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Margolis Advisory Group

Surfing the Convergence Wave: How Asset Managers Can Stay on the Board

- Investment managers face an increasingly crowded marketplace as convergence re-draws the playing field:
    - Traditional long-only firms entering the alternative space.
    - Product and vehicle proliferation leading to competition for new assets.
    - Blurring market channels and hybrid markets.
    - Consultants, money managers, and insurance companies all vying for the same opportunities.
- Firms that respond to convergence with a thoughtful strategic plan are best positioned to reap its benefits.

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Executive Summary

This paper discusses the threats and opportunities increasing convergence means for the investment management business. In the not-so-distant past, asset managers tended to play in their own sandboxes: institutional managers ran money for defined benefit plans and other large asset pools and retail money managers focused on the mutual fund marketplace.

Today, the investment management playing field encompasses an increasingly jumbled mixture of firms, products, vehicles and marketplaces.

Convergence forces money managers to make a strategic decision to either change course or remain in place. Both responses have risks and benefits, and it is best to understand and analyze the forces of convergence and how other firms have benefitted, or suffered, before coming to a decision.

Looking in the Rear-View Mirror

Before digging into the details of how convergence impacts asset managers, and how they can benefit from convergence, it is helpful to review the factors which, over the last decade or so, have hastened the pace of convergence. As is often the case in a marketplace transformation that impacts both established and new players, revenue needs and changing demand for specific investment asset categories or vehicles are key drivers.

Within the traditional, institutional business of defined benefit pension plans, revenue from net cash flows has been negative for some time due to a continuing trend away from the use of defined benefit plans toward defined contribution and hybrid plans. As a result, money managers who previously focused all their efforts on the traditional "institutional" arena are now in a "zero-sum game" resulting from revenue that is solely dependent on product and market performance. Without growth, managers are instead fighting for market share.

As revenue from the traditional institutional channel began to dry up, managers were also hit with rising costs merely to "stay in the game". A professionally-designed and functional website became a must along with, for many clients, password-protected internet access to portfolio holdings and other information. Meanwhile, client service, while less reliant on social interactions like golf and meals, increasingly required staffing up to complete clients' RFIs and DDQs. Other growing cost centers included sales (no self-respecting sales force would be without a CRM system!) and legal/compliance (emails, pitchbooks, and RFPs must all be monitored for promissory statements!).

As operating costs continue to rise and net flows from traditional defined benefit clients are negative, investment managers also confront increasingly fee-conscious buyers anxious to obtain the lowest possible separate account fee. Fee pressure is partly the result of a tremendous increase in the number of products available to institutional buyers; in a marketplace of multiple and similarly-built products, often the lowest fee will win the business. Another factor is the attraction of low-cost passive vehicles to buyers.

Convergence 101:

Originally from the field of biology, convergence is defined as "the tendency of unrelated animals and plants to evolve superficially similar characteristics under similar environmental conditions." This definition has been applied to organisms, processes and entities that evolve in a similar manner or begin to occupy the same space. In finance, we have heard for several years of the convergence of different businesses occupying separate but related 'spaces'. Convergence, for us, can apply to types of firms, specific firms or even functions within them.

Farewell to the "Good Old Days"

There are four broad areas of convergence, as noted below, which are changing the asset management arena in new and potentially disruptive ways for traditional businesses.

Types of Convergence	Description
Money Manager Firm Type	Alternatives vs. Traditional Firms
Money Manager Products	Across Asset Class, Vehicles, etc.
Money Manager Channels Served	Institutional vs. Retail (and hybrids of each)
Across Firm Type	Money Managers vs. Consultants and Insurance Companies

In this paper, we address each of these convergence factors and how investment managers may consider appropriate and strategic responses.

Firm Type, Or, What Do You Want To Be When You Grow Up?

Within money management, it's become tougher to distinguish between traditional (long-only) firms and alternative shops, as now many offer the products of one another. Also, historically hedge funds were dominated by one or two (investment/trading) individuals and the firms often had difficulty with personnel succession, so over time they have tried to add a variety of people and resources to improve longevity of the firm.

