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The Pressure Is On

Managing an investment business for results in 2012

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The Pressure Is On – Managing an investment business for results in 2012

Introduction

Revenue growth for asset management firms has slowed in recent years, and there is pressure on leaders to increase profitability. Some firms drive to become more efficient by first cutting or reducing, which can lead to all sorts of problems. In the absence of better ideas, across-the-board job cuts are often an early response to profit pressures.

It's true that there are fewer ways for leaders of asset management firms to improve efficiency in their business model than in most other businesses. With few balance sheet issues to tweak, asset management organizations are missing many levers to improve profits. With fewer ways to adjust costs, efficiency drives, other than job cuts, have a tendency to stall out quickly. This white paper will discuss ways to enhance profitability in the short run, while continuing to support long-term strategies. We'll address internal resource allocation, investment under-performance, sales shortfalls , other possibilities for profit improvement, and conclude with responding to a crisis, and turning around a firm's reputation. 12 suggestions for improving your business' profitability in 2012 concludes the report.

Owners versus managers

The emphasis on efficiency is not only a result of revenue pressures. Structural change in the industry has also led to an increased emphasis on managing the business efficiently. Ownership of many firms has been divorced from day to day management, and this has heightened interest in profitability. When businesses are tightly controlled, managers and their owners share the profits. No one worries too much about compensation versus profit on owner's equity. On the other hand, if corporate owners and/or retired owners are involved, there is an increased awareness of the need to earn an adequate return on owners' equity, as profits have to be shared between owners and managers of the business.

Misguided efficiency efforts

Leaders struggle when challenged to make changes that are meaningful to the bottom line. Most expenses have their militant advocates.

The result is that cutting expenses is either traumatic or laughable. I've worked in organizations which decided to eliminate subscriptions to publications to save money. While arguably laudable from the perspective of signaling a change in what expense behaviors are seen as acceptable, the real impact was small, but no less disruptive than a more consequential and helpful change.

Out of frustration over the trauma of cost-cutting, and in order to retain staff, many independent firms keep base salaries low for top executives, so that the inevitable down periods can be absorbed in lower bonuses for the executives, and leave bonus money available for other staff. When this sacrifice is insufficient to pay incentives, the easy answer is often an across-the-board cut in staff, or a more focused reduction of non-professional staff.

Resource allocation

If you are just days from failure, and are worried about making payroll, the issue of cutting costs now, is going to be at the forefront of your mind. Rarely though are investment businesses in that dire of a situation. More typical is an investment business that is under-performing the objectives of the owners, and perhaps falling behind the competition. This isn't just a theoretical concern, as earning less profit than the competition impacts the ability of the firm to hire, keep talent and win clients.

It's no secret if a firm is falling behind. Even without a public disclosure of the financial statements of the firm, competitors, or prospective clients and employees, can all read between the lines by viewing arrivals and departures of staff, announced wins and losses of clients and surmise that there is trouble in paradise.

In order to sustain the business in the long run, leaders have to make important choices, some of which may be practically irreversible.

Thoughtful resource allocation is your most important decision. No matter what you may say about your firm's strategy, what you spend your firm's money on outweighs your words. These choices drive your business model, and therefore drive profit.

You might want to think of each of your firm’s expenses as an investment. Every salary, every computer, every square foot of space is an investment in your firm. The question then can be asked: What products and activities do these expenses support, and what is the short and long term return on these investments?

Like an investment portfolio, many of your expenses are correlated as they support multiple activities. Often activities are interrelated, which complicates a financial review. For example, a specialty bond business benefits from the resources spent on your core bond capability, so it is important to consider the interconnections between businesses as well.

If you have more than one investment capability or product in your firm, some may be making a larger profit than the rest. While some business lines are core building blocks of your firm, other parts of your firm may represent "real options", or investments that may be insignificant to profit today, but that have the potential to be important in the future. A real option is the right, but not an obligation, to take some action in the future. For example, if you are in a manufacturing business, logically you need to have built a plant before you can undertake a plant expansion. Building the plant incorporates a real option on future plant expansion.

Here's an asset management example of a real option. A domestic small capitalization equity manager decides to introduce a new product, and they choose to introduce a domestic small/mid cap portfolio capability. The portfolio manager's original small capitalization capability includes research and portfolio management skills. These skills incorporate a real option that allows the firm to consider the introduction of additional products. which are both logical and low risk, because of the existing skills available in the firm.

On the other hand, a small cap manager might instead decide to introduce an emerging market small cap equity capability, which may be a more costly venture because of the additional complexity of international investing. The value of the initial domestic small cap capability in supporting an emerging markets capability is lower than in the previous example.

