

Asset Management

The day after tomorrow

Continuing the PricewaterhouseCoopers perspective series on the global financial crisis

The day after tomorrow for asset management

Business models under stress

1 Market volatility – new fee models

2 Regulation – new fee models

3 Sustainable cost management

Investors: how will they react in the post-crisis environment?

Investors will feel the need for more information

- Institutional investors will increase their due diligence efforts and asset managers will need to better articulate risk and reward to investors
- Investors will also want to see more evidence of enhanced management of risk, in its broadest sense
- The ability to explain how risk is managed and controlled is now as important as information about specific risk measures

Investors might seek to rebalance their portfolio

- Allocations to equity investments are likely to increase as investors seek to rebalance their portfolios after a period of declining values in their equity allocations
- However, the investment strategies of alternative products will be examined given relatively poor performance during the crisis
- Products that contain capital guarantees and other kinds of embedded “insurance” to remain popular

- All firms will need to bear in mind that less can be more
- There will be particular attention paid to counterparty and liquidity risk

- Many alternative products were found to be correlated to other asset classes – particularly equities – bringing into question the rationale for investing in some of them
- Products that contain capital guarantees and other kinds of embedded “insurance” will remain popular

Fiscal pressure to change shape of industry

Increasing budget deficits	<ul style="list-style-type: none">• Western governments are running budget deficits and debt to GDP ratios which are at historic levels.
Increasing taxes on asset managers	<ul style="list-style-type: none">• Asset managers, in common with the rest of the financial services sector, will be expected to be significant contributors to these efforts and can expect a more rigorous enforcement of tax rules, swifter closure of loopholes and a generally more adversarial environment.
Focus on privacy laws and tax evasion	<ul style="list-style-type: none">• Few asset managers will be unaffected by the renewed focus on privacy laws and tax evasion, mainly relating to individuals; either because of increased compliance requirements or changes in client preferences as a result of these developments.
Tax net closing in on wealthy investors and advisers	<ul style="list-style-type: none">• The OECD recently launched a paper on high-net-worth individuals with a view to bringing them back within the sphere of onshore taxation. Advisors will need to follow the progress of this process and keep abreast of current political and regulatory thinking.

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G8, G20: A new spirit of co-operation (with consequences for asset managers)

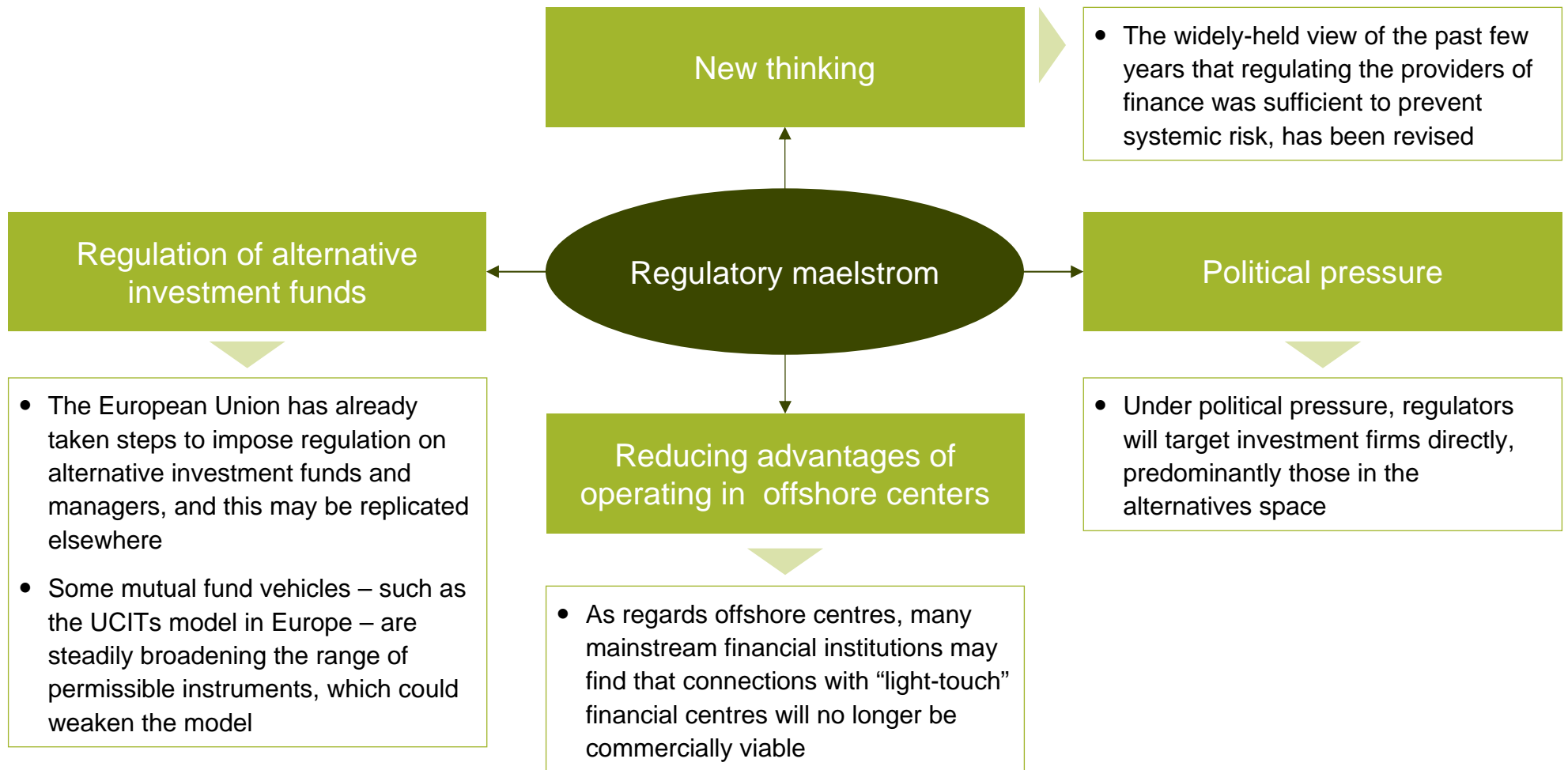
The group wishes to promote global trade and investment, while resisting protectionism.