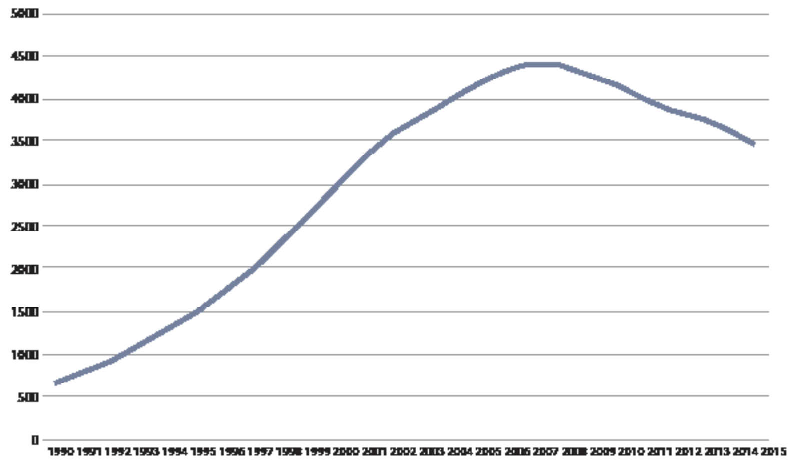
Why do long-only firms add alternatives? There are several reasons including higher fees, client demand, and the ability to keep staff who are interested in using their investment talents for such products. Conversely, alternatives-oriented firms that have added long-only products are attracted to the opportunity to manage even larger allocations of money. Furthermore, both groups want to scale their resources across higher levels of assets. Finally, given the high costs to compete in certain channels, and with certain products, and the increasing success of large firms (who tend to win more than their share of mandates) combined with much talk about larger firms being "winners", many organizations have chosen to aim high.

Product Proliferation and Vehicle Profusion

Investment managers seeking to grow revenue and assets under management (AUM) confront an increasingly crowded marketplace. As shown in the exhibit below, the number of U.S. equity strategies maintained in the eVestment database has soared from just over 500 products in 1990 to nearly 3,500 at the end of last year[1]. With demand from traditional institutional channels tapering off, and an average of 220 new competitors entering the arena each year prior to the recession, it is not surprising that firms have decided to expand into new channels.

[1] Note that the Great Recession took a toll on the number of strategies offered to investors. It will be interesting to see if the trend towards ever-increasing options resumes along with a recovering domestic economy.

Product Inflation?



Source: eVestment: All US Equity universe

Convergence across products has also become more common for firms that may have historically built their reputations on one asset class but now decide to diversify into others. This effort may not always be successful or may not be successful in a timely manner (e.g., PIMCO into equities) but incentives for firms to add these capabilities include:

- diversification of business risk;
- higher fee levels (e.g., fixed income vs. equity); and
- growth in demand (i.e., Liability-Driven Investing (LDI) or higher fees for global and emerging market equity products compared to domestic equity).

From a product perspective, alternatives have become more mainstream, taking share from long-only products. As these products have grown and the firms offering them have increased in number and size, there has been an accompanying blurring of alternative-focused vs. traditional product-only firms as mentioned above. They tend to be competing with one another in alternatives products, and even in long-only products which are increasingly also offered by alternatives shops to gain larger allocations of assets.

The increasing ability to outsource non-investment functions has allowed small boutique asset managers to grow by entering other markets and channels, knowing they have outsourced several of the key skills required for success and can keep their organization focused primarily on investments. As a result, this trend has created additional competition in many products and markets. On a related note, the dominance of flows to the largest firms in certain products and styles (e.g., passive and alternatives such as hedge funds and private equity) means that new and smaller firms have to be open to new ideas and markets as they seek ways to enhance their revenues.

Investment managers hoping to increase revenue and assets by targeting new channels for distribution may also face product design-related issues. In this case, one size may not fit all! Some product designs are more suited to one specific channel than others—a simple example would be hedge funds with high minimum investment restrictions that are beyond the reach of defined contribution investors or retail individual investors. Other challenges of product design for multiple channels can include cash allocations which are anathema to most institutional investors but might, in times of market dips, be appreciated by individual investors.