You'll want to identify any real options in your firm, and then assess what value they might have for your firm's business strategy.

In summary, the resource allocation decision should include a review of both short and long term profit opportunities, inter-relationships between business lines and the real options available to your firm arising from your products, distribution channels, client segments, and geographical regions.

By examining your business from a variety of perspectives, it is more likely that you will arrive at a suitable answer for your firm. There will also be a greater chance that you will have everyone in your firm on board with the conclusions of this analysis, and the sometimes tough decisions that will be suggested.

Contemplating change

The implementation of these resource allocation decisions is often difficult. For example, not only will those directly affected by downsizing or a modest resource reduction, be affected, but your entire firm may be troubled by the proposed changes.

People value what they already have, more highly than change, no matter how dissatisfied they are with the status quo. Even if they complain vociferously about the present situation, they are loath to endorse a change because of the fear of the unknown. A medical doctor once told me that he was always amazed at how people can become accustomed to difficult physical handicaps. No matter how difficult their physical affliction, it becomes what they are used to, their new reality. Organizations can also be stuck and almost resigned to bearing pain. As leader, you have to shake off this complacency.

Some parts of your business are going to be at the bottom of the list after you review their contribution to your firm, as they may have either persistently poor profitability, an apparently minor role to contribute to the organization, or they may not be a promising investment for the future. The result is that the employees and leaders of these orphaned businesses will feel immediately disenfranchised by being at the bottom of the list.

There are at least two answers as to what to do with businesses that are expected to contribute little to the economic value of the firm. One is to implement the changes rapidly, and to restructure, close or sell a line of business. This often makes sense from a pure economic perspective, and is the least painful in the long run for everyone involved.

An alternative is to use the poor positioning of the business to challenge the leaders of the under-performing business to rethink their model – to align their business better for profitability. They can try to either improve short term or long term profit potential, enhance their relevance to the profit of other superior businesses within your firm or develop new long term opportunities for profit for the firm. Many terrific ideas have been developed from this type of challenge to managers. In one situation, we shifted a small money-losing defined contribution platform into the black, by figuring out new profitable ways to add value to customers. A recent change in client needs, and leveraging existing capabilities in other business lines in the firm, presented opportunities which turned this business around.

Investment under-performance

While allocating resources effectively should be fundamental to any asset management firm's drive for efficiency, investment under-performance is often the trigger for a sudden need for a more efficient firm, and it may need to be addressed directly.

At what point should a leader become concerned with investment under-performance? How much under-performance constitutes a problem, and how long can you afford to wait before it needs to be addressed? At some point, action may be necessary.

What has happened to performance can be objectively analyzed using statistical and quantitative diagnostic tools examining macro factors, style, capitalization, sector/industry weights, leverage and so on. But this only addresses the results of the investment process. You may need to dig a little deeper to improve the process if required.

The first step, though is to craft an honest explanation for clients of what happened. Perhaps the under-performance was within reasonable limits in relation to investment style, for example?

If the explanation is straightforward, it's possible that you can refrain from modifying the investment process. However if the under-performance has been significant or persistent, it may be too late to not take action. Portfolio managers are bound to be psychologically affected by portfolio under-performance, and they may be paralyzed, unable to make decisions. Clients and consultants may have become skeptical of your team's abilities, and this will have long term business implications.

Listen to consultants and client criticism for any additional clues as to what caused the under-performance. You might also consider the possibility that the team has a blind spot. When I started managing bonds in the early 1980's, none of my peers in the industry had seen a bull market in their entire career, and were very skeptical that anything might be changing. Yet there we were on the cusp of a bull market that's now lasted 30 years. Things do change, on a semi-permanent basis.

The process change may not need to be permanent. Changes in the capital markets may trigger the need for temporary adaptations in the investment process. For example, many investment managers are aware of the risks of financial leverage at the end of economic cycles when interest rates are high. Portfolio managers may choose to adjust their investment process to respond to circumstances or opportunities.

More generally, as a firm's leader, you need to understand the strengths and weaknesses of the investment process. Is there a clear path from investment insight through to out-performance? Are there inefficiencies in the process that can be corrected or continuously improved?

You'll want to look at the team responsibilities and authority for decision-making. One investment counseling firm, without changing the members of the team, or its investment process, reconfigured the

portfolio decision-making authority three times within the same number of years.