There will be a particular focus on the activities of non-co-operative and light-touch domiciles and there is now the possibility of co-ordinated sanctions.

A key message from the G20 is that any activity that is viewed as systemically important to the financial system will need regulation and oversight. In this sense, the G20 is signalling that significant parts of the asset management industry will be regulated, where previously they have not been.

It may be that offshore unregulated business will reduce substantially, at least for a period, until the stance of politicians and regulators is clear or until jurisdictions raise levels of transparency to meet new requirements.

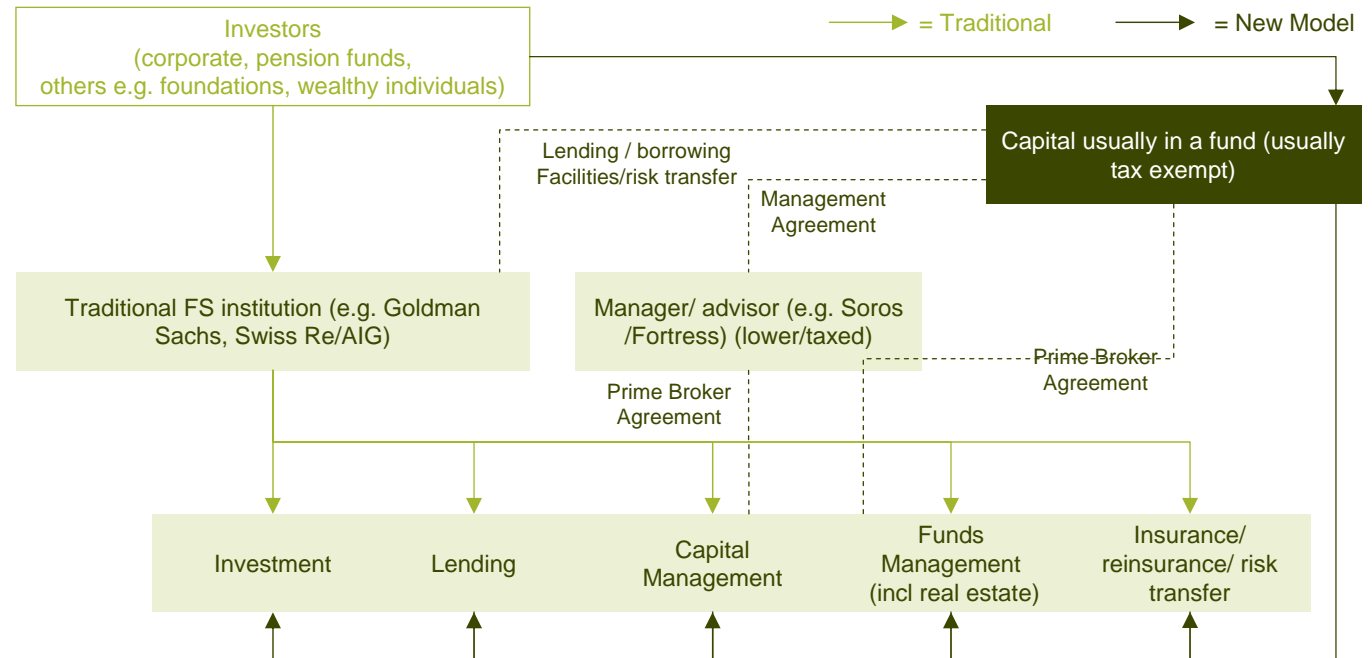
How will the regulatory maelstrom impact asset managers?



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Is the “new model” in financial services under pressure?