Large institutional investors, whether they are retirement plans or foundations/endowments, may have many managers; each with a specific role to fill in the overall plan. Significant style drift creates an issue for these asset owners, and managers are advised to maintain their approach regardless of market environment. Retail investors, whose exposure to an asset class might consist of one or two funds, are often more accepting of changes in investment strategy—as long as their return expectations are met.

Managers should hesitate before altering an investment process to "tailor" an existing product to new channel-specific expectations.

Investment managers should also be leery about making changes to an investment process, product risk exposures or minimum/maximum sector, cash, and other guardrails in an effort to "tailor" an existing product to channel-specific expectations. Doing so may lead to a 3- to 5-year period of monitoring by consultants and prospects to see the results of the tweaks before recommending those firms and products be hired.

Blurring Channels and Hybrid Markets

Perhaps the area that stands out the most is convergence across channels: much of this paper will address implications of channel convergence as this factor has the greatest impact on an investment manager and the decisions it faces.

Institutional firms are increasingly attracted to the sub-advisory, retail and high net worth channels for access to flows and, in some cases, higher fees. On the other hand, many retail firms, now that they are competing for defined contribution money, are closer to fulfilling the needs of institutional investors: a new channel with the potential for larger allocations than those from retail investors. For example, as part of their strategy to grow AUM, Oppenheimer Funds recently added a professional to focus on meeting the operational needs of institutional investors.[2]

[2] FundFire January 7, 2016

To survive and prosper, many investment managers seek to grow assets in other institutional areas such as endowments and foundations, as well as venturing away from the institutional arena into retail and high net worth money, with many stopping at the middle ground of providing sub-advisory services and funds for 401(k) plans offered by large record-keepers.

Despite the fact that retail money management offers higher fees per dollar managed than institutional assets, disadvantages on the retail side include higher infrastructure costs and lower assets per client, as well as more volatile client flows. As a result, some retail managers find both 401(k) money and institutional money to be of interest and are competing for those pools. For example, a money manager's name recognition matters significantly for 401(k) allocations, which are one step closer to institutional assets for retail firms and a logical place for them to compete (as they have for many years).

Managers seeking asset and revenue growth rely on the retail and high net worth platforms that have become more centralized and research-controlled (akin to consultants' impact on institutional business). Research teams at many platforms have traits of both retail and institutional investors, making it an easier transition for both pure retail and pure institutional firms to gain footholds.

Expanding into new channels can require expensive new vehicles suited to the requirements of the channel.

Expanding into new channels often requires adding new vehicle options that are best suited to the requirements of the channel. Investment managers with track records built on separately-managed accounts that wish to enter the defined contribution or retail markets will need to launch one (or more!) of the following: 40-act mutual funds, private placement funds, bank collective trust vehicles, or commingled funds to meet the needs of these marketplaces for liquidity and pricing frequency. Many firms might also consider launching Exchange Traded Fund (ETFs) vehicles for their strategies. Adding these types of vehicles can be costly; a new mutual fund can cost anywhere from $50,000 to $100,000 to launch and $150,000 to $200,000 a year to operate. Historically, institutional firms have garnered assets from these channels solely through sub-advisory relationships, but growth is limited without the creation of the vehicles mentioned above.

Commingled funds and trust vehicles, depending on the type of vehicle, have lower launch costs, but still require between $50,000 and $75,000 a year to administer. Vehicles for alternative strategies that hold private investments like equity real estate or commodities will be even more costly than vehicles for traditional, long-only equity or fixed income.

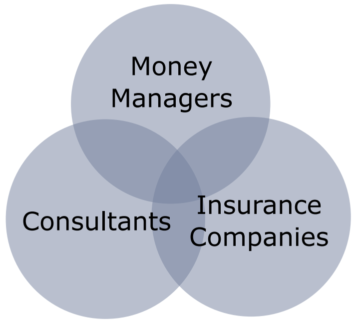
Entering the mutual fund space can also expose managers to additional layers of legal, compliance and governance oversight and cost. Deciding to launch new vehicles to meet the needs of new channels should include a strategic review of expected growth in assets and revenue, costs, and suitability of the product to the new channel.