Reviewing responsibilities, decision-making authority, and whether to restructure, hire, fire, or add staff, are all possibilities to consider, but any changes carry risks. Continuity of the people on your investment team is an important consideration for consultants or clients. If portfolio manager turnover occurs, there are definitely going to be questions raised by clients and consultants. You also have to consider that any new hires may be no more successful than your previous leadership. Internal staff also may be concerned about the implications of any staff changes.

More drastically, you might need to consider merging, closing or selling the capability, if the negative impact on your firm's reputation arising from under-performance is significant enough. In some cases, under-performance is of such a magnitude, or it has been such a persistent feature, that the long-term prospects for marketing the product are dismal.

Shutting down the under-performing capability may help to save the reputation of the firm's other capabilities. By doing the right thing in giving the clients their money back, clients may continue to trust you with their money for other mandates, both now and in the future.

Sales management

Every firm has an opportunity to improve its sales efforts.

In larger firms, you hire quality sales managers, who in turn, hire people with track records of sales success. In a smaller firm, you are either directly hiring sales staff, or you are personally responsible for sales. In spite of your efforts to have the right people in place, there may seem to be a missing ingredient, and sales just don't materialize as expected.

Here are some suggestions that can help to turnaround your sales efforts.

First, bring together your investment staff and salespeople on a regular basis to formally discuss the characteristics of your products. It's important to reconcile the market's perceptions of your product as understood by your salespeople, with what your investment people believe to be true about each product. Often these two groups can agree on immaterial changes to the investment process, or perhaps just the process description, and these can help to improve a product's appeal to prospective clients.

In some cases, the sales and investment groups may have to agree to disagree. Historic performance is one example of something that can't be changed.

Short-term investment performance issues may not always be detrimental to new sales opportunities. Market leaders in many product and service categories, across all industries, do not always have the best product by objective standards. They lead their category by having a total offering that

exceeds the competition. Even if your investment product has a blemish or two, there are ways to craft an attractive offering for clients. Many of the largest fund managers are fortunate to have brand names that can carry them through times of investment under-performance. Smaller managers can also respond to client's needs by offering increased access to portfolio managers for example, and be perceived as more service oriented, and maintain their appeal to clients through times of poor investment performance.

If performance is good, understanding why your clients hired you, can help to give you clues as to your firm's appeal to particular market segments. For example, clients and prospects who are inclined to be more aggressive investors, may not care about volatility in your investment results, if longer term returns are attractive.

But your firm may still face challenges. You may believe that you have a fantastic investment product including performance, process, and people. But it is often frustrating to get sales traction. You are battling against so many existing players, and new firms, that it is often difficult to find an audience. There are an infinite number of prospective customers to pursue, and so focusing your efforts is crucial.

From time to time, the market appetite for a particular asset class may be weak, and the investment performance of your product is then irrelevant. Intermediaries such as consultants, some distribution channels and certain geographic locations may have other preferences, or be following an investment trend. Use sales downtime to explore possible product extensions arising from your core capabilities, new distribution channels, and new geographic regions for sales.

Next, examine the competencies of your sales staff. Believe it or not, not everyone asked, or hired, to sell, likes selling. If they don't want to sell, they won't. And yelling at them or providing attractive incentives won't help. Your salespeople must have a desire to sell in their heart, and it's up to you to identify and regularly confirm that you have these people fully engaged with the task of selling. You also have to be realistic that only a minority of your sales force will fully meet your expectations.

You can't rely on an individual's historic sales success for insight into their current capabilities. People's personal goals sometimes change over time, and people can burn out.

Distractions can also derail sales effectiveness. Larger companies in particular, can contribute to fewer sales opportunities. Assess the burden of administrative tasks that occupy your sales staff. Cut these tasks away from your sales staff in order to simplify their life, and free up their time to sell.

You should be aware however that sometimes people who really don't want to sell, will bury themselves in administration. They will resist if you try to help them by pulling them away from this work. Then you'll know that they should not be in sales at all. You may need to aggressively manage out under-performing salespeople, and hire new sales people with stronger fundamental

sales competencies, and track records of performance.

For those salespeople who are exhibiting positive sales behaviors, the rewards for sales results should be clear, and any incentive programs should not build in disincentives. Sounds obvious, but I see it all the time. Examples of disincentives include caps on incentives, no incentive for particular products, or complex formulas.

You want your salespeople to focus on the best prospective clients. It is easy to be sidetracked by talkative prospects, or worse, people without hiring authority, or even influence in the money manager hiring process. You should check on who your salespeople are calling upon. Your sales force needs to manage their time carefully. If it appears to them that a prospective client or a consulting firm is not likely to be an early adopter for whatever reason, they should not waste time pursuing them.