- Over the last few years, capital has no longer flowed solely to the largest, full-service institutions, which both deploy and manage the assets.
- A model evolved whereby the deployment of assets and the management of them were often carried out by separate entities.
- But there is a possibility that asset management now returns to the days where funds were simply awarded mandates to run and had no deeper involvement in the capital markets. It is also worth considering how badly-bruised investors react to these “new model” groups and their offerings.
- There could be a flight to quality – to groups within those FS institutions that have maintained balance sheet strength.



- But the risks to the model are not all weighted to the downside: alternative funds should still be more nimble, flexible and attractive to talent than mainstream financial services competitors. Although the business environment will be more challenging, they should still derive greater opportunities

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Deleveraging in the banking system

Banks have expanded their balance sheets rapidly in recent years without a simultaneous rise in core capital.

They are now being compelled to redress this imbalance

Thus are likely to be ruthless in enforcing penalties on covenant breaches by companies they lend to.

Impact on Asset Managers:

- Asset Managers have a high natural gearing to markets which hits their earnings disproportionately in a downturn.
- This leaves them exposed to potential breaches of covenants and other cashflow and balance sheet difficulties.
- The biggest impact of deleveraging is on those hedge funds and private equity which depend on debt.
- Without access to affordable leverage, their business models may struggle.

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Compensation: What's good for banking...

If

Management and performance fees continue to decline

Asset managers are owned by banking parents that have accepted state financial assistance

Then

There will be an imperative to implement a long-term review of compensation

The influence of government is likely to make itself felt even at the asset management level

What to expect:

- Compensation may be regulated or otherwise monitored
- Performance fees on unrealised profits will be challenged by investors and consultants
- There could be market pressure to move to a fee model that rewards only realised profits, private equity style
- The size of management fee on large private equity commitments may be challenged as fewer deals are transacted and performance moderates

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The re-awakening of Asia

The West is starting to consume less and save more, which implies slower future economic growth

Meanwhile Asia, less affected by the global crisis and less encumbered by legacy debts, should grow at a faster rate in the foreseeable future.

This hints at the extraordinary opportunities that are available to investors – a one-off re-rating of Asian stocks in the short-term could be complemented by long-term growth at a higher trend rate than in the West.

China will have a bigger economy than the US well before 2040 and India will be as big as Germany, Britain and France combined.

Increased savings rates, together with the need to restore assets in retirement accounts due to the significant market losses, in Western economies will provide opportunities for asset managers to exploit this growth.

The nine themes we see in the new world of asset management

Themes		Imperatives
Business models are under stress	Firms seeking to maintain profitability or contain losses	<ul style="list-style-type: none"> Evaluate all avenues for sustainable cost management, including disposal of non-core businesses, targeting key variable costs such as human resources Seek new fee models that could smooth returns and help to ensure that cost cuts are kept to a minimum in times of market distress
How will investors react in the post-crisis environment?	Focus on risk adjusted returns and value for money	<ul style="list-style-type: none"> Work out ways to improve transparency and to articulate risk adjusted performance and complex strategies to investors Re-evaluate product mix in the light of changing investor preferences Distributors to rethink their value proposition and to rebuild trust
Fiscal pressure will change the shape of the industry	Budget deficits and widening tax net	<ul style="list-style-type: none"> Work out intelligent responses to government pressure Establish a robust framework to deal with tax issues such as transfer pricing Consider procedures in place to follow and implement measures to encourage transparency
Co-operation between the G8 and G20 nations	Possibility of co-ordinated sanctions	<ul style="list-style-type: none"> Adapt to measures that might impact fundamental financial viability
How will the regulatory maelstrom impact asset managers?	Need for a complete new compliance infrastructure	<ul style="list-style-type: none"> Understand the potential impact on strategy of legislation on the horizon targeting the investment management industry, particularly alternative investment funds and managers

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The nine themes we see in the new world of asset management

Themes		Imperatives
Is the “new model” in financial services under pressure?	Flight to quality and financial strength	<ul style="list-style-type: none"> Consider increased capital requirements and regulatory restrictions that may impede ability to manage certain assets Assess potential benefits to competitors backed by large FS groups and devise strategy to retain assets
Deleveraging in the banking system will affect asset management	Need for capital and collateral	<ul style="list-style-type: none"> Grasp consequences (including unintended ones) of deleveraging Refresh perspective on sources/uses of all types of financing Investors may in the future only be willing to commit funds to vehicles with solid financial backing and access to ready cash. Are you in a position to acquire weaker competitors or perhaps sell a non-core asset?
Compensation in asset management is likely to take its cue from banking	Rewarding the key contributors and better aligning compensation with investor interest	<ul style="list-style-type: none"> Ensure that the firm has a strategy for retaining the most valuable people, given that compensation may be regulated creating an incentive for the best analysts and traders to set up independently Relook at management and performance fee arrangements that are likely to be challenged
The re-awakening of Asia	Opportunities from high growth rates	<ul style="list-style-type: none"> Challenge and adapt strategy given new basis of competition Exploit opportunities from increased savings rates

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