For some managers, the addition of vehicles has been a home run. But for others, particularly managers experiencing low asset growth in the new vehicles, the experience has been costly and unsuccessful. In many cases, this is because fees are calculated on assets in the vehicle, and managers may have to subsidize the cost of running the fund for years to keep fees competitive with peers—all the while experiencing increasing fee competition in the marketplace.

New Players in the Sandbox

Other factors at play relate to the nature of both money management and consulting which are driving competition between these organizations. For many years, consultants earned significantly less than managers because of the lack of measurable and attributable results. To remain viable, and to retain talent, consultants continue to search for ways to increase profits towards the level enjoyed by money managers.

The consultant search for new revenue sources has led them to offer outsourcing services for legal, financial and operational reasons. While outsourcing capabilities are attractive offerings for consultants, the increasingly consultative sales approach common today means that money managers need to possess the same skills, making it more likely that they can offer services to compete with (and potentially even replace) consultants.



When Consultants Become Competitors and Vice Versa

Money managers increasingly find themselves competing against consultants. The search for higher fees has led consultants into the Outsourced Chief Investment Officer (OCIO) business. Consultants already have many of the capabilities needed to oversee an entire fund or foundation/endowment, but need to add additional fiduciary responsibility and portfolio management/trading oversight to be effective in the OCIO role.

The OCIO channel is attractive, primarily due to potentially doubling existing fees that would be charged for standard consulting services. On the other hand, consultant recommendations that clients hire Liability-Driven Investing (LDI) managers have opened the window for competition by managers who offer LDI and solutions-oriented products to their clients in direct competition with consultants. It's no longer just firms that manage multi-asset class (or style) portfolios and Hedge Funds of Funds (HFOF) that have to manage potential conflicts with consultants; it is now the industry norm.

Convergence and competitive threats aren't limited to money managers and consultants. Insurance companies have historically included asset management units (many of which focused on fixed income and real estate as these are insurance firms' areas of concentration for their own portfolios). With the advent of pension buy-outs (acquiring the pension liabilities and then assuming responsibility for the assets in order to make it a profitable endeavor), insurance companies now compete with money managers for client assets while simultaneously awarding mandates to managers with specialties outside of those managed internally by insurance companies.

Better Put On Your Strategy Hats

There are a multitude of implications of convergence that relate to strategic decisions, including investments, marketing and distribution, and other personnel/areas.

Given the new realities, it is increasingly important to understand the dynamics before making a decision on your firm. Understanding who the competition is and might be, along with who your firm is, can help a firm decide if it wants to compete in a particular channel. For example, many institutional firms want retail flows but don't want to spend the money associated with building the necessary vehicles and infrastructure to be successful. Firms such as these may prefer to keep their current corporate culture; as a result, sub-advisory management can be a strong option for building assets despite the lower fees typically found in sub-advisory relationships. Lower fees, for these firms, can be seen as an acceptable trade-off for having another party sell their capabilities.

The same is true on a product level. International and emerging market equities offer significant upside in demand growth, but investment managers should first consider the variety of competitors. Which are from the institutional area?

Are there some from retail firms who have strong results but don't yet have the institutional name and are expected to succeed once they apply the relevant resources?[3]

Considerations such as these need to be reviewed to help determine whether and how to add products and vehicles. Does expansion build on your firm's unique value proposition or is there a risk of muddying a brand which may have taken decades to create?

If We Build It, Will They Buy It?

With increasing competition, it is reasonable to expect that it will take longer to grow assets of internally-incubated strategies UNLESS a firm has a large and dominant sales force, very satisfied clients open to cross-sales of the new product and a relationship management staff to execute the strategy.[4] If this is not the case, then internally-generated strategies will require a great deal of excellent performance combined with patience to be successful. This also applies to new and emerging firms; consultants who 10 years ago considered new strategies and firms of $100 million in AUM today seek at least $250 million before evaluating them for clients.