An old friend of mine in the retail business worried a lot about people entering her store. She felt that you had to quickly size people up as either prospects for buying something from you, or suspects, i.e. potential shoplifters.

You need to be careful with the amount of time that is spent on social obligations with prospects, prospects who ask a lot while giving little in return, and be alert to prospects who tell you directly that there is little chance of your winning business from them in the foreseeable future.

Sales goals help to keep salespeople focused on the best prospects, but only if they are regularly reminded of their goals, and their follow up plans are reviewed. The expectations will then be clear, and conversations about progress can be more action-oriented. Great sales people don't confuse activities with results. When the pressure is on to improve profitability, your salespeople need to guard their time, and utilize it more effectively than ever.

For those prospects that look promising, try to develop a business personal relationship with them. No amount of marketing material or contact via technology can replace at least an initial face – to – face meeting. People more often buy from their friends as everyone knows.

These personal meetings will also allow your team to understand current industry trends in order to effectively position your products. You have to match up what you have to offer with what the world is willing to consider buying from you, at a moment in time.

You also want to participate in the flow of industry gossip which is about more than just people. If you can influence the trends in investment thinking towards your best products, you can contribute to your own success.

Lastly, simple and regular reporting of key drivers such as the number and quality of contacts, and the next steps for prospective clients who have already been contacted, keeps everyone involved in your firm's sales efforts in alignment.

To a firm struggling with poor sales, it sometimes feels like there are no answers. Turning around your sales force and growing your sales is within your grasp.

Other profitability tactics

There is always a lot of internal debate about the appropriate level of fees. From your firm’s perspective, there is a critical intersection between a fee so high that prospects are discouraged from hiring you, or clients are looking for excuses to fire you, and yet a fee high enough that you extract as close as possible to the maximum that someone is willing to pay you for your services.

Hedge funds have been among the most aggressive by specializing and innovating products for which they can charge higher fees and earn higher profits, although there has been some evidence of increasing client resistance lately.

But there are still opportunities for high fees in return for demonstrating value added propositions. For example, a long-only management firm may decide to expand into offering alternative investments.

Another approach is to focus on working for clients who can better afford your services. You may choose to target your products, and your sales efforts, towards prospects who will contribute most to your economic value. One way to do this is to analyze who currently contributes the most to your firm’s profit and why, and look for more clients that resemble these high value targets.

Another way to enhance profitability is by lowering your delivery cost to clients. There are ways to enhance relationship management efficiency by segmenting clients based on profit contribution and offering different service levels. You can also encourage the use of pooled investment vehicles, instead of more expensive separate accounts.

Decreasing fixed operating costs offers less opportunity for profitability enhancement but shouldn't be ignored entirely. The timing of billing and collections, optimizing your space and usage of equipment and utilization are all examples of opportunities for cost savings.

To the extent possible, costs need to vary directly with the volume of business. Declines in markets, product outflows and closures can be absorbed if the cost base is not fixed but variable instead.

Technology and operations often represent a significant part of non-compensation costs. These areas should be as complicated as they need to be, and no more. Something between good enough, and state-of-the-art is the range that you're looking for. But every step that positions you above good enough has to be economically justified. This argues for simplification of the technology and operations of your firm.

Just because another piece of software or hardware can be tacked on, and provide superior benefits on a standalone basis, doesn't mean that it won't diminish overall economic value for your firm. The cost of training, support, maintenance and also increased operating risk for standalone software and hardware, may detract from your firm’s value.

Outsourcing

Outsourcing analyses, particularly when led by the internal person responsible for the function, rarely look like they will lead to added value. Net of transitions costs, they often appear to offer only a modest pickup in profit in the short-term.

But outsourcing offers additional benefit that is rarely explored in any analysis. Top leadership, for example, is often distracted by businesses that should be outsourced – typically low margin activities that are either commodity businesses, or add little value to internal users or even clients.

Sometimes the activities that could be outsourced are relatively capital intensive. For example, some activities need equipment maintenance or upgrades that are frequent or costly, and yet are required to remain in business. If the activity doesn't directly contribute significantly to investment performance, or the client experience, then it should be a candidate for outsourcing. Focus your resources, including and especially top leadership time on the highest opportunity set available to you at all times.

Responses to a crisis

My prescriptions to improve profits may not be enough for your firm. Your firm may have a more urgent need spurred by a crisis.

