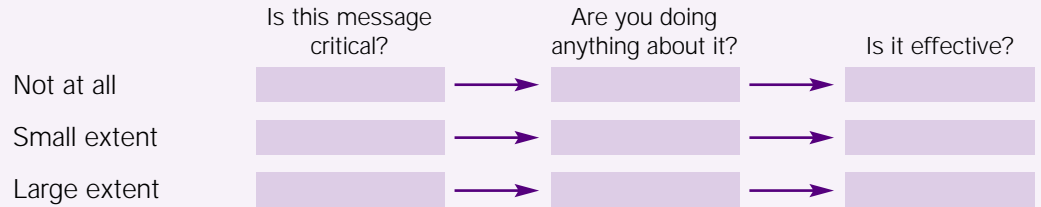
**Message 5** Investment, operational and reputational risks have become ever more dynamic; the challenge is to manage the business in an uncharted environment.



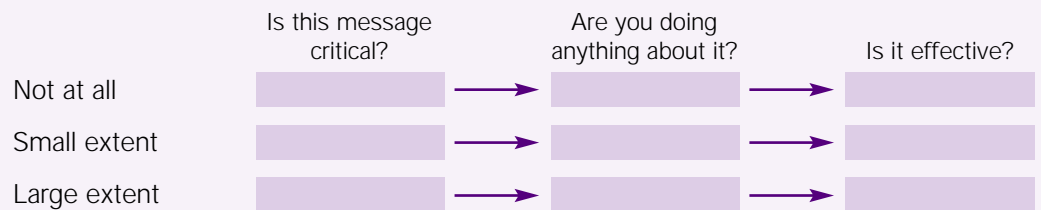
**Message 6** Competition is driving consolidation; but M&A should complement, not substitute, the actions towards a variable cost model; strategic positioning in the emerging polarization is vital.



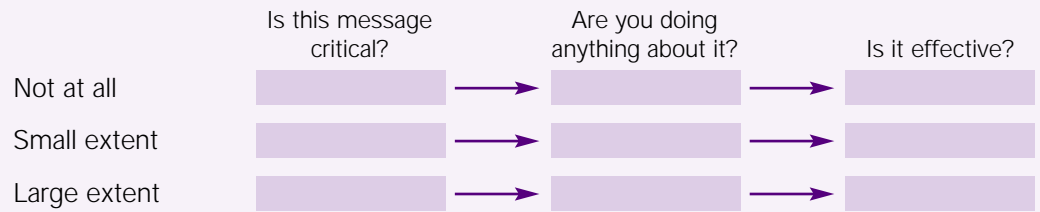
**Message 7** As the business takes off, the law of unintended consequences produces black holes; they dilute the economies of scale and scope alike; they sap scarce dollars and emotional energy.



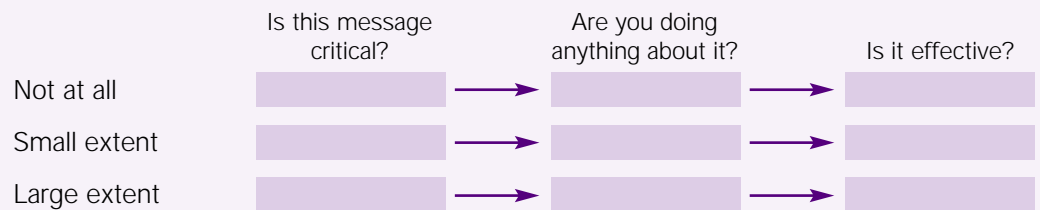
**Message 8** Outsourcing and centralization are not everything; they can reduce costs only so long as they are packaged within a strategic approach that involves actions on other fronts as well.



**Message 9** The sacred fat cow of pay and bonus is long overdue for slaughter; uncontrolled greed is destroying the economics of the business; customers have wised up, as have the regulators and the media.



**Message 10** The old ways of doing things are a recipe for disaster; equally, the new ways are daunting; so senior people need far more mental agility, emotional resilience and personal rapport than before.





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Produced by KPMG's Global Financial Services practice July 2003.  
Designed by Mytton Williams. Printed by Jevons Brown, UK.