Expansion can either build on a firm's value proposition or muddy a brand which may have taken decades to build.

Another important strategic decision relates to how one conducts business with an entity who is a consultant to your clients (hence a client-like relationship) but also a competitor. Every firm needs to consider how they treat these consultants, including information they provide and the nature and frequency of the interactions. It is easiest to say that one will not share competitive information, but the changing nature of this relationship should be considered at a macro level in determining the types of clients one seeks (and how one gains them) down to a micro level including which people and resources are assigned to the accounts.

It may be also be constructive to consider Hedge Funds of Funds (HFOF's) as a channel. These funds now face competition from consultants recommending separate accounts at lower fee levels than ever, and who may counsel clients to avoid the added fee level charged by HFOFs for finding and allocating to multiple separate hedge funds. Some consulting firms may even offer the same services as HFOFs, and HFOFs increasingly need to dedicate greater resources to finding and servicing direct clients without consultants while still meeting the needs of the clients.[5]

[3] An example of the latter is Matthews International Capital Management, which is known for its expertise in Asian equities but primarily in the retail mutual fund channel.

[4] A sober analysis of market demand and track record strength is required before funding an internally-generated investment idea. Firms who do so to "keep the peace" with portfolio managers risk investing time and money in an idea with meager demand. The portfolio managers will probably eventually be frustrated with the time it takes to build assets, so this may not be worth the effort as it just "kicks the can" down the road a few years.

[5] For example, see Christine Williamson's article citing Texas Permanent's partnership with Blackstone and Grosvenor (*Pension & Investments*, 11/10/2014).

Another strategic dimension asset managers should consider is which services to provide. In many respects this decision relates to the channels served. Institutional firms can be almost solely investment-oriented, outsourcing elements of operations and sales; at the other extreme, retail firms often have large custody and operational components plus substantial sales forces that exceed the institutional sales/service and consultant relations model. Retail firms need to continuously engage not only the research heads at platforms but also directly with brokers, producers and professionals who select funds for their clients. Within the world of wealth management, tax knowledge and additional client services are important, as well as extensive relationships with the external service providers who refer clients to investment firms.

Next steps will be to expand on these strategic dilemmas and review how convergence affects critical components of the business of money management; including:

- Portfolio management and vehicle options – how to bring investment insights to potential institutional, sub-advisory, retail and high net worth clients
- Staffing – Finding the right balance to take advantage of increasing convergence in the asset management business
- Distribution – How best to gear up (or gear down) sales, consultant relations and marketing in the face of convergence
- Client service and support functions – Critical, but often overlooked, manager functions including operations and legal/compliance need to be structured in line with optimal responses to increasing convergence

Summary

There are many facets of convergence impacting how investment managers run their businesses including blurring of the lines between alternative-focused and traditional long-only firms, products that are now expected to appeal to multiple types of investors, and new channels hoped to yield a surging wave of increasing assets and revenues.

As asset managers struggle to adapt to the new normal of rapid convergence, the lines between different industry players are also less firmly drawn as each struggles to gain a foothold in areas that, traditionally, were the separate province of consultants, money managers and insurance companies.

Investment management firms confront a variety of possible responses to convergence ranging from what might be termed the Luddite option of doing nothing to an aggressive expansion strategy involving new products, additional channels, and acquisitions to grow the business.

Firms embracing the latter approach may do well to seek advice on the best way to go about adapting to, and benefiting from, the wave of convergence in the asset management industry.

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About Margolis Advisory Group

We work exclusively with the investment management industry to enhance sales growth and retention through people, product and process improvements and practical solutions.

With extensive industry experience raising billions of dollars for investment firms, from start-ups to large organizations, we work with executive management teams, and sales and marketing staff to achieve desired results.

While our expertise assists investment managers in thinking through problems and analyzing the marketplace, our clients benefit most when we help them in translating that thinking and analysis into execution.

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