I think that first on the agenda should be a focus on employee morale. Without your employees having their emotions acknowledged, any further actions are going to be extraordinarily difficult. Supporting your staff helps them, in turn, to hold the customers' hands, and assure them that everything will be okay.

One approach that can be used to inspire your own staff is to identify, and do in-depth research, on the key competitors who are gaining market share. Gather as much research as possible from a variety of sources, and create a clear comparison of what you represent versus the competition. Identify key advantages that your company holds over the competition, and create both an internal and an external campaign for communication of those key advantages.

Your firm may not be the only one affected by a crisis. If the crisis is wide-spread, keep in mind that there are winners in every environment. There will be some firms that will emerge from the troubled environment with a platform for growth for the future. Look for emerging opportunities - changes in regulation, industry structure, or customer needs that perhaps you can invest in, in a small way, in order to prepare for the future.

Every day you should assess the risks of various alternative actions. Daily and weekly intense focus on the issues at hand is extremely important.

Turning around a firm’s reputation

Rebuilding your firm’s reputation can suddenly become your first priority. If your firm is acquired or merges with another firm, this can raise concerns about possible employee departures, and future investment performance. If you have a parent firm, and if it is struggling financially, this can also raise eyebrows. Regulatory issues or lawsuits may draw negative attention as well.

One way to help rebuild your external reputation is to leverage the fact that suppliers and providers to your firm are continuing to do business with your firm, and that they remain comfortable with the stability of your organization. If true, this fact should be communicated to clients, prospects and other intermediaries to give them confidence.

If related companies, such as sister firms or a holding company, show their commitment to your firm, this can also help to rebuild your reputation by demonstrating your organization’s overall resilience.

Remaining clients can also be a great resource for restoring more positive word-of-mouth, and so your efforts to serve these customers must be stellar.

Institutional investment consultants, particularly the largest ones, will not be your friend. At the best of times, they are slow in adopting new firms due to the large number of available money managers, compared to the resources available to consultants. By one estimate, there are 20,000 institutional quality investment firms from which to select, and even the largest consulting firms are familiar with less than one half of these firms. They may not have the time to spend on understanding the nuances or any improvements, in your firm’s situation.

To rebuild your relationship with consultants, you have to act as if you are a startup again. Target small to midsize consulting firms to restart the momentum. Be alert however, that investment preferences in the market may have shifted, and the lack of interest in your capability may have nothing to do at all with the hit on your reputation.

It is also likely that you will need to replace at least some of your sales staff. Their credibility will have been damaged by the negative impact on the firm’s reputation, and they will have a hard time re-gaining trust with clients and prospects.

You will find that there are ex-clients who have memories like elephants, and while they may be cordial, gatekeepers, directors or trustees may be reluctant to rehire your firm. While this is an unpleasant thought, not to worry, there are many potential clients out there.

You need to admit mistakes and drive on. You should also recognize and reflect in your communications what is going right for your firm, but without denying or covering up the mistakes of the past.

Clearly, you'll probably need to upgrade your resources whether it be people, process, or otherwise. You need to protect your best people, convince them of your vision of the

future and communicate aggressively and unceasingly.

My belief in turnaround situations is that you need to take direct action. There's no time to waste. I believe that you need to isolate the negative effects and address them directly.

Turning around a firm from a challenge to its reputation can be a thrilling time in a leader’s career. Many leaders can ride the wave when conditions are good, but only a few in the industry have the courage and skill to help an organization back to its feet in more turbulent conditions.

Twelve suggestions for profit improvement in 2012

Staff

1. Only hire staff who will enhance your best performers.

2. Changing a culture usually means replacing people. Why not start now?

Investment

3. Make your investment process more robust through continuous improvement.

4. Clients expect you to manage portfolio risk today much better than in 2008.

Marketing

5. What attracted your clients to your firm? Find prospects who share these characteristics.

6. Retain salespeople who currently exhibit the attitude and behaviors required to be successful.

Planning

7. In a private company, start building the capabilities today to remain successful after your firm's current owners retire. Ensure that the firm has transferable economic value to the next generation, or to another buyer.

8. Reallocate resources to the best future opportunities that are unique to your firm, don't just cut costs. Consider investing some of your available resources in ideas that run counter to current industry trends and forecasts.

Legal

9. Be sensitive to any indication that your clients are not completely certain that you act in their best interest.

10. Actively anticipate future regulatory compliance requirements.

Execution

11. Key people in your firm who are responsible for leading the execution of plans need to be included in the planning phase as well.

12. As a general rule, most asset management businesses should keep fixed costs low, and variable costs high in their business model.

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